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SOVEREIGNTY AND ECONOMIC DEVELOPMENT: THE CASE OF ISRAEL AND PALESTINE*

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The future permanent economic agreement between Israel and Palestine will have to determine, among other things, the trade regime and whether there should be economic borders. The decision will have to satisfy goals of economic development, including a reduction in economic and social gaps between the two countries, and questions of sovereignty. We describe and analyse the evolution of the Palestinian economy before and since the Oslo agreements. Concerning the future agreement, we discuss the tradeoffs between sovereignty and prosperity and argue for the establishment, at first, of economic borders and a regime of less than full integration.

In 1994, following the September 1993 breakthrough in political negotiations between Israel and the Palestinians, an economic agreement between the PLO and Israel was reached in Paris. The Paris Protocol, as the agreement is called, defined the *de jure* regime for an interim period of five years. Its wording expresses the desire to bring prosperity to the Palestinian economy.[1]

The economic arrangements set out in the Protocol reflected Israel's demand that no borders – economic or otherwise – be determined during the interim stage of the negotiations. Thus, the agreement was not necessarily the outcome of an economic analysis of alternative arrangements but rather the upshot of political decisions to put off, perhaps even to avoid, the need to agree on the demarcation of borders. Ironically, since the Paris agreement the Palestinian economy has suffered a severe crisis, resulting from, among other factors, a series of border closures. In January 2001, when this paper was being written, as a result of the violent events that began in September 2000, an even more severe closure of the areas controlled by the Palestinian Authority has been imposed. Thus, since the Oslo process began, the *de facto* regime reflects a move in the direction of imposed economic separation.

We will argue in this paper that the economic crisis which has occurred since Oslo in the West Bank and Gaza is the result *inter alia* of the circumstances generated by the Paris agreement. A clear conflict emerged between the Protocol's basic premises concerning economic borders and the new reality. Nevertheless, this conflict has not brought the sides back to the negotiating table to reconsider the various elements of the agreement. This is interesting in itself, and we shall provide an explanation for the lack of renegotiations.

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[1] The 'Palestinian economy', as the term will be used in this paper, refers to the economies in the West Bank and Gaza, excluding the Israeli settlements which were built in these areas since 1967. This definition was used by the Israeli Central Bureau of Statistics [ICBS] when it produced the National Accounts and Labour Surveys for the Palestinian economy from 1968 to 1994 first under the title 'Administered Territories' and then under the title 'Judea, Samaria and Gaza Area'.

However, according to the agreed schedule of the peace process the time for the permanent arrangements has arrived. Currently, apart from the enormous political problems, a major issue is thus the long-term economic relations between Israel and Palestine.

To understand the nature of the unusual economic ties between Israelis and Palestinians, it is worthwhile to look at their evolution since 1967. In Section 1 we briefly describe those ties and the performance of the Palestinian economy between 1967 and 1994. In Section 2 we discuss the Protocol and economic developments between 1994 and 1999. In Section 3 we explain the structural weaknesses of the Protocol and analyse the factors that should have led the architects of the agreement to anticipate the obstacles to attaining its goals. In Section 4 we present an economic analysis of 'economic sovereignty', emphasising both control over borders and freedom to choose economic policies as elements of sovereignty. In Section 5 we discuss the trade-offs between sovereignty and prosperity. We argue for the establishment of economic borders and a regime characterised by less-than-full integration, and propose that such an arrangement might constitute a better macroeconomic environment than one with complete economic integration. Section 6 concludes the paper.

1. Economic Structure and Performance, 1967–94

It is common ground among those who study the Palestinian economy that the unusual links with Israel were the single most important factor in determining the course of economic development. These links were shaped by economic policies unilaterally imposed by the Israeli government in the Palestinian Occupied Territories to serve Israeli political, military and economic interests as perceived at the time. (See Gazit, 1985; World Bank, 1993; Arnon *et al*, 1997; World Bank and MAS, 1999.)

It took approximately five years after the 1967 war for the economic links between Israel and the Palestinian economy to attain a stable structure.[2] Two closely related elements in these links – labour flows and bilateral trade – led to what can be described as an *imposed, incomplete, economic integration* between Israel and the Palestinian economy. The interdependence of decisions regarding trade and labour was due to the fact that together they determined the welfare of the Palestinians. As is well known, the occupation in 1967 separated the West Bank and Gaza Strip from Jordan and Egypt, respectively. Had the Israeli government decided to continue the separation of these two areas also from Israel, as was the case before 1967, this would have caused a rapid deterioration of economic life and a sharp drop in standards of living. Such a strategy was unacceptable to both the Israeli government and the military.

[2] For a detailed analysis of the process during those years see Arnon and Gotliebb (1995) and Arnon *et al.* (1997).

Thus, free movement of either labour or goods or both had to be allowed across the borders between Israel and the Occupied Territories.[3]

Many Palestinian workers switched from the Palestinian to the Israeli labour market, where they could earn higher wages. In 1968, the ratio between the wages of Palestinian workers in the Israeli labour market and in the 'home' economy was approximately 2:1; by 1972 the ratio had decreased to 1.2:1 and it remained at this level until the outbreak of the Intifada in 1987. By 1972 more than 50,000 Palestinian workers, out of a labour force of close to 200,000, had found jobs in the Israeli economy. Since then, approximately 40% of Gaza's labour force and 30% of the West Bank's labour force have been employed in Israel. The workers' remittances became a significant part of disposable income in the Palestinian economy, amounting to 30% of GDP in the West Bank and even more in the Gaza Strip (see Tables 1 and 2). While this process undoubtedly raised the standard of living in terms of GNP per capita, it was an expression of the heavy dependence of the Palestinians on the Israeli economy.

The trade regime that existed between Israel and the Palestinian economy from 1967 was ostensibly free and the geographical area comprising Israel, the West Bank and Gaza Strip had no internal customs borders. Nevertheless, since there was no Palestinian (economic) authority that could participate in policy-making, all decisions were made by the Israeli authorities according to their perception of the interests of Israel.[4] The imposed (and incomplete) economic integration between the Israeli and Palestinian economies resulted in Palestinian structural trade deficits, and, more specifically, in very low levels of exports (excluding labour services) and high levels of imports. This bilateral trade deficit with Israel was thus another form of dependency.

One might have expected a higher level of exports to Israel and a lower level of imports from Israel under such an (imposed) customs union. This did not occur because of political intervention in the economic process. One such major intervention took the form of direct administrative measures that prevented the development of productive capacity in the Palestinian economy. Palestinian entrepreneurs had to apply for licenses from the Israeli authorities for many of the economic activities they sought to initiate. Israel's policy, at least until the 1990s, was to slow down local economic development. This policy, and the measures taken to implement it, also contributed to transforming important parts of the Palestinian economy into a captive market for Israeli producers.[5] Thus the competition that should have evolved between Israeli and Palestinian producers, had the integration been 'normal', did not materialise. The resulting trade figures are revealing: 60% of the West Bank's exports and more than 90% of its imports were to and from Israel. The trade deficit

[3] See a detailed description of the process in Gazit (1985); General Gazit had been the first coordinator of the Israeli government's activities in the Palestinian economy.

[4] The study of Israel's economic policy regarding the West Bank and the Gaza Strip suffers from a paucity of reliable sources. However, the written evidence of retired high-ranking officials (Gazit, 1985; Beckenstein, 1987) and the report of the Sadan Committee (1991), which recommended changing Israel's policy towards the Gaza Strip economy, support the claims made in our text. See below.

[5] This is one of the outcomes in (Arnon *et al.* (1996), which uses a gravity model.

Table 1

Economic Data on the West Bank 1968–93

	GNP (average annual change, %)	Population (average annual change, %)	Employed in Israel (% of total employment)	Factor Income from Abroad (% of GDP)
1968–72	22.8	2.0	21*	20
1973–79	5.7	1.8	30	32
1980–87	5.0	2.4	32	28
1989–93	9.0	4.3	31	30

*Average 1970–2
Source – ICBS

Table 2

Economic Data on the Gaza Strip 1968–93

	GNP (average annual change, %)	Population (average annual change, %)	Employed in Israel (% of total employment)	Factor Income from Abroad (% of GDP)
1968–72	21.3	2.1	17*	9
1973–79	8.4	2.1	37	28
1980–87	5.4	3.0	45	57
1989–93	7.3	5.2	34	46

*Average 1970–2
Source – ICBS

amounted to an average of 45% of GDP in the West Bank.[6] This high trade deficit was financed mostly by workers' remittances, but also by capital inflows and unilateral transfers.

After several years of the Intifada it became clear to observers, including several Israeli officials, that the nature of the links between the Israeli and Palestinian economies needed urgent re-evaluation. Defence Minister Moshe Arens appointed a committee to examine 'means to develop the economy of the Gaza Strip'. The Sadan Committee[7] reviewed the alternatives and emphasised the need to retain a 'common market' approach. However, it also stated clearly that the common market framework had so far been only partly implemented and that the time had come to modify the links between the Gaza Strip economy and Israel, so as to change the former's extreme dependence on work in Israel into an emphasis on the export of goods. This re-evaluation of Israeli economic policy in the Palestinian territories led the committee to articulate one of the most revealing statements about Israel's policy towards the Palestinian economy:

[6] See Arnon *et al.* (1997) ch. 4. The figures for the Gaza Strip indicate a very similar pattern concerning exports and imports, but the trade deficit was even higher, at 68% of GDP.

[7] The Sadan Committee included, among other experts, General Danny Rothshild (coordinator of government activity in the territories at the time) and Amos Rubin (economic advisor to the Prime Minister).

> 'All the governments of Israel recognised their obligation to care for the welfare of the inhabitants of the Gaza Strip. However, in promoting the economic interests of the population, the focus was on wage earners and on the short run. Regarding wage earners, priority was given to increasing their income by employing them in the [Israeli] economy. Only rarely did the policy opt for the development of an infrastructure and the encouragement of 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 *the promotion of local entrepreneurship and the business sector* in the Gaza Strip. Moreover, the authorities discouraged such initiatives whenever they threatened to compete in the Israeli market with existing Israeli firms.' [(Sadan (1991), p. 11) Authors' translation; italics in the original Hebrew version].

This is a rare official acknowledgment that the policy implemented since 1967, both in the Gaza Strip and in the West Bank, was not in the best interests of the Palestinian economy. Not only did the authorities fail to encourage the Palestinian economy, they created obstacles aimed at protecting Israeli interests. The Sadan Committee recommended a policy change that would '... allow and encourage initiatives in the Gaza Strip *including those that compete with Israeli products*'. However, the recommendations were never implemented.

When in 1993 the Israeli and Palestinian delegations met in Paris to formulate the Economic Protocol of the Oslo Agreement, the Israeli side came well prepared. During the year that preceded Oslo, with the intensification of the negotiations, a new committee, chaired by Professor H. Ben-Shahar, was nominated to reassess the economic situation and recommend a new economic policy for the interim period.[8] The committee's recommendations guided the Israeli side in the negotiations that led to the formulation of the Paris Protocol. On the other hand, to the best of our knowledge, no parallel work of that kind was available on the Palestinian side.

2. The Interim Period, 1994–9

2.1. *The Paris Protocol*

The Protocol on Economic Relations between the Government of the State of Israel and the PLO, Representing the Palestinian People was hammered out in Paris in the interval between the Declaration of Principles of September 1993 and the agreement on its implementation in the Gaza Strip and Jericho in May 1994. The Protocol's title itself deserves close attention; an effort was obviously made to present it as having been drawn up between two equal partners, in spite of the fact that one party was a state and the other an organisation. The preamble to the Protocol, quoted in the introduction to this Feature, stresses the importance of the economic dimension and for the first time accepts the fact

[8] See Ben-Shahar (1993).

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

The issue of an appropriate economic regime became a bone of contention in the Paris talks. The negotiators knew that economic issues were subordinate to political ones. For months the two delegations, headed, respectively, by PLO senior executive, A. Qurie (Abu-Ala), and Israeli Finance Minister, A. Shohat, exchanged drafts, while waiting for the politicians to conclude their deliberations. Some Palestinians preferred a free trade agreement (FTA), which would have necessitated the demarcation of borders between their economy and Israel. The Israelis, on the other hand, had firm instructions from Prime Minister Rabin – based on the recommendation of the preparatory economic committee headed by Professor Ben-Shahar – to reject the notion of any borders being drawn between the two economies. The reasons for these different positions were both political and economic: the Palestinians sought to acquire as many attributes of sovereignty as possible, whereas the Israelis wanted to defer as many decisions as possible to the negotiations over the Palestinian territories' final status. The Palestinians aspired to set their own priorities, without Israeli interference, including the formulation of a new Palestinian trade policy, which would reflect their own best interests; the Israelis tried to convince the Palestinians that a more protectionist policy would reduce the Palestinians' chances of building a prosperous economy, and proposed to continue the existing *de facto* (partial) customs union, which, of course, did not require the creation of trade borders between the two economies.

The final stage of the negotiations was tense. No official records have been published, but it seems that the Israelis, in a reversal of their previous stand, now proposed the creation of an FTA rather than a customs union. This new offer, which was more in line with the Palestinian proposals, was actually a bargaining chip because it included the stipulation that under an FTA the flow of labour would not be as free as under a customs union. The Palestinians were facing a dilemma – the new proposal emphasised the link between free trade and employment of Palestinian workers in Israel: the greater the Palestinian sovereignty in determining their trade policies, the lesser their potential employment in the Israeli labour market. It also brought to the forefront the possible contradiction between political sovereignty and economic prosperity on which we will elaborate below. The Palestinians opted for the customs union package.[9] Once the political leaders reached an agreement on the implementation of the Declaration of Principles in the Gaza Strip and Jericho, the discussions on economic matters were concluded.

The negotiators on both sides were fully aware that Israel's trade policy might be amended from time to time: 'Israel may from time to time introduce changes [in its trade policy] ... provided that changes in standard requirements will not constitute a non-tariff-barrier ...' This reservation was probably

[9] Although there is no explicit reference to a 'customs union' in the Protocol, its third article, 'Import Taxes and Import Policy,' translates this economic concept, with some modifications, into legal terms.

introduced because of the non-tariff barriers (NTBs) used by Israel in the past to protect domestic producers. The only additional restriction on Israel was its obligation to give the Palestinian Authority prior notice of any changes (Article III, Paragraph 10). Thus, the customs union continued to reflect Israeli policy and was not a bilaterally coordinated trade policy as is the case with many other customs unions in the world. (See Kanafani in this volume for a fuller discussion of the trade issue.)

The two sides agreed to create a Palestinian Monetary Authority to solve the problems of financial intermediation. The PMA was to have all the powers vested in a central bank *vis-à-vis* the banking system, but not the power to issue an independent Palestinian currency, which was postponed for the permanent stage of the negotiations due to its symbolic expression of independence. There were now two legal tenders in the Palestinian economy: the Jordanian Dinar and the Israeli Shekel.

The important issue of labour flows is addressed in Article VII. Its first controversial paragraph states:

> 'Both sides will attempt to maintain the normality of movement of labour between them, subject to each side's right to determine from time to time the extent and conditions of the labour movement into its area.'

Interestingly enough, all the other paragraphs in this article focus exclusively on the transfer to the Palestinian authority of payments made by permit-bearing Palestinian workers to the Israeli National Insurance and medical insurance systems.[10]

To summarise, the vision that the Protocol represented was to create favourable conditions for the development of the Palestinian economy. The investments of the public and private sectors within the Palestinian economy and the continuation of labour movement to Israel should have generated full employment. Financial intermediation would be provided by the emerging banking system under the guidance of the PMA. The public sector should have been strengthened and an efficient tax system created. Funds originating in donor countries should have helped in financing the necessary infrastructure. Free trade with Israel was expected to enhance growth.

This strategy, however, failed to bear the desired fruit. As we shall see below, the expectation that Palestinian employment in Israel would reach pre-1993 stable levels, and that trade would be relatively free did not materialise. Although the Protocol does not provide explicit figures concerning the flow of labour from the Palestinian economy to Israel, the implicit intention on the Israeli side was to have 70–100 thousand Palestinians working in Israel.[11] Moreover, as is explicitly stated in the Protocol, interruptions in the free flow of labour were to be transitory and brief, and imposed only under exceptional

[10] This was an important issue for the Palestinians, who felt that they were paying dues without enjoying their benefits. See also Hamed and Shaban (1993) and Shaban (1993).

[11] The Ben-Shahar Report (1993, pp. 26–39) cites a figure of 60,000 annually. In Ben-Shahar (1995) the estimated number of Palestinians expected to continue employment in Israel in the long run is 100,000–120,000 annually.

circumstances. While the parties presupposed (almost) free movement of labour and trade, political and military reality dictated a different process.

2.2. *Economic Performance, 1994–9*

The economic Protocol became the *de jure* regime in May 1994 in those parts of Gaza and the Jericho area that were handed over to the Palestinian Authority. Towards the end of 1995 the Protocol's jurisdiction was extended to other populated areas in the West Bank as they came under the control of the Palestinian Authority (Areas A and B in the Oslo II agreement).

The data for 1994–6 suggest that standards of living in the Palestinian economy declined steeply,[12] mainly as a result of the sharp decline in employment of Palestinians working in Israel. Whereas in the 1970s and 1980s the proportion of Palestinian workers employed in the Israeli economy exceeded 30% in the West Bank and even more in Gaza, after 1993 the average proportion over both areas decreased steadily to only 14% in 1996. Consequently, the remittances of Palestinians employed in Israel dropped from about one-third to less than 10% of GDP. This unanticipated structural change in the links between the Palestinian and Israeli economies led to a severe economic crisis: effective demand in the Palestinian economy declined and unemployment increased to an average of 24% in 1996. After 1997 the number of Palestinian labourers working in Israel increased, but because the level was more volatile than in the past it also contributed to the macroeconomic uncertainties facing the Palestinian economy (see Tables 3, 4 and 5).

The main cause of this structural change in the composition of employment in the West Bank and Gaza was the new Israeli policy of regulating the flow of labour from the Palestinian areas. Whereas in the 1970s and 1980s there were only minor barriers, 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, partly as a result of a series of terrorist attacks, Israel introduced a 'closure policy': roadblocks were set up on major transport arteries at very short notice, denying entry into Israel from the Palestinian areas.[13] Closures were declared for different lengths of time and were imposed on various categories of workers, according to sex, age, marital status etc. As long as a closure was in effect, all existing permits were suspended. Israeli entrepreneurs, especially in those sectors most likely to be severely disrupted by the absence of Palestinian workers (e.g. construction and agriculture), opposed the closures. In part as a result of the pressure of these employers, most closures were lifted after a few days.

The frequent closures led to a decline in the number of Palestinians working

[12] Acording to IMF and World Bank estimates, measures for standard of living such as GNP per capita and consumption per capita decreased by more than 15% in real terms in 1995–6. See Barnett *et al.* [IMF Report] (1998, Table 1); World Bank and MAS (1999). For an early criticism of the Protocol see El-Musa and El-Jafari (1995).

[13] For a detailed analysis of the closures see World Bank and MAS (1999).

Table 3

Economic Data on the West Bank & the Gaza Strip 1994–9
Main Indicators on Growth and Employment

	Population (% annual change)	Real GNI Per Capita (% annual change)	Employed in Israel (% of total employment)	Unemployment (%)
1994	6	−4.9	17.8	15.1
1995	6	−9.6	16.0	18.2
1996	5	−9.0	14.1	23.8
1997	4	3.5	17.1	20.3
1998	4	7.7	21.7	14.4
1999	4	3.5	22.8	11.8

Sources – ICBS, PCBS, IMF, World Bank and Other International Agencies.
See Secretariat of the Ad Hoc Liaison Committee (2000), 'West Bank and Gaza: Economic Policy Framework Report', Prepared by the Palestinian Authority in collaboration with the staff of the IMF.

Table 4

Economic Data on the West Bank & the Gaza Strip 1993–9
Main Indicators on the Balance of Payments

(million $, current prices)

	Exports of goods and non-factor services	Imports of goods and non-factor services	Factor income from abroad (remittances)	Revenue clearances
1993	245	1,333	586	n.a.
1994	456	1,433	575	25
1995	611	2,089	535	266
1996	653	2,509	469	420
1997	661	2,735	606	496
1998	730	3,169	828	542
1999	740	3,398	914	626

Source – ICBS, PCBS, IMF, World Bank and Other International Agencies.
Note: The above data include only partial balance of payments information.

in Israel and opened the market to foreign labourers (notably from Romania and Thailand). Closures could now continue indefinitely, without incurring protests from Israeli employers. Note, however, that the substitution between Palestinian and other foreign workers was far from perfect. For example, Israeli employers in construction have expressed their preference for experienced Palestinian workers rather than the East European alternative.

Interestingly, since 1994 significant differences have emerged between the West Bank and Gaza concerning labour flows to Israel. Whereas before 1994 the proportion of Palestinians employed in Israel was higher for Gaza than for the West Bank (e.g. 45% for Gaza in the 1980s compared with 32% for the West Bank), since 1994 the proportion has been higher for the West Bank than for Gaza (see Table 5). Second, the figures for the Gaza Area have been more volatile than those for the West Bank. These differences reflect the

Table 5
Employment in Israel

(Percentage of Total Employment and in Thousands)

Dates of Labour Surveys	The West Bank (%)	The West Bank ('000)	The Gaza Strip (%)	The Gaza Strip ('000)
Sep–Oct 1995	20.7	57.7	3.6	4.0
Apr–May 1996	11.4	29.7	3.4	3.8
Jul–Oct 1996	18.3	52.2	8.9	10.7
Oct 1996–Jan 1997	19.4	56.8	11.8	14.5
Feb–Mar 1997	20.5	58.8	13.8	17.6
Apr–Jun 1997	18.7	59.2	11.3	14.7
Jul–Sep 1997	18.7	58.2	7.1	8.3
Q1 1998	22.0	71.8	16.0	22.7
Q2 1998	24.6	87.3	16.7	24.6
Q3 1998	24.7	86.6	15.5	22.1
Q4 1998	24.4	93.5	14.7	23.0
Q1 1999	26.7	96.0	15.9	25.4
Q2 1999	25.1	95.3	15.5	26.4
Q3 1999	25.6	97.6	14.9	26.5
Q4 1999	25.3	99.1	16.5	30.7
Q1 2000	25.3	100.8	14.1	24.9
Q2 2000	25.2	105.2	15.3	28.8

Source: PCBS, *Labour Force Surveys* and authors' calculations.

different forms of the borders between the two areas and Israel and the non-uniformity in enforcing closures. Whereas Gaza has a clear and enforceable border between itself and Israel, there is no such border between the West Bank and Israel.

The closure policy also had 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.

Two mitigating economic factors operated to ease the deteriorating situation in the Palestinian economy: the growing public sector and sizeable international aid. The establishment of a Palestinian public sector – and, more specifically, that of the Palestinian National Authority – generated an increase in public expenditure which stimulated the economy. However, there has been a tendency to adopt restrictive trade arrangements, which resulted in excessive monopolisation; and some elements have succumbed to the temptation to exploit public capacities for personal benefit. On the whole, though, many observers, including the World Bank, believe that the performance of the Palestinian Authority was not worse than the relevant comparable international standards (see World Bank and MAS, 1999).

The financing of new public expenditure tells an important story. Revenues came partly from local tax and non-tax collections, partly from 'revenue clearances' with Israel as agreed in the Protocol, and partly from 'foreign financing' (i.e., international aid). Since 1996 around 60% of non-foreign revenues originated in 'revenue clearances' with Israel, and less than 40% from tax and non-tax revenues.

The willingness of the international community to support the transition of the Palestinian economy was impressive. Pledges for the period 1993–8 totalled circa \$3.7 billion, of which \$2.3 billion were promised in late 1993. Actual disbursements in 1994–8, as reported by international agencies, came to about \$2.5 billion, or 60% of one year's GNP. The hope in October 1993, immediately after Oslo I, was that the Palestinian economy would undergo a smooth process of growth. However, the target of sustainable growth was not reached. Instead, important parts of foreign aid were channelled to a series of emergency, ad-hoc programmes, most of them carried out by the public sector. In summary, only part of the Protocol was implemented.

3. Structural Weaknesses of the Protocol

The story told so far is disappointing. In spite of the two parties' declarations concerning the importance of economic development to the peace process, the results have been less than satisfactory. This failure invites different interpretations. One widespread explanation, offered by several Israelis, blames the violent terrorist attacks for the collapse of the '1993 vision'. According to this line of argument, the architects of the Paris Protocol erroneously assumed that the transition from war to peace would proceed in a non-violent fashion. It did not. Thus, the Palestinian economy's poor performance must be attributed to the violent opposition to the peace process, which left Israel with no option but to close the borders. Many Palestinians, as well as other observers, seem to favour another line of thought. They argue that the Protocol should have anticipated that the transition would not be smooth, and incorporated steps to enable the economy to function also in periods of tension. Moreover, they regard the closures not just as a security, but also as a political measure, used as collective punishment following terrorist attacks. According to this view, economic relations cannot be disentangled from the political process, and the closures are a means of subjugation.

Both explanations contain some elements of truth. But beyond these simplistic explanations lies another, more subtle, reason having to do with the mechanism *design* of the Protocol, which is a direct result of the uneven balance of power between the two parties and the transitional nature of the agreements. Israel is a well-established state with a thriving economy and a large modern army, while the Palestinian Authority has limited autonomy and is making its first steps towards national sovereignty. As a result, the power sharing of the Protocol itself gave significantly more power to Israel than to the PA. In contrast, in many agreements on extensive economic cooperation, such as the European Union and other free trade organisations, the mechanisms of regulation are designed to give the smaller countries more weight than their relative economic power, and even the power of veto in some cases.

Our purpose in this section is to use the conceptualisation of incomplete contracts in order to explain how the design of the Protocol in itself contributed to the undesirable outcome.[14] Complete contracts are those in which all contingencies are covered. The economic agreement between Israel and the PLO, like all complex agreements on economic cooperation between two political entities, is inherently *incomplete:* it is impossible to specify all potential contingencies (this term, borrowed from contract theory, should not be confused with the fact that the Oslo agreement and the Protocol were transitory arrangements and thus unfinished). It is interesting to note that the North American Free Trade Area (NAFTA) agreement, which attempted to meet many contingencies and extended to one thousand pages in contrast with the Protocol's twenty, is also incomplete. Parties to agreements are usually aware that they are necessarily incomplete and that subsequent re-negotiation of certain issues is unavoidable. Incomplete economic contracts are those that lack an efficient enforcement mechanism, e.g. courts are unable to provide remedies. Thus, in order to achieve a satisfactory outcome in a process of re-negotiation, power must be reasonably shared between the two parties.[15]

The Protocol itself recognised the possible need for re-negotiation and established a Joint Economic Committee, whose task is 'to follow up the implementation of this Protocol and to decide on problems related to it that may arise from time to time'. (Article II). Consider now a circumstance not foreseen in the Protocol: e.g. a security risk due to suicide terrorist attacks. The Protocol does not specify the reaction of the parties to such an event, and only states that: 'Both sides will attempt to maintain the normality of movement of labour between them, subject to each side's right to determine from time to time the extent and conditions of the labour movement into its area.' (Article VII).

A possible interpretation of the above is that Israel is entitled to temporarily halt labour movements (say, in cases of terrorist attacks), but not to disrupt the 'normality' of labour movement for extended periods. A re-negotiation of the conditions regulating labour movements under the new political circumstances was therefore needed. However, due to the asymmetry of power and control, it did not materialise. Although the frequent closures contradicted the basic assumptions held at the time of negotiations, the issue of border closures was not seriously addressed by the Joint Economic Committee. An additional important example of the asymmetry is an event that took place in the summer of 1997. Following a wave of terrorist attacks, Israel decided to delay the transfer of tax revenues to the Palestinian Authority. This measure was *prima facie* a violation of the Paris agreement, representing the imperfection of the bilateral contract, whereby one side could violate the agreement without bearing significant consequences. The events that started in Septem-

[14] This issue has been analysed in Arnon *et al.* (1998).

[15] Hart (1995) describes such a contract between himself and a building contractor. Instead of trying to pre-specify all the obligations of both parties under all possible contingencies (a tedious, expensive, and fundamentally futile proposition), they agreed on a payments scheme commensurate with the work's progress, which left each party with sufficient latitude and control, thus making re-negotiation efficient.

ber 2000, where the economic cost for the Palestinian economy has been dramatically heavier than for the Israeli economy, offer an extreme example of the asymmetry.

An analysis of the undesirable effects of the excessive economic power given to Israel in the Protocol, and an attempt to generate a more balanced structure, will contribute to healthier future economic relations as well as to an improved Palestinian economic performance. If the Protocol and the resulting economic environment are modified wisely, economic cooperation could develop to the benefit of both sides. Several such modifications entail the creation of an economic border. If there were no political constraints, the 'first best' option, derived from standard economic theory, would be to have no economic borders. However, since 'security borders' do exist, and sudden disruptions in the normal flow of goods and labour cannot be ruled out, this 'first best' option is simply unfeasible. The creation of economic borders with well structured crossing points represents a 'second best' alternative, which is preferable to the present situation of inefficient *de facto* economic borders. The idea of creating a 'closure safe' industrial zone on the border between the Gaza Area and Israel (the Karni complex) is a step in the right direction. But we can still ask why there have been no serious attempts since 1995 to turn the whole Gaza and West Bank areas into 'closure safe' regions. After all, most objective observers realised shortly after 1994 that the illusion of no-borders, and hence no secure crossing points, had resulted in an economic crisis. The answer to this question lies, in our view, in the imbalance in power sharing. The Israeli side was reluctant to reopen the agreements both because they believed that the agreements could still become workable but also since the agreements served political purposes. Economic pressure has been used to influence the bargaining between the two sides.

Another example that illustrates the advantages of a 'second best' solution is the case of the Gaza seaport. It is well known that there are scale economies in using a seaport. Consequently, many economic experts objected to the construction of a deep-sea port in Gaza, maintaining that the Palestinians could use the nearby Israeli port of Ashdod. However, due to the complications caused by the closures, Palestinian access to the Ashdod port was frequently disrupted. Again, the 'second best' solution of creating a Gaza seaport would have benefited both sides. Israel would have improved its security, while Palestinians' international transactions would not have been harmed. However, under the current conditions, amendments of the Paris Protocol were unthinkable. Israelis did not want to change the status quo in terms of borders or the balance of power in economic relations because they seemed to believe that they served useful political purposes.

4. Economic Sovereignty: Borders and Policies

One of the flaws in the Paris Protocol is in its failure to address the problem of sovereignty on the Palestinian side adequately. It is true that the agreement was perceived to be a temporary solution. Nevertheless, it created a model for the future permanent settlement and thus ought to have taken into account the Palestinians' aspirations for sovereignty. The establishment of a customs union with Israel based on Israeli trade regulations, in conjunction with Israeli control of labour flows and the lack of a domestic Palestinian currency, imposes severe limitations on sovereignty. Moreover, it perpetuates the heavy dependence of the Palestinian economy on Israel and its economic policies.

What is sovereignty? Its essence lies in the ability to decide and implement decisions. Of course, in most cases sovereign decision-makers are restricted by many factors including the behaviour of other decision-makers. Thus, sovereignty is always a relative concept. Usually it relates to a group of people who control a well-defined territory. Economic sovereignty includes, among other things, the freedom to choose economic policies. For example, in recent years economists have analysed 'monetary sovereignty' in the context of European integration, and have focused their analysis on the 'pros' and 'cons' of sacrificing this element of sovereignty. Because trade and labour issues have proved to be of most importance in the present context, we focus on these and do not address the issue of monetary sovereignty.[16]

The implementation of sovereignty in trade implies that the Palestinians would be free to choose their own trade regime and adopt trade policies according to their perceived interests. This requires *inter alia* the demarcation of a border between the two parties. Such a border would serve both as a symbol of political sovereignty and as an instrument of policy making. It would allow Palestinians to adopt trade policies that are consistent with their goals of economic development and do not necessarily coincide with Israeli interests. Such a framework is not opposed to ideas of free trade. Indeed, the Palestinian economy has better prospects of growth if it has free access to the Israeli market, which is the closest and most natural outlet for Palestinian output. However, regarding third parties, the PA should be free to adopt policies independently from those chosen by Israel. This situation calls for the establishment of a free trade agreement rather than a customs union with Israel. Such a trade regime would require the demarcation of an economic border between Israel and Palestine and the formulation of rules of origin. An independent trade policy towards third parties implies that on the two sides of the border different trade laws may apply, implemented by two sovereigns. The latter can, of course, decide that they prefer to sacrifice their power, and implement a *joint* trade policy. Such an agreement will substitute interdependence for current Palestinian dependence on Israeli policy makers because the two sides will have to jointly agree on trade policy.

In the past, remittances of Palestinian workers in the Israeli labour market amounted to between one quarter and one third of Palestinian GNP. This heavy dependence of the Palestinian economy on Israel still exists, and constitutes a further limitation on their sovereignty. This point needs to be explained. Economic ties in other parts of the world generate interdependence among nations. Such interdependence does indeed reduce sovereignty

[16] This topic has been discussed in Arnon and Spivak (1996*b*).

to some extent, but in ways that affect all sides involved similarly. In the Israeli-Palestinian case, there is one-sided dependence and no interdependence and only Palestinian sovereignty is limited by the lack of reciprocity.

This dependence of Palestinian income on Israel cannot and should not be terminated at once. However, in the long run, for the sake of Palestinian domestic development and healthier relations between the two peoples, this phenomenon should be gradually reduced. One important benefit would be a reduction of the employment volatility that the Palestinian economy has experienced during the last four years, which is shown in Table 5. Greater stability, both economic and political, would stimulate investment and enhance long run economic growth. Thus, a gradual phasing out of Palestinian employment in Israel would contribute to both sovereignty and prosperity. In other words, it seems that even though some trade-off between sovereignty and prosperity prevails in the short run, no contradiction between these two goals necessarily exists in the long run. In the longer term, when the two economies will become closer in levels of income, a deeper economic integration, possibly including other countries in the region, ought to be considered.

5. Conclusion: Between the 'Old' and 'New' Middle East

We conclude with several general observations concerning the region. The MENA (Middle East and North Africa) region is characterised by relatively low integration.[17] Political causes (the Arab-Israeli conflict and intra-Arab conflicts) as well as economic factors (e.g. inappropriate economic policies) are mentioned as possible explanations for the current low level of economic integration by El-Erian and Fischer (1996), who conclude that 'the developing peace process offers an important opportunity for enhanced economic cooperation within MENA' (p. 14). Since 1996, when these lines were written, the optimism that they and others expressed has significantly diminished.

This belief emphasised a two-sided link: economic integration will bring prosperity which will strengthen the support for peace; and the peace process will create the conditions for more integration and prosperity. A typical statement of this belief is the following:

> 'The ongoing peace process in the Middle East has aroused considerable interest in the potential for economic cooperation and integration in the region, especially among the parties to this process. ... There already exists among these countries a potential nucleus of regional integration, formed by three bilateral economic agreements reached, respectively, between the Palestinian National Authority (PNA), Israel and Jordan.' (Awartani and Kleiman, 1997, p.216)

These authors also claim that the above-mentioned agreements which

[17] See El-Erian and Fischer (1996) who state '... intra-regional economic interactions [in the MENA region] [have been] at an abnormally low level during recent decades'. They believe that 'merely restoring these interactions to their natural levels will give an important impetus to economic growth within the region' (p. 14).

resulted from 'the need to accommodate' the small Palestinian economy may lead, 'paradoxically', towards more integration in the region. Thus, 'the Israeli-Jordanian-Palestinian "triad" may eventually prove to have performed for the Middle East economies a catalytic role similar to the one the Benelux countries performed for Western Europe'.[18] The core argument is based on expanding the 1994 arrangements between Israel and the PLO. Thus, the integration process which has already started between the Israeli and Palestinian economies has been described positively as the beginning of new regional integration.

As expressed throughout this paper, we are sceptical of the merits of this approach, sometimes known as the 'new Middle East', with respect to both Israeli-Palestinian economic relations and wider relations in the whole region, at least for the coming few years. Scholars and politicians who advocate a full integration of the Palestinian and Israeli economies minimise non-economic factors such as the Palestinian yearning for independence and sovereignty. The example of economic integration in Europe is not comparable or equivalent in any way to the baseline conditions prevailing between Israel and Palestine or the MENA region. In the often-quoted European case, the integration agreement was formulated between fully independent countries, which had previously experienced long periods of sovereignty and felt that they had reached a level of social and political stability that could allow the sacrifice of some elements of sovereignty in return for economic gains.

This is not the case with Israel and Palestine. The Palestinians are in the process of emerging from a secular state of occupation: more than two and half decades under Israeli occupation, two decades under Jordanian occupation, three decades under British occupation, centuries under Ottoman occupation. Clearly, customs union agreements with the most recent conqueror have inflicted a heavy cost on their social fabric, their political stability, their national pride and their overall national identity. Moreover, the proposed customs union in general, and the external parameters of trade in particular, are likely to be tailored to the economic interests of Israel which is by far the stronger partner in such a venture. In addition, the economic gains for Palestine of close integration with Israel are not certain. In theory, one could foresee that economic integration between a highly developed economy and one that is at a much lower level of development might create an outcome whereby the latter would become a long time supplier of cheap labour to the former, and inadequate economic development would take place in the latter. This is clearly undesirable both on moral and on practical grounds. Such a lasting situation is a certain recipe for future animosity and conflict between the two nations.

In our view, the Palestinians should be free to choose the economic regime that would best meet their needs for both sovereignty and economic development. Any agreement that includes elements perceived as being imposed is

[18] A very similar approach characterises Lawrence (1995) (the Harvard report). In that influential report the year 2010 is set as a target when a full customs union will exist between the triad economies, and may be extended even beyond that.

doomed either to fail or to be violated. Both sovereignty considerations and the goals of economic development call for the creation of economic borders. Such borders should be open, and replace the existing arbitrary arrangements with new ones that will bring stability. It will be healthier for both sides to have a well specified economic border, with clear rules and mechanisms, rather than having the existing Protocol regime, where *de jure* there are no borders and there should in principle be 'normal' movements of goods and labour, while *de facto* high barriers to economic exchanges prevail. Moreover, an agreement on the establishment of economic borders might contribute to the development of a more balanced relation between the sides, including relatively more employment opportunities within the West Bank and Gaza than at present, and to a more stable atmosphere in the West Bank and Gaza. This in turn will stimulate private investment and further economic development.

When the time is ripe, a real process of integration along the lines of the European Union experience might develop, on the condition that there is symmetry between the parties and mutual conviction that the choice is really voluntary. It seems to us that the vision of a 'new Middle East', along the lines of present realities in the European Union, is premature. But more modest arrangements now and gradual evolution could pave the way for greater integration in the future.

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