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The Israeli-Palestinian Economic Agreement and Current Consequences

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The Paris Protocol, the economic agreement signed by Israel and the Palestinian Liberation Organization (PLO) in April 1994, is at the center of debates regarding the economic crisis that the Palestinian Authority (PA) is undergoing. This article analyzes the Protocol and its effects from 1994 to 2000. Its implications are relevant both to the reality and economic challenges faced by the PA today and its economic relations with Israel.

In the early 1990s, before taking control of the West Bank and the Gaza Strip, the PLO's economic perspective was influenced by its desire to give the future Palestinian entity the characteristics of a nascent state. The PLO leadership attached particular importance to the economic sector, believing that the Palestinians' political independence would depend on their economic independence. They knew that their chances of establishing stable self-government and winning the support of the population depended on their ability to raise financial resources and implement effective economic policies.

The political agreements between PLO and Israel were accompanied by understandings regarding the need for extensive fundraising to encourage economic and social development in the West Bank and the Gaza Strip and to establish the institutions of the Palestinian Authority. International aid was meant to bolster the PA's rule and encourage public support for the peace process, by illustrating the advantages and benefits of peace. Aid agreements set goals for an improved economy, an effective democratic government and regional cooperation.

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Donor states convened in Washington in September 1993 under the initiative of US President Bill Clinton, immediately after the signing of the Oslo Accords. The donors promised $2.4 billion over five years, from 1994 to 1998.The 36 donor states and four NGOs established the Ad-Hoc Liaison Committee to coordinate the aid. This Committee met with observers from the Palestinian Authority and Israel, and made decisions regarding the scope and goals of the aid. The World Bank served as the secretariat of the Liaison Committee and was in charge of the transfer of funds to the Palestinian Economic Council for Development and Reconstruction (PECDAR), which was established in late 1994, following a decision made by Yasser Arafat, and was in charge of transfer of funds to the relevant ministries in the PA, of reporting and of work relations with the World Bank, the IMF and the donor states.

The emergency plan drawn up by the World Bank to assist the Palestinians assumed that there would be regional cooperation in infrastructure, for example in water and electricity. The plan aimed to tackle the most urgent needs of the Palestinian economy in order to give it a solid foundation; it placed special emphasis on the private sector, both in financing and in project implementation. The Palestinian leadership was expected to settle for modest infrastructure projects and to maintain an economic link to Israel, despite its preference for disengaging from the Israeli economy.

In discussions held after the signing of the Oslo Accords, Palestinian economists, especially PLO members from Tunisia, spoke out against a continued economic relationship with Israel, claiming that a customs union would be a “disaster” for the Palestinians as it would perpetuate dependence on Israel. However, Palestinian businessmen from the West Bank and the Gaza Strip who insisted on continued access to the Israeli market gained the upper hand.

The Paris Protocol, the Israeli-Palestinian economic agreement regulating the economic relations between the two parties for a set period of five years, was signed in April 1994. It created a customs union, and included, among other things, the following: lists detailing products the Palestinian Authority was permitted to import; standards of products imported to the Palestinian territories and fixed the duties on them; a value added tax (VAT) rate of 15-16 percent, similar to that of Israel, with the possibility of limited changes compared to the Israeli VAT rate; issuing import licenses - under each party’s responsibility; the implementation of imports, including standardizing products, fixing duties and issuing licenses, was to be handled by Israel.

The Palestinian Authority’s main economic institutions were established following the Protocol: the Ministry of Finance, including a budget department, a Monetary Authority and a Central Bureau of Statistics. The Palestinian banking sector also enjoyed a high level of openness and liberty and a lack of restrictions on currency exchange, thus drawing in many external Palestinian investors. The implementation of the Israeli indirect taxation system, including a single VAT rate, created effective tax collection for the Palestinians.

The Protocol institutionalized the economic integration that had developed between Israel and the Palestinians during the direct Israeli rule, since 1967. The Israeli labor market remained the main employer of Palestinians; nearly 60,000 people from the

West Bank were employed in Israel. Israel remained a main import and export destination; it continued to control the external Palestinian transportation and trade relations, and to collect taxes for the PA; and it had control over a large number of the Palestinian Authority's central economic decisions, such as currency, tariff rates, interest and standards. These developments caused the Customs Union to become asymmetrical: blocks, permits, searches and various restrictions on the movement of labor and goods prevented Palestinian exporters from having full access to the Israeli market and other markets, and from time to time, Israel froze Palestinian tax revenues.

A study conducted by the World Bank in 1999 determined that trade between Israel and the Palestinians, which was conducted according to the Paris Protocol, was highly distorted in favor of Israel in the following ways:

1. Trade preference in favor of Israel – according to the Paris Protocol, Israeli products and services were exempt from duty, unlike products from other countries, which had a duty rate of 50% on average. This policy creates significant protection for local goods and damages trade with the rest of the world, causing a preference for trade with Israel.

2. The duty and tax system protected certain economic activities, thus differentiating economic sectors. This situation does not encourage the investment and trade required for economic growth, and it worsens due to the high trade costs, caused by the Israeli security policy. It is reflected, for example, in transport costs, which add an average of about 35% to the price of a product, compared with only about 15% in the rest of the Middle East (according to the trade data from 1998).

3. Restrictions on trade with the Arab states (except for limited lists of products) placed significant hardships on the development of Palestinian trade.

The World Bank recommended establishing a new system for distributing revenues, in order to minimize the leakage of taxes from the PA to Israel. Furthermore, the International Monetary Fund recommended that the PA negotiate with Israel on expanding the range of goods it could import; change the tax system and move from reliance on indirect taxes to direct taxes; and cancel Israeli deduction of 25 percent of the income tax imposed on Palestinians working in Israel. The study also showed that the Palestinian economy suffered from high trade costs due to having to bring goods through Israel and from the preferential treatment for Israeli products. Therefore, they recommended that the Palestinians "harmonize" external duties (that is, equalize duties on imports from Israel and other countries), and that the preferential treatment of Israeli goods be cancelled.

Due to of the lack of mid- and long-term economic planning and of a single address for coordinating activity related to the transfer of funds and their channeling to the various recipients, the economic activity in the PA was characterized by decentralization of authority and responsibilities between the various ministries (Economy and Trade, Finance, Planning and International Cooperation). Internal struggles between the ministers in the PA regarding the question of responsibility over receiving aid and its allocation caused further difficulties in the transfer of funds, stemming from the lack of effective mechanisms and experience in administration and economic management on the Palestinian side. The PA struggled to meet donors' conditions regarding transparency and accountability in the process of transferring funds and utilizing them. The result was a wide gap between stated commitments and actual transfers.

These difficulties prevented the implementation of most of the projects listed in the five-year plan. Almost 40 percent of the funds (about $1 billion) received between 1993 and 1998 were allotted for covering budget deficits in the Palestinian Authority, while the remaining 60 percent was invested in projects. Donor priorities regarding the allotment of aid to different destinations and sectors differed from Palestinian developmental needs. For example, industry, agriculture and infrastructure, placed at the top of the Palestinian development plans, received limited aid. Much of the aid was allotted to technical spheres, such as professional training classes and classes for officials, senior administrators, police and prisoners released by Israel. These classes were usually taught by foreign experts, and the funds were intended to finance their salaries.

Occasionally, allotments of funds were influenced by the donors' political agendas. For example, US aid transferred through the US Agency for International Development (USAID) gave preference to democratic development projects, whose main beneficiaries were the NGOs that adopted the US agenda. The main beneficiaries were the NGOs, which adapted, either willingly or out of necessity, to the donors' agenda. These organizations held dozens of conferences, workshops and seminars on subjects such as majority rule and minority rights, or the role of citizens and civil society as elements that complement the government system. These activities continued the effort which began before the founding of the Palestinian Authority, to instill the concept of good governance (*al-hukm al-saleh*).

The Palestinian Authority had little influence over the donors' priorities. In the tangle of committees established in order to coordinate the transfer and allotment of aid, most of the authority was given to World Bank representatives, which marginalized PECDAR representatives. The PA's ineffectiveness was also exacerbated by rivalries and internal tensions between the economic ministries in the PA, between them and PECDAR, and between different departments within PECDAR, reflecting the PA's lack of centralized long-term economic planning.

Blockades and other limitations imposed by Israel for security reasons damaged the Palestinian market. Many Palestinian laborers lost their jobs in Israel and the ongoing unemployment crisis affected households and workshops, merchants and businessmen. The cumulative loss due to the Israeli impositions between 1993 and 1997 was twice as high as the total aid donated to the Palestinians, causing donors to feel that the aid did not achieve its goals of restoring and strengthening the Palestinian economy, which thus negatively affected their willingness to transfer funds.

Alongside these difficulties, which prevented the Palestinian leadership from realizing its initial intentions of turning the Palestinian economy into an independent economic establishment, the leadership failed to implement an efficient economic policy. Aside from institutional corruption, the phenomenon of monopolies stood out – a phenomenon that caused most economic power to be concentrated in the hands of a small group of Palestinian officials and damaged the ability to maintain a free economy. The PA's leaders allowed the establishment of economic monopolies in products such as cement, flour, iron by senior officials in the PA, including the heads of security, and established economic entities which acted as official monopolies, including the Fuel Authority and the Tobacco Authority. This monopoly system enabled the PA to concentrate information on purchases made in Israel or through it, in order to receive the maximum refunds from the VAT, the customs and the excise tax collected by Israel. These refunds formed the bulk of the PA's income from its monopolistic activity.

In conclusion. the PLO's aspiration to give the Palestinian Authority the characteristics of a nascent state and its aim to achieve economic independence, believing that the Palestinian political independence would depend on it – was dashed. The Palestinian economy has not changed significantly since the first years of autonomy (1995-2000) from what it had been under Israeli rule. Most of those employed in the private sectors continue to work in small industry, services and agriculture. An absence of investments, low production, low wages and poor working conditions continue to be the distinctive marks of the economy. New jobs have not been created for young people, veteran employees and those who became unemployed following Israeli travel restrictions. The public sector established by the PA became the largest employer. For example, at the end of 1996, it employed about 75,000 people (about 13 percent of the Palestinian workforce), and at the end of 1997, 100,000 (17 percent). In comparison, during Israeli rule, only six percent of the Palestinian workforce was employed in the Civil Administration. The public sector, which is essentially unproductive, exceeded the needs of the PA and increased governmental expenditures, most of which went to pay salaries. The results were reflected in indices such as per capita income, GDP per capita, private investment and the share of exports in the GDP. These indices were in decline during the period.

Under these conditions, despite foreign aid, the PA has achieved only limited economic and social development. Centralization of the economy damaged private sector activity and limited economic growth prospects, since it prevented competition, efficiency and lowering prices of monopolized products. The absence of an economic planning body and the lack of coordination between the economic ministries in the PA has prevented the formulation of economic plans and policies. Dr. Samih al-Abed, Director General of the Ministry of Planning and International Cooperation, has explained that the difficulties in social development stem from the limited scope of the construction of laboratories, scientific research centers, technological centers and public library, and a lack of teachers, physicians, nurses and social workers.

Additionally, economic and social development continued to be affected by the fact that Palestinian society is a traditional one. Agriculture remained its main source of produce and exports, despite the decline in the number of farmers during the years of the occupation. In the absence of an authority and a comprehensive social development policy with a long-term vision, the situation that existed under Israeli military rule continued: weak coordination between civil organizations in the public and private sector limited the role social institutions and aid organizations, both local and foreign, could perform in social growth.

The Palestinian economy, characterized by a centralized market, a bloated and inefficient public sector and a policy of encouraging monopolies, has not brought about economic growth and improvement in the population's wellbeing. International aid has not achieved its goals of establishing an improved economy, effective democratic rule and integration into regional development. The plans formulated by economists and academics as well as the Singaporean model discussed by the Palestinian leadership remain a distant illusion. The crisis of expectations experienced by the population was expressed in critical public discourse and a decline in support for the political process. However, the demands of economists, farmers and members of the industrial and service sector from below have not been enough to change reality.

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