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Palestine Economic Policy Research Institute

Review and Assessment of Palestinian Trade Policy Options

Sobhi Samour

2016

The Palestine Economic Policy Research Institute (MAS)

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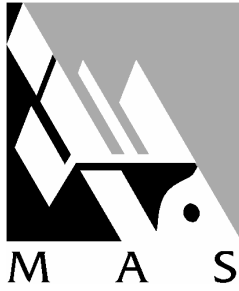
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Foreword

Trade-related research has been on MAS agenda as one of our main areas of policy research since the establishment of the Institute. In the spring of 2015, MAS started contemplating the idea of launching a research program that would lay the groundwork for an independent trade policy for Palestine to be implemented when this becomes politically possible. The process, as envisaged, entailed completing a series of eight studies on various trade-related issues. This was going to be a rather complicated undertaking, and it was not possible to embark on it without securing the necessary resources first. So, MAS sought the endorsement of the Ministry of National Economy (MoNE), which it received, and was thus encouraged to pursue efforts to secure the needed financial resources, which was and remains a difficult task. The first of the studies in this program was “Review and Assessment of Palestinian Trade Policy Options,” which became the cornerstone for the rest of the undertaking. The program would culminate in delivering the “Building Blocks of a Sovereign Trade and Customs Regime for Palestine.”

It was our good fortune that two major Palestinian businesses expressed their interest in contributing to determining what would be a suitable trade regime for a sovereign independent Palestine and offered to partially fund such an investigation. Consolidated Contractors Company.

(CCC) and Bank of Palestine (BOP) have both been avid supporters of MAS research and core activities, and with a grant provided by BOP this time, MAS was able to supplement some partial funding provided by the Arab Monetary Fund (AMF) through the Islamic Development Bank (IDB)/Al-Aqsa Fund. The research work was assigned to Dr. Sobhi Samour, who had just joined MAS and who completed the meticulous work that we present in this volume.

We trust that all those who are interested in Palestinian trade policy options will find this research study useful as well as delightful to read. It provides the comprehensive review that MAS sought to have as a starting point and a basis for putting in place in due time a Palestinian customs regime. On behalf of MAS, I thank the author and congratulate him on this work. I also thank the reviewers for their detailed comments and keen interest in the study. In addition, we at MAS are particularly grateful to Bank of Palestine and the Islamic Development Bank for funding this study.

Nabeel Kassis, PhD
Director General

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Executive Summary

There is hardly a sector in the Palestinian economy that has been as extensively researched as that of the problems and prospects of the Palestinian trade policy performance. The question whether the existing trade regime – principally the Customs Union with Israel – is the best available one, provided it can be fully implemented, or whether the Palestinian economy would benefit from a move towards a different regime, has been approached from diverse angles and with different political and economic assumptions. It is, therefore, not surprising that such research has yielded different and contradictory results.

This study on Palestinian trade policy is the first of its kind. Through an intellectual history documenting the framing and evolution of trade policy research, it provides a map of the terrain of existing research on trade policy reform and brings order into the conceptual confusion created by conflicting policy recommendations thus derived. It does so by comprehensively reviewing, and critically assessing, research by a wide range of authors and institutions produced over the past three decades. The study therefore provides a reference from which further trade policy research can draw and a guide to inform Palestinian policymakers and stakeholders engaged in trade policy formulation.

The study analyses four permutations of possible trade policy frameworks that have dominated the analyses and proposals of the studies reviewed here:

- the current framework established by the Oslo Accords, the Protocol on Economic Relations between Israel and the PLO, which reflects one form of a Customs Union (Chapter 2);
- a functional and improved customs union with Israel (Chapter 3);
- a Free Trade Area with Israel in different hybrid formats (Chapter 4); and,
- a Non-discriminatory Trade Policy, based on Most Favored Nation treatment of all partners (Chapter 5).

In presenting the literature that has analyzed the comparative advantage and disadvantage of these options and how they might function in the specific Palestinian context, the study encompasses all dimensions of the debate, in particular:

- the comparative theoretical advantages to the Palestinian economy of the different options, assessed especially through their relative impacts on

- trade creation and trade diversion, as well as other factors such as institutions and market dynamics;
- the political factors which have shaped and changed approaches towards what is considered as the preferable Palestinian trade policy regime, be they the PLO negotiating stance, Israeli security interests, joint Palestinian-Israeli peace-building initiatives, or international organizations privileging a particular view on the relationship between trade and development; and,
 - the extent to which the current or proposed alternative arrangements correspond to, or are incompatible with, the twin imperative of Palestinian sovereignty and development.

The cumulative body of research reviewed here and ostensibly aimed at reforming Palestinian trade policy has proceeded along three tracks: proposals for piecemeal improvement of (some would say cosmetic changes around) the present trade policy framework; work assessing the optimal trade policy based on various economic theories and assumptions that has often abstracted from real world constraints on the ground; and, research that has taken these constraints into account with the assumption that the Palestinian economy should either chart its future from within these constraints or attempt to set itself free from them. Despite these established research approaches to Palestinian trade policy options, most analyses fail in systematically linking trade policy to wider development goals, economic sovereignty and political independence. The concluding chapter to this study outlines recommendations to avoid several flaws in future trade policy research, be they methodological, theoretical or political.

In reviewing the literature, this study shares the widespread position that the Customs Union with Israel has either failed to meet its promises or was an ill-devised trade policy framework to address Palestinian economic challenges in the first place (Chapter 2). Supported by internationally-sponsored confidence-building measures aimed at breaking the diplomatic deadlock, the study recognizes that various proposals to reform the Customs Union have remained influential. Reviewing these, the study finds little basis on which such proposals can address the structural challenges of the Palestinian economy (Chapter 3). The trade policy alternative most extensively discussed, are various forms of a Free Trade Area with Israel with some qualifications that would recognize the need to rebuild the Palestinian economy. While such an arrangement would meet many demands expressed by Palestinian negotiators over the past three decades, it might not be an appropriate trade policy framework considering structural deficiencies of the Palestinian economy and that the practicalities of its implementation could entail

significant costs (Chapter 4). A relatively under-researched trade policy alternative is the Non-discriminatory Trade Policy that would constitute a dramatic break from the existing trade relationship with Israel. Some empirical studies that have assessed this trade policy alternative have found it to be superior to all others, but the question as to what tariff-structure should be applied divides opinions and calls therefore for more empirical, sector-specific research (Chapter 5).

While it is instructive to look at trade policy reform from a purely theoretical perspective, in the complex world of real multilateral and regional trade policy negotiation, outcomes are driven by political interests rather than notions of efficiency, trade creation or diversion. This resonates in particular in the specific Palestinian context, whereby even the most perfect trade arrangement might well entail the most imperfect political outcome from a Palestinian vantage point. The study reserves final judgment on precisely which basic scheme and what hybrid version of it might be the optimal future configuration for ensuring Palestinian strategic economic development interests.

The review nevertheless demonstrates the extent to which the current framework is inferior to any option, and how even an improved version of an Israeli-Palestinian customs union would most likely be inadequate to end volatile growth and break the path of adverse dependence on Israel that continues to dominate the prospects of the economy of the occupied Palestinian territory. The inextricable link between political prospects and the optimality of any scheme absent full Palestinian independence and sovereignty is such that none of the theoretical models could deliver their assumed benefits.

Hence, it seems premature to attempt to state with certainty which alternative might be optimal, short of a yet another exercise in constructing a political counterfactual (which has been done repeatedly in the studies reviewed). However, the imperative of moving away from the constraints of the current trade policy framework in line with Palestinian development interests and political demands is today greater than ever as the economy struggles to realize its productive potentials, yet finds its ability to trade with the world on terms that enhance its autonomous bases curtailed by the Protocol's design and operation.

The challenge therefore is not only to decide on how and under what circumstances the current trade regime should be abandoned, but rather to identify the direction that trade policy reform should be pursued: towards less

integration with Israel or the terms under which more integration with it could facilitate economic sovereignty and political independence; towards more trade openness with the region and the rest of the world or a selective trade policy that would use elements of both, export promotion and import substitution; towards understanding trade as the prime engine for economic growth or using it as but one instrument in the toolbox of macroeconomic policy and development strategy. These are matters which call for the urgent attention of Palestinian policymakers, who have so far failed to pursue a strategy for trade policy reform consistently, and have all too often reduced trade to a magic bullet instead of placing it within a wider strategy for economic development.

While each of the optional regimes has a different answer to those challenges, largely based on political preferences and assumptions about the nature of future Israeli-Palestinian relations, one missing element from the body of research has been the necessary empirical work on examining the economic impact of the alternative tariff structures implied by the optional regimes. Such an effort, currently underway at MAS, is needed so as to be able to render a reliable quantitative assessment that best informs policy making in this area and accordingly dispels the blurred lines between the different hybrids of the options debated. Such research should move on from this review and previous studies both in terms of the quantitative sectoral analysis of trade data that it should employ and of the link it will seek between economic sovereignty, political independence and a trade policy that emphasizes strategic economic development needs, productive sector growth and social equity goals. This is not simply a matter of promoting sound and researched public policy-making processes, but is necessary to ensure the best possible quality of economic development awaiting the Palestinian people.

Chapter 1. Introduction

There has hardly been a field in the Palestinian economy that has been so extensively researched as that of the problems and prospects of Palestinian international trade and the form that a trade policy regime should take to fully exploit the potential the Palestinian economy has to offer and, thereby, build the economic basis of an independent Palestinian state. The purpose of the present study is to review literature on the subject in a manner that classifies the existing body of thought and critically assesses why the answer to the seemingly straightforward question about the optimal trade regime for a future Palestinian state remains elusive and manifestly complex. Positing the question in such a way is both a reflection on the past and an attempt to construct the future.

1-1 Background and aims of the study

To be sure, the discussion about the optimal trade regime began even before the Oslo Accords were negotiated, but it was through the Madrid Middle East peace process launched in 1991 that a prosperous economy, led by a strong external sector, became almost synonymous with a successful peace process. The issue of Palestinian trade, and the appropriate institutional framework in which it was to expand, has been subject to numerous studies in the past two decades, approached with diverse broader visions for Palestinian growth and development frameworks that utilized different theoretical and political assumptions. It is therefore, perhaps, not surprising that the question about the optimal Palestinian trade policy regime has yielded different and at times contradictory answers.

While most studies on the Palestinian trade regime tend to agree on the need to reform the current trade regime institutionalized in the Paris Protocol on Economic Relations (PER), a consensus does not exist about the trade policy regime that should replace it. Underpinned by diverging views on how to address the challenges faced in designing trade policy for a future sovereign Palestine, the alternatives for trade policy range from improving the existing Customs Union (CU) with Israel to implementing a Free Trade Area (FTA) or moving towards a Non-Discriminatory Trade Policy (NDTP), rooted in the principle of Most Favoured Nation (MFN) treatment. Beyond the trade policy regime itself, opinions also diverge regarding the question of the tariff structure in the event that a move towards a new Palestinian trade policy regime bestows Palestinian policymakers with the sovereign decision-making capabilities to set tariffs and conclude preferential trade agreements. It may be

argued that there are really only two choices, either a deepened and improved customs union or a MFN separate tariff regime with, or without, preferential (or free) trade agreements with select (Israel and/or Arab) partners. However, this study follows the pattern established in the studies produced over the past 20-odd years, which have generally looked at the three alternatives as mutually exclusive.

In reviewing the arguments as to the relative optimality of alternative Palestinian trade policy regimes, there is a temptation to ask what value such an undertaking will add to the existing copious body of research that has investigated the very same question. While much of the subject matter this study will recall what has already been proposed, the study seeks its rationale at several distinct levels:

- First, it will provide a comprehensive, up-to-date overview of the existing body of knowledge on Palestinian trade options and contrast and critically assess the various trade policy recommendations formulated hitherto. For each trade policy alternative proposed in the existing literature, the study maps out points of divergence and convergence in the findings both within a specific trade policy regime and with other regimes.
- Second, it will trace the shifting positions of particular parties that have been engaged in trade policy advocacy and assess the wider context of these shifts.
- Third, by comprehensively engaging different trade policy options and showing their different economic and political assumptions, the study will equip Palestinian policymakers with the analytical basis for informed economic decision-making. In particular the study will present the relative benefits and costs of optional trade policy regimes, needed to pave the way for a broader effort to examine which configuration is best-suited to address the economic development challenges of a sovereign Palestinian state.
- Fourth, by outlining the pros and cons of alternative trade policy regimes, the Palestinian private sector will be provided with better preparation and predictability regarding possible changes that might be decided in the trade regime (even prior to independence and sovereignty), while also pointing towards ways the international community can direct technical aid and expertise to support the reform of the Palestinian trade regime.
- In addition, in light of Palestine's plans to negotiate WTO membership, a critical assessment of trade policy options helps to situate that effort within the development strategy framework that should guide trade policy-making.

- Lastly, the study is a precursor to a separate research project that will empirically assess the current Palestinian trade regime tariff structure and the potential impact that alternative regimes would have on a number of factors. The preferred future trade regime should be assessed along the lines of its ability to optimize, or at least minimize potential trade-offs between, three factors which define optimality, namely comparative impacts on a) local productive capacity, b) welfare, and c) fiscal balance.

There is little doubt that the current Palestinian trade regime has produced suboptimal results for Palestinian development, growth and its trade balance. As enshrined in the PER, Palestinian trade and its relations to the most important trading partner, Israel, is governed by a customs union (CU) with some exceptions. The CU determines a common external tariff but accords the PA the right to fix its own tariffs for specific quantities of a limited number of goods. In reality, Palestinian-Israeli economic relations come closer to approximating an economic union as both economies share the same framework for monetary, fiscal and trade regulations. Since these regulations largely reflect Israel's broader economic and trade preferences, the CU has a structural bias towards the more advanced Israeli economy and the interests of its producers.

The Palestinian economy is ill-served by having to adopt trade policy and customs procedures of the Israeli economy which, given geographical proximity and Israel's control over trade routes, locks it into the status of a captive market for Israeli goods. The economic policy framework governing the current Palestinian trade regime does not only limit the potentials to boost Palestinian trade performance, but also denies the PA a range of macroeconomic options to independently determine fiscal, monetary or exchange rate policy. As research by the IMF as early as 1997 acknowledged, the CU "forces the WBGS to adopt a trade regime that might not be best suited for its economic circumstances (resource endowments) and development strategy and [binds] the WBGS to the pace of trade liberalization under way in Israel" (Zavadjilet.al., 1997: 38).

Widespread criticism of the CU notwithstanding, this particular trade regime has had, and continues to have, strong supporters who blame the failure of the PER to boost the Palestinian economy on political or institutional reasons rather than inherent problems with suitability of the trade regime itself. The questions as to whether the current trade framework could be reformed to correct for structural imbalances, how it might generate benefits to the Palestinian economy assuming political stability, or, conversely, whether the Palestinian economy might be better served in choosing a different trade

policy regime governing its relations with Israel and the rest of the world, will comprise a major part of this study.

Writing about the optimal trade regime of a future Palestinian state is an endeavor fraught with difficulties. As recognized in one of the earliest studies on trade policy options for the Palestinian economy, the World Bank opined in 1993 (p.48) that such “an activity [has] a feeling of paradox.” “On the one hand there is a bewildering range of choices of trade options, ranging from the status quo of an incomplete customs union with Israel, to alternatives with Jordan, with or without Israel, to Free Trade Areas as variants of these, to going it alone with an independent trade and industrial policy. On the other hand, actual choices will at any point of time be highly restricted, by the political outcomes of the negotiations and (at least for now) by the costs and difficulties of having a customs border between Israel and the West Bank.”

To the chagrin of many public officials, economists are notorious for their two-handedness: equivocating between one option or explanation, and the other. True, the cumulative effect of reasoning for and against various trade policy regimes has contributed to a wider understanding needed to identify the necessary criteria – and possible trade-offs – on which basis an optimal Palestinian trade regime could be defined. Yet, the challenge this study poses to itself is to produce, as far as possible, a one-handed analysis by assessing to what extent existing trade policy proposals link economic to political sovereignty. To the extent that economic sovereignty, in particular ability to the set trade policy autonomously and political sovereignty co-determine each other, a move towards carving out a new independent trade policy responsive to Palestinian development needs would unquestionably support the PA in its quest to achieve political independence.

1-2 A brief history of the Palestinian trade policy debate

It is perhaps too obvious to state, and yet important to remember, that Arab Palestine never had an independent trade policy regime and that it has always been subject to the economic interests of foreign powers. Even the UN Partition Plan for Palestine of 1947 (UN Resolution 181) that recommended the creation of an independent Arab and Jewish state envisaged an economic union between the two entities, thus tying, if not subsuming, Palestine’s economic interest to that of another and more advanced economy. The economic union proposed in UN Resolution 181 was itself based on the Peel Report of 1937, recommending that it would be in the interest of both parties to “impose identical customs-duties on as many articles as possible” (p.387). According to UN Resolution 181, the economic union would be based on a

CU, thus meeting the preference of identical customs duties, a common currency system and external exchange rate and joint economic initiatives overseen by a Joint Economic Board (JEB) (Cobham and Kanafani, 2005: 1).

Thus, in some respects, the trade regime and design of cooperation set out in the PER can be traced back historically to the UN Partition Plan. While the political component of the latter was never implemented, and remains still elusive today, its economic component has been in full force since 1967 albeit in a lopsided form cemented by decades of occupation and military rule (Khalidi, 2007: 5-6). The trade regime imposed on the Palestinian economy under Israeli occupation was that of a CU and as many have argued, while the PER is built on some formal and rhetorical recognition of parity and cooperation originally envisaged in the Partition Plan, in reality the PER merely institutionalized the structures of economic inequality and domination that developed since occupation in 1967 (see e.g. Elmusa and El-Jaafari, 1995; Naqib, 2002).

It is, in this context, pertinent to note that many trade policy proposals for the Palestinian economy that made the rounds in the wake of the Middle East peace process, just as the PER itself, were strongly predisposed to favor some form of integration and economic cooperation with countries in the region, notably Israel. As a starting point thinking about a suitable trade position for the Palestinian economy, such a bias makes good sense. It is without doubt that for a small, underdeveloped economy such as the Palestinian one, regional economic integration and cooperation (such as in tourism or infrastructure projects) would be advantageous and could facilitate a political climate of trust based on reciprocal economic interests and benefits. Thus, during the euphoric period of the 1990s, grand projects were forged that were predicated on a transformation of the Middle East from a war-torn, protectionist and stagnating region to its integration in the global economy based as a regional trading bloc, indeed a "New Middle East" (Fischer et.al., 1993; Paris, 2000; Rosenberg, 1992). One such scheme was a trilateral economic union between Palestine, Israel and Jordan modeled after the Benelux example. In such an institutional arrangement, trade would be based on a customs union, that is to say, free of tariffs between the participating parties and regulated by a common external tariff. In the long-term, too, the free movement of people, capital and services could be foreseeable and the economic union would be cemented by close macroeconomic policy coordination (see e.g. Lesch, 1992: 136-142; Shtayyeh, 1998). In a similar vein, a phased plan was suggested to establish a FTA consisting of the trilateral axis of Palestine-Israel-Jordan. Since it was widely accepted that the Palestinian economy needed some kind of special measures to remove

structural distortions, while maintaining its trade links with historic Arab partners, it would have been granted the temporal freedom for government-sponsored measures for investment and trade promotion. Such a trilateral FTA, moreover, would involve tight economic cooperation in areas of tourism, infrastructure, the generation and transmission of electricity and water service provision (The Institute for Social and Economic Policy in the Middle East, 1993). Once successful and facilitating peace and generating prosperity, this FTA could provide a springboard to a region-wide common market marked by economic cooperation, and free trade and factor mobility, thus underpinning political stability (Lawrence, 1995).

In hindsight, it must be said that the foundations on which such schemes were based were overly optimistic, if not naïve, for they assumed that the primacy of economics would trump, and solve, the problems of politics. Besides underestimating the stickiness of political obstacles however, the underlying economics of such trade policy proposals was also questionable. First, the general approach with which many of these proposals were formulated implicitly treated trade options for the Palestinian economy merely as one small part of a wider regional economic challenge instead of warranting trade policy proposals that would take into account its own status as an underdeveloped, highly distorted economy in need of a special trade regime that would both promote and protect its external sector.

Second, the crucial issue of sequencing economic integration has largely been neglected in such ideas, given the dominant consensus at the time that open trade borders are significantly correlated with or cause economic growth (Bhagwati, 2003; Krueger, 1998; Singh, 2010). Thus, more cautious analysis pointing towards the need to have a sector-specific approach towards trade liberalization *and* protection to nurture a strong domestic economic base on which basis liberalization can succeed, was discounted. In so doing, no attention was given to methodological problems with cross-country studies that have made the case the causal relationship between free trade and economic growth, just as the historical evidence suggesting that the relationship was in fact inverse. In other words, trade liberalization was often the outcome of, rather than a prerequisite for, a successful development strategy (Chang, 2002; Pritchett, 1996; Rodrik, 2001; Shafaeddin, 2005).

Third, as a corollary, the deliberations around the reconstruction of the Palestinian economy have often been centered around a trade-driven approach to development rather than a development-driven approach to trade. That is to say, efforts should have been concentrated on addressing the economy's structural weaknesses, strengthen and diversify its productive sectors through

a growth strategy that integrates trade policy as one of many other components of the national development strategy (UNCTAD, 2006: 30). Instead, many of the trade policy proposals advocated in the studies examined here exemplify an approach that elevated export growth and trade openness to the main strategy with which other development challenges were to be harmonized. It was then only a logical step for most trade policy regime proposals to prioritize the continuation, and indeed further deepening, of trade relations with Israel. Reviewing various trade proposals to date, Khalidi (2014a: 124) argues that most of them were flawed as they were based on various assumptions and goals but failed to ask “the only important question—namely, does this or that [trade policy proposal] strengthen Palestinian sovereignty and national economic security?”

One proposal that did accord the strengthening of Palestinian sovereignty and national economic security the importance it deserved was reflected in the Palestinian Development Program (PDP) prepared by the PLO Economic Department in 1993 under the leadership of Yusif Sayigh and a team of Palestinian economists. The rationale of the PDP was built around what it called a ‘dual imperative’ to pursue a balanced growth strategy underpinning the quest for political independence. As to its approach to trade policy, the PDP hoped that Palestinian independence would herald Palestine’s return into the Arab economies and, simultaneously, reduce the excessive trade dependence on Israel. In this wholly Palestinian endeavor concluded prior to Oslo, an independent tariff regime, without any preferential arrangements with Israel was favored, and a mix of export promotion and import substitution was proposed, together with a public investment program in sectors that had the potential to sustain or create comparative or competitive advantages and where the substitution of imports was most feasible. Importantly, the PDP was firm in its position that opening up the Palestinian economy to international competition, or indeed its ability to compete in international markets, had to precede the construction of a strong domestic economic base. By extension, the appropriate trade policy regime that would be needed for such a strategy to materialize would have looked very differently than the ones discussed above, or indeed the CU that was actually institutionalized in the PER.¹

This highly condensed background to deliberations of trade policy proposals helps to widen the analytical and historical context for assessing contemporary research on trade policy options. Within the realm of *ideas*, the

¹ For explanations why the PDP was swiftly buried or could not stand a chance to be pursued, see Farsakh, 2013 and Khalidi, 2014b.

CU created in the PER was not the only available possibility even if, of course, strong political factors – primarily Israel’s interests – almost predestined its creation. The PER was not only based on, and largely institutionalized, distorted and debilitating economic relations between occupier and occupied, but its historical lineage can also be traced back to the UN Partition Plan underpinned by political assumptions that have not materialized separated sovereignty and economic assumptions of mutually beneficial integrative union, neither set of which has been realized. Diplomatic processes have meant an effective divorce of seeking an economic framework that mutually reinforces the realization of both economic *and* political sovereignty. Meanwhile an inherent bias in most trade proposals has privileged closer integration with Israel instead of redirecting economic relations to the wider Arab world and providing a trade policy framework under which local industries could be nurtured and protected to enable them to expand in international markets.

1-3 Demands on a Palestinian trade policy framework

Despite considerable efforts that have been invested into pursuing the ‘dual imperative’ of economic and political sovereignty, realities on the ground remain bleak. It has been long argued, and indeed much proven, that occupation precludes the possibility of development (Abed, 1988; Roy, 2012), understood as the removal of several types of *unfreedoms* that prevent people from realizing their full capabilities, a notion popularized by Nobel Prize winning economist Amartya Sen (1999). Instead, economic policies should actively prioritize moving closer to, and providing the preconditions for, the realization of the ‘dual imperative’. In this respect, future trade policy can play an important role once its parameters take into account what previous trade policy proposals lacked and once it becomes part of a wider economic strategy instead of it being seen – as has often been the case – as the main engine through which economic growth could be achieved.

Given the concrete challenges faced by Palestinian policy-makers, and based on this review study, a future empirical assessment of the suitability of new or old trade policy proposals should be based on the following considerations:

- The impact on local productive capacity and structure, especially whether they allow for the use of tariffs to shelter and promote promising industries.
- The impact on the standard of living and poverty, particularly in light of the existing material deprivation and poverty and the high dependency on imported foodstuff.

- The impact on fiscal revenues the government generates through tariff revenues and the wider multiplier effects a change in trade policy may create.
- The ability to strengthen existing, and create new, forward and backward linkages to optimize potentials for export promotion and import substitution.
- The ability to make full use of regional trade agreements and meet standards set out by the WTO given existing accession plans.
- The ability to reduce economic dependency on Israel in a sustainable manner in light of the manifest macroeconomic imbalances this has caused and Israel's practice to hold Palestinian decision-makers to ransom.

As a theoretical exercise, it would be difficult to determine a trade policy framework that would optimize all of the goals stated above. Indeed, all trade policy options discussed in this research are characterized by numerous trade-offs between certain goals. This poses the question whether a conventional trade policy framework can be defined *a priori*, and implies that a careful assessment of the constraints and opportunities of the Palestinian economy and its external trade options should *conclude* with identifying the trade policy framework that is best suited to address these challenges. Such a framework would most likely not follow a textbook trade policy design and instead would (like most of the proposals discussed below) be hybrid in form, shaped by the historical trends, current structural realities and future potentials and likely constraints (both economic and political) specific to the Palestinian case. Hence, deliberations of potential trade policy frameworks aimed at maximizing some factors must be integrated into a wider development strategy capable of pursuing strategies that actively minimize eventual trade-offs.

1-4 Overview of the study

Chapter 2 provides a concise overview of the theory of the CU deemed necessary since much of the advocacy on the Palestinian trade policy regime has always been about the *potential* benefits the Palestinian economy would gain through the CU, rather than those actually represented by the PER. After contrasting the expected benefits with the actual trade performance of the Palestinian economy under the PER, the various explanations offered within literature diagnosing the causes behind the disappointing trade performance are assessed. The chapter ends by identifying the diverse factors, and actors, that have formed an

ever-increasing consensus to move beyond the PER as a regime governing Palestinian trade.

Chapter 3 looks at the rationale for proposals calling for a reform of the existing CU and assess claims as to how this would improve conditions of Palestine's external trade sector. It scrutinizes concrete areas in which institutional improvements are proposed and dissects their feasibility from various angles.

Chapter 4 discusses the evolution of research on the FTA as a trade policy option for the Palestinian economy, investigates the basis of variations within studies advocating it and how some elements of this trade policy option have been modified to increase the chances of its effective implementation.

Chapter 5 then turns to the NDTP as a trade policy option by discussing the general rationale behind and how research on this policy has evolved within the context of Palestine. The merits of this trade policy will be assessed, both on its own and compared to other trade policy frameworks discussed in this research. Moreover, this chapter will provide some thoughts on the key disagreement dividing proponents of the NDTP, namely the issue of the tariff structure.

Chapter 6 provides concluding remarks summarizing the key shortcomings of existing trade policy research and offers pointers towards the required work on defining the essential components of a future Palestinian trade and tariff policy and how forthcoming research will address these.

Chapter 2. The Paris Protocol and the customs union

There are a number of good reasons why the CU established by the Protocol on Economic Relations between Israel and the Palestine Liberation Organization (PER), negotiated and signed in Paris in 1994 seemed not only the most pragmatic arrangement to regulate Israeli-Palestinian trade relations in the interim period, but also one that promised – potentially – significant economic opportunities for the Palestinian economy. Amidst the growing criticism that has accompanied the CU since its inception, and the chronic weaknesses of the Palestinian trade sector, it is thus easy to forget that the CU was heralded as the best possible trade arrangement in some analyses (see e.g. Panagariya and Diwan, 1996; Sadan and Lowenthal, 1997). It continues to be advocated as such even if politically it might be not considered viable (World Bank, 2006). True, analyses highlighting the *potential* advantages of the CU have always been quick to point out that political developments undermined the functioning of the CU and that, therefore, the theoretical arguments in favor of the CU remained valid (Abed, 1996; Diwan, 1999). However, such an explanation verges on tautology since, as Kanafani (2001) has pointed out, the design of the PER as a whole and the CU in particular were shaped by political rather than economic considerations, so it was only to be expected that political developments would determine its interpretation and application. While a theoretical analysis of the potential or actual effects of the CU in assessing the Israeli-Palestinian experience is certainly instructive, such a venture more often than not rests on the assumption of a frictionless world where political factors do not outweigh economic considerations and can therefore provide merely approximate results intended for illustrative purposes.

The purpose of this chapter is *not* to engage in another discussion of the manifold failings of the PER (in design or application) that are widely viewed to have inhibited various sectors and policies in the Palestinian economy. These have been registered in various publications and do not need to concern us here directly (see e.g. Kanafani and Taghdisi-Rad, 2012; UNCTAD, 2011 and 2014). Rather, the aim of the chapter is threefold: first, to recall the economic advocacy for, and political rationale behind, the creation of the CU (in the PER version); second, to juxtapose the expected outcomes of the CU with the actual performance of the Palestinian trade sector; and finally, to demonstrate that structural economic and political problems, rather than ‘frictions’ undermining an otherwise optimal theoretical rationale of the CU, were the main causes for the inability of the Palestinian trade sector to

develop beyond its observed performance. As such, the chapter provides a reference point for the analysis presented in the rest of the study.

2-1 The customs union in theory

Trading partners may decide to further their economic integration and harmonize trade regulations through various frameworks institutionalizing the reciprocal abolition of forms of trade discrimination, each representing a different degree of integration. The spectrum of integration ranges from removing barriers to trade to liberalizing factor mobility and harmonizing economic, trade, monetary and fiscal policies as the most complete form of integration. The dynamic effects created by various forms of trade integration, in particular the increased size of the market, efficient allocation of resources and production based on patterns of comparative advantage, have for a long time been assessed as raising welfare for participating countries *per se*, in general, and facilitate peaceful relations between participating countries.²

Within institutional forms of integration, a CU is situated between a Free Trade Area on the one hand, and a common market and economic union on the other. In a FTA, participating trading partners opt to reduce or abolish tariffs between them but retain the right to determine tariffs for imports from non-participating trading partners. Going an integrative step further, a CU abolishes tariffs between participating members just as in the FTA but, in addition, also determines a common tariff vis-à-vis imports from the rest of the world. A common market builds on the CU but adds factor mobility (capital and labor) to its menu to constitute a higher form of integration. As the most advanced form of integration, an economic union coordinates policies between the participating countries with joint institutions to unify regulations governing macroeconomic management (Balassa, 1961). Thus, in a somewhat paradoxical development within the body of economic thought stressing the advantages if not inevitability of free global trade, the CU removes trade barriers between participating members but also, *ipso facto*, represents a form of trade discrimination vis-à-vis those trading partners outside the CU. In other words, a CU may increase the welfare of its participating members, and by extension (and *ceteris paribus*) world welfare but it does not maximize it (Lipsey, 1960: 497). The CU, therefore, has also

² See Keynes (1933) for a notable exception to this tradition. Keynes argued that “the age of economic internationalism was not particularly successful in avoiding war” and urged countries to rely more on local production so as to prevent international antagonism caused by trade wars or, in today’s world, the excesses of globalization. More recently, there has been a marked backlash against globalization and regional integration in regions and countries that have been among the most liberalized such as the USA and the EU.

come to be known as a discriminatory or preferential trade agreement that was however still viewed favorably as it represents a movement towards freer trade, if not a way station towards free trade (Pomfret, 2001).

Historically, efforts to establish a CU have been driven not only by the desire to bring about higher welfare to participating members, but have also been intended to act as a harbinger for political unification. The German *Zollverein* of 1834, a de-facto CU formed by several principalities, acted as the earliest instance exemplifying the political dynamics created by the economic effects of a CU (Shiu, 2005). Likewise, and more contemporary, the creation of the European Union Customs Union (EUCU) in 1958 remains a central pillar for the political project of the EU. Within the economics discipline, the development of CU theory as well as its refinements and extensions is often linked to the seminal contribution of Jacob Viner's *The Customs Union Issue* published in 1950 [2014]. Up until then, the professed position of many economists was that CU was always welfare enhancing for participating members and should thus be promoted.

Viner, subsequently, suggested that the welfare effect produced by a CU is indeterminable in advance and instead depends on the relative weight of a balance of forces. According to him, all that economic theory can achieve, within limits, is to attempt to measure the relative strength of countervailing forces and demonstrate how the CU should operate for it to raise net-welfare (Viner, 2014: 53). Notwithstanding the historical myopia regarding the intellectual origins of this claim, this conclusion was startling in the field of international trade at the time of writing. Indeed, Viner made no claim about the originality of his contribution. In fact, the factors according to which economic integration should be assessed - trade creation and trade diversion - were already discussed by classical economists such as Adam Smith and David Ricardo whose insights informed much of Viner's writing (O'Brien, 1976)

Before detailing the balance of forces determining the welfare effects of a CU, Viner's conclusion can be demonstrated in more abstract terms through the prism of the concept of "the second best". Suppose that there are n obstacles towards maximizing welfare and productivity in an economy, one of which the existence of trade tariffs that limits the efficient use of factors of production. The abolition or reduction of tariffs as a result of creating a CU with one or more countries thus removes one set of obstacles and brings the economy closer to maximization. Thus, a CU represents $n-1$ situation for achieving a general improvement in the economy. This, in effect, was the conventional position in international trade *before* Viner's intervention. With

Viner's position, it is thus possible to make the case that removing one obstacle for maximization in fact does not improve the economy and that, indeed, the removal of this particular obstacle in the form of creating a CU may make the efficient allocation of resources worse. The economy may well be better off with n obstacles than with $n-1$ obstacles (Lipsey and Lancaster, 1956; Negishi, 1969).

This seemingly paradoxical result is brought about by two countervailing effects the creation of a CU produces – trade creation (TC) and trade diversion (TD). We will refrain here from a technical exposition of TC and TD and instead, sufficing for the purpose of our discussion, note the import of these concepts in more practical terms.³ Once a CU is established, the removal of trade barriers between the participating members shifts production from high-cost to low-cost producers, thus increasing or *creating* trade within the union. Such a process leads not only to better allocation of resources benefitting all members of the union as they are now in a position to reallocate resources towards productive activities in which they are relatively more efficient. For consumers too, the TC aspect of a CU produces will lead to an increase in the consumer surplus by substituting higher-cost locally produced goods with those imported from the CU partner. However, since a CU is a preferential trade agreement it is also, by definition, a discriminatory one, as it favors imports from partner countries over imports from those countries outside the CU. This favorable treatment of imports from a CU partner means that some goods that were imported from other sources before the creation of the CU at lower prices are now imported from the higher-cost sources from within the CU. The CU then leads to the effective *diversion* of demand to the less-efficient producers protected against lower-cost producers by the provisions of the CU. The effects of TD are felt both by the consumer, who has to pay a higher price than previously, and the public purse that loses out on the revenues previously generated by the customs collected on import of goods from the cheaper supplier. Moreover, global welfare too is negatively affected as the TD effect produces a misallocation of resources by protecting less efficient producers.

From this short exposition, it becomes apparent why Viner argued that there is no way to determine the welfare effects of the CU *a priori* and that these instead depend on the relative weight of TC and TD, which in turn depends on a number of factors. The relative weight of TC is more likely to be greater than that of the TD, the greater the size of the CU, the lower the average tariff

³ For a representative technical exposition, see Baghwati, 1967 and Kanafani, 1996: 4-9. For Viner's description of these processes, see 2014: 53-62.

applied to imports from non-member countries, the lesser the degree of complementarity between production and tradable sectors in partner countries and the greater the difference in the unit costs of the protected industries within a CU (Viner, 2014: 63-64).

To reach these conclusions, Viner's analysis of CU effects was based on a number of simplifying assumptions, in particular constant returns to scale and zero price elasticity in demand.⁴ In other words, if the costs of production are constant and demand for goods is independent of changes in relative prices, the only effect of a CU is constituted by the geographical shift of production as indicated by TC and TD. It is easy to see how Viner's examination of a CU is in effect a *static* analysis – privileging short-run or once-and-for-all results that focus on resource allocation instead of a *dynamic* analysis that takes into account long-run and cumulative changes of a CU that may result in higher economic growth.⁵ While Viner's exposition of TC and TD clarified the indeterminate welfare outcome of a CU and some of its theoretical drawbacks, these effects do not exhaust all possible consequences of a CU once it is subjected to a dynamic analysis. Indeed, just as Viner concluded that there can be no *a priori* assessment on whether a CU is welfare enhancing, a number of studies concluded that there can be no complete assessment of a CU without the incorporation of its dynamic effects (Cooper and Massell, 1965; Kreinin, 1964). Empirically, such an assessment has been confirmed by exercises demonstrating the difference between the static and dynamic gains two decades into the existence of the European Union CU. While the direct welfare gains – those can be captured by the Vinerian analysis – were estimated at slightly less than 1 percent of GDP, the dynamic gains amounted between 3 and 6 percent (Grimwade, 2013: 8-9).

The foremost contribution introducing the notion of dynamic effects that may result from trade integration, and one that has since then been a mainstay in international trade theory, is generally conferred to Balassa (1961), first systematically introduced into CU theory by Cordon (1972). The principal factor accounting for the dynamic effects of a CU is that of economies of scale. These refer to the reduction in inputs per unit of output, or more specifically redistribution of fixed costs as result of higher volume of production. As the CU enlarges the 'home market' and leads to greater specialization of firms, a higher output level is accompanied by using factors of production more effectively and with higher productivity. Such a process is further induced by the learning effects created by producing at a higher output

⁴ See Viner, 2014: 57 for his dismissal of increasing returns.

⁵ For a critical engagement with Viner's assumption, see Krauss, 1972 and Michaely, 1976.

level, increased investment brought by the enlargement of the market well as technological change and competitive pressures brought by the creation of the CU. These impacts (synergies) endow economies of scale with a dynamic nature.

Despite the significant theoretical advances made that have extended Viner's original analysis of the CU to provide a more realistic evaluation of the potential effects of a CU, a definite assessment will always have to depend on an analysis of a concrete situation. Thus, Viner's position that no *a priori* position on the economic effects of a CU can be made remains pertinent. Moreover, as a preferential trade arrangement, CUs have always been less attractive than FTAs. For example, in 2009, CU only accounted for about 10 percent of regional trade arrangements notified to the WTO as compared to 85 percent consisted of FTA (Andriamananjara, 2011: 111-112). One reason for the relative lack of policy preference for a CU is that, unlike a FTA, its common external tariff requires a much higher degree of policy coordination between its members. The determination of a common external tariff can translate into the loss of sovereignty or, worse, the larger or more powerful economies' imposition of its interest on the smaller partner(s) with potentially negative economic implications. Finally, a CU also prevents its members from engaging in individual preferential trade agreements with trading partners outside the CU, thus limiting flexibility and imposing a straightjacket on its autonomy. As Andriamananjara (2011: 118) concludes, "in a world of criss-crossing and overlapping trade agreements, the issue of the loss of autonomy can severely constrain members of CUs in using trade agreements as an effective commercial instrument."

2-2 Trade regulations and practice in the Paris Protocol

The trade regime agreed between Palestinian and Israeli negotiators as part of the Paris Protocol has been, and continues to be, extensively scrutinized by either assessing the impact of the trade regime as a whole, or particular aspects of it, on the Palestinian economy (Al-Botmeh and Kanafani, 2006; Bannister and Erickson von Allmen, 2001; Dabaq, 1996; Naqib and Atyani, 2003; UNCTAD, 1998). As a benchmark for the wider discussion in subsequent chapters, this section will first outline the salient features of the trade related aspects of the Paris Protocol and situate these within the theoretical discussion on CU theory of the previous section. Next, we reconstruct the arguments that expected the trade regime to provide a conducive building block for developing the Palestinian trade sector in the Oslo period.

In some respects, the trade regime agreed on in the PER formalized the trade relations between Israel and the WBS as they had evolved in the decades following the military occupation of the territories by Israel (Elmusa and El-Jaafari, 1995). The nature of these trade relations has been variously described as involuntary, imposed, one-sided and asymmetric CU and the structural impediments it created for the Palestinian economy have been fully analyzed elsewhere (see e.g., Arnon et.al., 1997; Hamed and Shaban, 1993; UNCTAD, 1989; World Bank, 1993). While the Paris Protocol trade arrangement comes close to a CU, it contains a number of provisions that limit its classification as a CU in its pure form as we shall see further below. These qualifications to a full CU sought to rectify various imbalances and detrimental effects of prolonged occupation to Palestinian external trade patterns and partners by introducing a number of corrective measures, which constituted the core of the new trade arrangement. The spirit of these measures, as the preamble of the PER proclaimed, was to be guided by “the principles of mutual respect of each other’s economic interests, reciprocity, equity and fairness” and to empower the Palestinian side “in exercising its right of economic decision making in accordance with its own development plan and priorities” (Protocol on Economic Relations, 1994).

Concretely, three principles characterized the new trade regime that was to, ostensibly, mark the departure from the previous nature of the trade relations. These were:

a) Free trade between the parties

This refers to, in principle, the movement of agricultural and industrial goods free of any restrictions between the two sides as specified in Articles VIII.1 and IX.1 of the Protocol. In practice however, this principle was more relevant for Palestinian producers since it formally removed a host of trade and non-trade barriers put in place by Israel in the previous decades while Israeli producers used the Palestinian economy as a captive market (see Shadid, 1988). For agricultural goods however, this principle was qualified in Article VIII.10 that placed temporary quotas on Palestinian export to Israel for six agricultural products.

b) Import policies: exceptions to the common external tariff

As per a trade regime that approximates, in the main, a CU between both parties, imports from third parties are determined by a common external tariff (CET). As specified in Article III.5, the basis for the CET, as well as a range of other import charges, was to be constituted by the prevailing Israeli rates. These rates act as a lower bound which means that while the PA is not allowed to set tariff rates at a lower level it can, in principle,

impose higher rates than those of Israel. Importantly, the PER also provided for some exceptions to this rule that both mark a departure from the previous trade arrangement and from a CU in its fullest form. These exceptions took the form of three lists comprised of goods that bestowed the PA with some flexibility to apply independent import regulations, thus partially liberalizing Palestinian trade with the rest of the world and, through the central role Jordan and Egypt, facilitating the integration of the Palestinian economy into the region.

For goods on List A1 and A2 that consist mainly of consumer goods, the PA was provided with full discretion over import policy but on quantities limited by quotas. Goods imported under List A1 must be locally produced in Egypt, Jordan or other Arab countries while goods imported under List A2 can be imported from Arab, Islamic and other countries (this confusing and overlapping distinction has been widely noted in the literature). The import of goods from these lists is regulated by quotas defined as 'agreed quantities' in order to avoid the necessity of a customs border and thereby preserve the institutional framework of a CU. For goods on List B, consisting mainly of capital goods, the PA's discretion over import policy is not limited by quotas but must meet Israeli standard requirements (Kanafani, 1996: 19). Moreover, the PER permitted the PA to determine its own level of customs and purchase taxes on imported motor vehicles (Article III.11). In principle, the PER allowed the PLO, on behalf of the PA, to enter into trade agreements with countries with which Israel had no relations, but in practice this only permitted agreements that did not otherwise challenge the operation of the Protocol.

c) Clearance of customs revenues

In Article III.15, PER stipulates that the revenues from taxes and fees levied on imports will be cleared, on a monthly basis, on the basis of 'destination' rather than, as in the past, the 'point of entry' in which all revenues on imports from third parties accrued to the Israeli Treasury. For the Palestinian side, this change meant that import revenues were transferred to the Palestinian public treasury even if the goods were imported through Israel or carried out by Israeli agents as long as the place of destination (PA) was specified in the import documentation. The PER also provided a clearance system through which Israel would collect and transfer such revenues to the PA after deducting a 3 percent administrative fee.⁶ To monitor the implementation of these arrangements and address any problems the PER failed to anticipate, it was decided

⁶ While this fee may have been appropriate at the time the agreement was signed and with Palestinian imports from the rest of the world at a relatively low level, the World Bank argues that "the current amount current amount [accrued to the Israeli side] significantly outstrips costs incurred by [Israel] to handle Palestinian imports" and recommends the fee to be lowered to 0.6 percent (2006: 2, 20).

(Article II) to form a Joint Economic Committee (JEC) that would meet on a regular basis. The specific problems associated with these three principles forming the trade arrangement with Israel will be discussed further below.

To continue with the review of the trade regime, we now reconstruct the theoretical reasoning that made observers expect the Palestinian economy to benefit from the trade arrangement institutionalized through the PER.

First, it is worth briefly situating the nature of the trade regime within the more common forms of trade integration to understand why many observers have opted to avoid classifying the trade regime as a perfect CU (see e.g. Arnon et.al., 1997; Farsakh, 2005: 128; Jawhary, 1996: ix; UNCTAD, 2006: 12). Judged by the salient features of the trade arrangement determined in the PER, it is evident that while it institutionalizes a framework for integration, the theory of economic integration provides no clear precedent to classify the form of integration. Indeed, as Kanafani (1996: 24-25) pointed out, the various mechanisms of integration incorporated in the PER include the following: a) CU features in the form of free trade between the two sides and a minimum CET; b) FTA features as represented through the three lists that allow the PA to specify its own tariff policy; and c) aspects of a common market with the PER allowing for, to some extent, the free movement of labor and capital mobility (in the form of a common currency). Given the confluence of various higher and lower forms of integration within the PER, the use of standard literature on trade integration is only of limited help in assessing it as based on what trade theory predict should occur.

This, however, did not prevent a number of observers to predict that, on balance, the Palestinian economy could reap significant gains from the (quasi) CU. Such claims were based on the static analysis – that is to say the likelihood of Vinerian TC outweighing TD – but also, and more importantly, on basis of the dynamic gains of trade integration (Abed, 1996; Kanafani, 1996: 38-40; Panagariya and Diwan, 1996). As to the former, given the Palestinian's economy relative comparative advantage in labor intensive industries and agriculture, the trade arrangement's specification that allows for free trade in industrial goods and phases out restrictions on the unlimited access to Israel's market for Palestinian agricultural producers thus signifies how TC effects in the Palestinian economy could be attained. Likewise, the relative high CET for agricultural goods and some industrial goods (such as wearing apparel and footwear) determined in the CU, while detrimental to global welfare as well as Israeli consumers through creating TD effects, could provide Palestinian producers with a competitive edge and boost Palestinian

gains created through the CU. Moreover, as argued by Schiff (2002: 15), another category of benefits of the CU consists of the costs saved due to avoiding a customs border, such as training personnel, buying equipment or building custom posts.

While such *static* gains may (or may not) be large, they are likely to be significant only in the short- and medium-term and pale in comparison to the nature of the *dynamic* gains that should be attainable through a CU. Such dynamic benefits of a CU are based on the potential gains a small, underdeveloped economy may reap from integrating with a larger, more advanced economy. Principally, the advantage the small economy obtains from entering into a CU with a larger economy consists of free market access, thereby enlarging the 'home market'. Indeed, as Kanafani argues (1996: 39), a significant benefit the Palestinian economy would gain through entering into a CU with Israel was the elimination "of one of its most debilitating structural constraints, namely the limited market".

Access to a large market should allow a higher level of production in sectors with a comparative advantage, achieve economies of scale and a more efficient allocation and utilization of resources. The exploitation of comparative advantage encourages further investment while the scale effects lead to a higher productivity of these investments. In addition investments are induced by the inflow of FDI intended to take advantage of the proximity to a large market and a domestic economy with low labor costs. The transfer of knowledge and technology that is likely to take place further exemplifies the expected dynamic nature of benefits of a CU.

Another benefit of a CU for the smaller, less advanced economy consists of issues related to political economy or what Bagwell and Staiger (2003: 32) call the 'commitment approach'. By institutionalizing free trade with the CU partner and anchoring a CET, a CU provides certainty and transparency for investors on the one hand. On the other hand, a CU arrangement avoids costly lobbying and rent-seeking by domestic interest groups seeking to alter trade policy determinants and provides incentives to obtain incomes through market activities rather than lobbying efforts. The significance of the latter argument has been repeatedly stressed in studies assessing the benefits of CU for the Palestinian economy (see e.g. De Melo, 2003; Schiff, 2002: 17). However, as most analyses of Palestinian economic performance and trade development since 1994 have established, the trade regime in place has delivered few, if any of the static or dynamic benefits of integration, with respect to structural transformation, investment, productivity, or market access. Whatever limited knowledge and technology transfer effects of the proximity to Israel may have

occurred, these have kept Palestinian producers many stages behind the rapidly and constantly growing and transforming Israeli economy.

2-3 Stylized facts of Palestinian trade

This then, is as much as can be said in a succinctly abbreviated manner about CU theory that provided a framework for analyses anticipating the Palestinian economy to benefit from the PER, not least through an export-oriented growth strategy facilitated by its trade related provisions. The unfolding reality in the aftermath of the PER, however, was unkind to those authors who had expressed optimism, qualified, guarded or otherwise that it would facilitate a much-needed recovery of the Palestinian trade sector. As this section documents, the trade performance of the Palestinian economy under the provisions of the PER did not undergo a process of structural transformation and in many ways, sustained or worsened detrimental features that characterized the imposed nature of the trade relations with Israel in the previous decades. To what extent this disappointing trade performance was due to unforeseen political and security developments within the wider Oslo process, the lack of implementation of the PER or its actual design will be discussed in the next section.

To begin with, let us recall that the ambition of the PER, by implication or explicit recognition, was to rectify the lopsided trade relation with Israel through recognizing the right of the Palestinian economy to develop and build external economic relations according to its own interests. This implied reversing two key symptoms of economic dependency on Israel, namely the excessive trade concentration with Israel and the resulting chronic, and high, trade deficit. A brief look at trade data from 1986, that is before the start of the first *intifada* partly interrupted ‘normal’ trade relations and further undermined the quality of available data, illustrates the challenge that the PER was expected to be able to overcome.

In 1986, the total volume of Palestinian merchandise exports was \$378.3 million (25.3 percent of GDP) against \$890 million (59.6 percent of GDP) in imports, leading to a merchandise trade deficit of \$511.7 million (34.3 percent of GDP) that was covered, in large parts, by Palestinians working in Israel and remittances. Expressing total trade (exports+ imports) as a ratio of GDP to measure trade openness indicates, at first sight, that the Palestinian economy was highly ‘open’ at 84.9 percent. However, once its main trading partner – Israel – is excluded from this calculation, the Palestinian economy turns into a rather closed economy with a trade openness index of 13.1 percent as confirmed by the trade data with Israel. In 1986, merchandise exports

destined to Israel were estimated at \$274.6 million (72.6 percent of total exports) and the value of imports purchased from Israel was \$797.8 million (89.6 percent of total imports), resulting into an estimated trade deficit with Israel in the amount of \$523.3 million (or 35.0 percent of GDP).

This trade concentration with Israel, in particular in regards to imports, is further exemplified by contrasting trade figures with the second most important trade partner, Jordan. In 1986, the Palestinian economy exported 26.6 percent of its total exports to Jordan while importing just a mere 1.2 percent (calculated from UNCTAD, 1989: Table 8). Although the Palestinian economy experienced a sizeable growth in its exports during 1970-1986, so did the level of imports, thus unable to affect the chronic trade deficit (UNCTAD, 1989: 39). Data on the composition of Palestinian trade in the 1970s and 1980s is rather sketchy. No data on the commodity composition of merchandise trade with Israel exists which, in any case, should be treated as internal trade rather than international trade (UNCTAD, 1989: 44, 48). Data on the trade composition with Jordan – the Palestinian's economy second main trading partner – exists however, and reveals that agricultural exports consisted mainly of citrus fruit while the bulk of industrial exports was provided by processed food products such as olive oil and dairy. Whereas industrial imports from Jordan consisted mainly of oils used in soap production and dairy products, the value of imports from Jordan is altogether too insignificant to allow for any meaningful commodity composition. In 1986, just 1.3 percent of the total agricultural imports from countries other than Israel come from Jordan – in comparison, 13.2 percent of the total industrial imports from countries other than Israel came from Jordan.

The PER in general and its trade related provisions in particular must be assessed against the background of its institutional capacity to counter the widespread existence of structural distortions in the Palestinian economy and lopsided trade patterns as shown above. By institutionalizing a CU, it was of course expected for the Palestinian economy to trade more with Israel. In fact, if increase in the volume of bilateral trade is taken as the sole basis to assess the PER, then there is no doubt that it has been a success. However, as Al-Botmeh and Kanafani (2006: 81) point out, the formal objective of the PER – and the explicit goal of its Palestinian negotiators – was not to increase bilateral trade *per se*, but to reverse its asymmetric nature that has resulted into a chronic trade deficit, import dependency on one country and underdeveloped trade relations with the rest of the world.

Thus, from a Palestinian perspective, the success of the PER should be measured on the basis of its ability to restructure its trade relation by

diversifying its trading partners and penetrating into new markets, thus facilitating the establishment of a Palestinian economy with greater autonomy. Arguably, a CU might have been counter-intuitive to achieving these goals given that it is premised on greater integration with Israel, not with other partners. While the circumstances that made Palestinian negotiators agree to a CU are discussed in the next section, for now it suffices to note that a number of provisions within the CU – such as the list of goods Palestinians were free to import from other sources or the agreed on phasing out of quotas on Palestinian agricultural exports to Israel, as well as the general *spirit* of the PER that promised fairer trade relations with Israel and, for Palestinian producers, freer access to Israeli and international markets – should have put achievement of these goals within the realm of the possible. Instead, Palestinian trade performance under the PER has been disappointing and not only failed to ameliorate, but also worsened, many of the structural problems in the Palestinian economy. The extent to which these outcomes are due to the intrinsic design of the PER or rather caused by unforeseen political developments is discussed further below.

Table 1 (in the Appendix to this chapter) provides a general glance at the Palestinian's economy merchandise trade performance from 1997 onwards.⁷ Although the value of exports gradually increased (with the exception of the collapse caused during the second *intifada*), its growth of 146.8 percent for 1997-2014 lags behind the growth rate of imports that registered at 153.9 percent for the same time period. Significantly, the export base of the Palestinian economy not only remained exceptionally weak, but also deteriorated when compared to its level in the 1980s. As mentioned earlier, the ratio of exports to GDP for 1986 was 25.3 percent; between 1997 and 2014, the ratio moved between its peak of 10.2 percent in 1997 to its historical low of 6.5 percent in 2010. On the other hand, the import to GDP ratio, despite its decline in the period under investigation, actually increased from its levels in the 1970s and 1980s and remains exceptionally high an average of 51.3 percent. As a result, the trade deficit of the Palestinian economy steadily increased and its ratio to GDP (with an average of 43.5 percent between 1997 and 2014) was significantly higher than its level in the previous decades. From 2008 onwards however, there has been a notable decline of the trade deficit/GDP ratio from 50.3 percent in 2007 to 37.3 percent in 2014 which, at first sight, appears as a cautious sign of relative improvement in the Palestinian economy's external balance but actually reflects the preponderance in the import bill of increasingly inexpensive bulk

⁷ 1997 is taken as a base year to allow for an analysis of the trade performance once the changes brought forward by the PER to come into full effect.

import items such as oil products. Indeed, a closer look at the data reveals that the downward trend of the trade deficit to GDP ratio was mainly driven by increased GDP growth. And since GDP growth since 2008 has been largely aid-driven (UNCTAD, 2011a), the resulting decrease of the trade deficit to GDP ratio was neither a sign of a sustainable recovery nor did it provide a basis for a structural improvement of the economy's external balance.

Table 2 highlights the peculiar nature of the Palestinian economy's merchandise trade relation with Israel under the framework of the PER. An assessment of the trends in bilateral trade not only reinforces the description of the general structural problems as they are reflected in the total merchandise trade performance, but these are also the driving force behind many of the problems in the Palestinian external sector given the predominance of the Israeli-Palestinian trade relations. True, to take a more positive outlook, the last nineteen years have seen a gradual, slow but noticeable reduction in the Palestinian's external sector asymmetric and extreme dependence on the Israeli economy. Thus, the ratio of exports to Israel to total exports declined from 94.1 percent in 1997 to 83.9 percent in 2014. Likewise, the ratio of imports from Israel to total imports declined from 82.7 percent to 69.9 percent in 2014. Between 2008 and 2014, the growth in the Palestinian economy's total exports, and those destined to Israel, outstripped the growth of its imports from the rest of the world and Israel. As a result, the ratio of the trade balance with Israel to the total trade balance declined from 80.4 percent in 66.8 percent in 2014 or, as expressed in relation to GDP, from 39.7 percent in 1997 to 24.9 percent.

There are a number of factors that may account for the relative decrease of the Palestinian economy's trade dependence on Israel. First, past and ongoing policy initiatives coordinated by PA ministries and private sector associations to acquire better global market information to penetrate into new markets or exploit price differences to import goods at cheaper prices from suppliers other than Israeli are gradually showing results (see e.g. PNA, 2011: 25-27). Second, both small-scale efforts to substitute Israeli imports by local production as well as civil society campaigns to boycott Israeli goods are likely to have played some part in reducing the relative share of imports from Israel.⁸ Third, some of these trends may have also been influenced by a change in Israeli tariff policies. Specifically, the elimination or reduction of tariffs on a range of consumer goods increased the relative price of Israeli goods, thus providing an incentive for Palestinian buyers to import goods

⁸ For the second quarter of 2015 for instance, the World Bank (2015: 5) reported a 24 percent decline of Israeli imports citing the same reasons.

from other trading partners (WTO, 2012: viii; 17). Fourth, changes in world prices affecting fuel imports and the fact that there is a high proportion of re-exports from Palestine to Israel that are not Palestine-originating products (some 27% of total exports) have helped to bring down the deficit. Finally, with the Gaza Strip's heightened blockade since the mid-2000s, including the dramatic reduction in, if not total ban on (as in the case of exports), trade with Israel, the observed changes in the bilateral trade with Israel are entirely due to developments within the external sector of the West Bank. Given that the Gaza Strip's relative import dependency on Israel has been much higher than that of the West Bank historically, the significant drop in Gaza's imports from Israel thus automatically 'reduces' the import dependency of the Palestinian economy as a whole.

These gradual changes for the better notwithstanding, they are – more realistically – better interpreted as a small, slow and perhaps reversible improvement. While, as argued, some of these changes have come about by conscientious trade policy efforts and have been driven by a higher rate of exports in the past years, the trade balance is more likely to be determined by variations in imports given that their total value is about six times the value of total exports. Moreover, the ability of Palestinian businesses to export their goods still remains significantly influenced by the relative intensity of border closure and transaction costs involved in moving goods across the border. While incidences of border closure in the West Bank have declined in the past years when compared to the previous decade, this situation cannot be taken for granted given the volatility of political developments (UNCTAD, 2011: 7-8). On a more fundamental level however, the stylized data on Palestinian trade show that since 1997, export growth still lacks behind import growth and that the trade deficit, despite its decline, remains high. Likewise, and again despite relative improvement, the lopsided dependency on trade with Israel persists – about two-thirds of the Palestinian trade deficit is caused by trading with one partner – with potential significant economic and political costs.

To round up the overview of Palestinian trade performance under the PER arrangement, we briefly assess the composition and geographical distribution of Palestinian trade.

Table 3 disaggregates Palestinian imports into SITC groups (Standard International Trade Classification) for selected years. SITC groups 0 to 4 are generally labor intensive goods, while those between 5 to 9 are mainly capital

intensive.⁹ The composition of Palestinian imports over the period between 1997 to 2014 reveals two observations of note. First, before the start of the second *intifada*, more Palestinian imports consisted of capital intensive goods (53.4 percent in 1999) than labor intensive goods (46.6 percent in 1999), with manufactured goods ranked as the single most imported SITC group (24 percent). In 2003 however, these import categories switched ranks giving the lead to labor intensive goods, a trend that has continued since then. In 2014, labor intensive goods consisted of 58.5 percent of total imports. Second, the main reason tilting the balance towards SITC 0-4 goods is the significant increase in SITC category 3 imports consisting of mineral fuels etc. Whereas in 1997, this group merely ranked fourth with 13 percent of all registered imports, the group catapulted to the highest imported category from 2003 onwards, reaching 33 percent in 2014. The bulk of goods of the SITC category 3 are imported from or via Israel – in particular gasoline, diesel and electric energy (ibid: 9-10).

Table 4 shows that the composition of Palestinian exports that is dominated by capital intensive goods (67.8 percent in 2014) as opposed to labor intensive goods (32.0 percent). The bulk of exports in the former category consists largely SITC groups of manufactured goods (SITC 6) and miscellaneous manufactured articles (SITC 8). However, their dominance in Palestinian exports should not be confused with a strong or advanced domestic industrial sector since most of the goods consist of low technology and added-value products such as machine parts (SITC 8) and textiles, ceramics and building stone (SITC 6)z

Table 5 and 6 summarizes the geographical distribution of Palestinian exports and imports and together underscore the assessment of Palestinian trade dependency on Israel and, by extension, the untapped potentials for expanding trade diversification. While the value of imports from both Arab countries in Asia and Africa between 1999 and 2014 has increased considerably by 258.1 percent, and 179.1 percent respectively, Palestinian imports from these sources remain insignificant accounting in 2014 for 3.8 percent and 1.0 percent, respectively of total imports. The EU as an import market also remains well below potential – although the growth of import value increased by 6.5 percent between 1999 and 2014, the relative contribution of imports from the EU to the total value of Palestinian imports has declined from 16.1 percent to 9.1 percent in the same period. Within the regional classification of Remaining Asian Countries – which includes Israel as the main source of

⁹ Though not exclusively, since cigarettes and minerals and fuels are included in SITC 0-4 and are increasingly capital-intensive categories.

imports – Turkey constitutes the second most important import source with 5.7 percent of total value of imports in 2014 and China the third most important source with 5.0 percent. Palestinian exports destined to countries other than Israel, despite being marginal in their absolute value, have experienced a relatively greater trade diversification than imports over the past two decades.

This is indicated by the significant growth in their value – though arguably often from a low starting point. For instance, exports to American Countries increased from US\$ 17 thousand in 1997 to US\$ 13 million in 2014, representing an increase by 3,493 percent even while exports to this regional market represent only 1.4 percent of total Palestinian exports. In contrast, the relative contribution of exports to Arab Asian Countries to Palestine's total exports increased from 5 percent in 1997 to 12 percent in 2014. While encouraging, this increase is still below the potential considering the geographical and cultural proximity and similar consumer demand of Arab neighboring countries that implies possibly achieving greater economies of scale in some sectors were normal market access possible.

Of concern is also the low value of exports and export ratio to the large EU market: while its value increased from US\$ 878 thousand in 1997 to US\$ 20 million in 2014 (an increase of 1,217 percent), only about 2.1 percent of Palestinian total exports are destined to the European market. This weak performance is notwithstanding that in several agricultural branches Palestinian exports to EU are duty-free, an advantage not even enjoyed by Israel. As for the Remaining Asian Countries, the observed degree of diversification noted for Palestinian imports has not reached Palestinian exports which are still largely destined to Israel. Altogether, these trends show that the number of trade agreements the PA has entered into with other countries or trading blocs has not produced the desired effect of trade diversification in order to reduce the Palestinian external sector's dependence on Israel.

2-4 The CU: diplomatic compromise, political failure or economic trap?

The disappointing performance of the Palestinian external sector over the last two decades has sparked many debates aimed at identifying the underlying reasons behind the failure to revitalize the Palestinian external sector and undo the macroeconomic imbalances caused by structural factors stifling its improvement. These debates ensued right after the PER was signed, thus

indicating the disputed manner with which the trade-related aspects of the PER were received (see e.g. Elmusa and El-Jaafari, 1995; Dabbagh, 1996). In this context, it worth remembering that the CU was not the preferred choice of Palestinian negotiators who initially hoped to agree on an agreement more resembling an FTA with Israel (Arnon and Spivak, 1998). However, both the interim nature of the PER, originally conceived to be in force for five years only, as well as an expected economic trade-off between, on the one hand, acquiring a greater level of trade policy autonomy (as in the case of a FTA) and, on the other, maintaining relatively free access to the Israeli labor market which a CU was seen as more likely to ensure than a FTA. The latter deliberation was particularly important given that around one-third of the Palestinian labor force found employment in Israel, thus providing a significant relief to the domestic economy.

By contrast, Israel opposed a FTA primarily because such an arrangement would have necessitated the delineation of custom borders and thus, so its negotiators argued, predetermined an outcome that should have been left to final status negotiations. Israeli negotiators also reminded their Palestinian counterparts that a FTA would provide no guarantees for maintaining access to the Israeli labor market on their part, a threat that made the Palestinian side reconsider their preference for a FTA (Farsakh, 2005: 128). According to Kleiman (1994: 335), Israel was only willing to offer a FTA-like arrangement for the Gaza Strip as its location would have made the establishment of borders more feasible. Such differential treatment of the Gaza Strip and the West Bank was counter to the interests of Palestinian negotiators who insisted on preserving the institutional and legal unity of both territories. In the end, given the need to maintain access to the Israeli labor market, the asymmetric distribution of power between the two negotiating sides and Israel's insistence that no economic or political borders were to be erected in the interim period, the CU-formula was the only possible outcome (Arnon, 2007; Jureidini, 1998).

Kanafani et.al. (1998: 1) classify the debates around the assessment of the PER according to three different interpretative schools. The first considers the formal rules governing the PER as a sound framework that should have boosted the Palestinian external sector given the conventional view regarding the benefits of integration for a small economy with an advanced one. That the PER failed to do so in practice was due to the quickly deteriorating political relation between Israelis and Palestinians, the proliferation of the Israeli closure strategy that halted or significantly interrupted the movement of goods and the detrimental effects this had on the Palestinian economy in general and advancing competitiveness of its external sector in particular. The

problems that have caused the poor performance of the Palestinian trade sector, therefore, were overriding political and security factors *external* to the PER, which otherwise was economically the best deal for Palestine (see e.g. Hleileh, 1999; Kleiman, 2001). Such a view was reiterated and reaffirmed as late as 2006 by the World Bank.

The second interpretation, while acknowledging the overall difficult political environment, locates the factors responsible for the poor trade performance as *internal* to the provisions of the PER and specifically Israeli and Palestinian failure to exploit the framework to its maximum. Indeed, reams of studies have argued that, as the stronger side, Israel has routinely violated the spirit if not the actual provisions of the PER (see e.g. Zaghera and Zumlot, 2005), even while claiming to be abiding by it. This perspective not only considers the implementing failure of certain provisions of the PER, but also Israel's peculiar interpretation of those arrangements it actually implemented. To start with, the JEC – the body formally responsible to supervise the implementation of the PER – was supposed to serve as a technical body of dispute resolution but became quickly politicized by Israel's linking of economic and security matters (Khalidi and Rad-Taghdisi, 2009: 16). Ineffective, and rarely convening during better times, the JEC has been de facto inactive since 2000 (Husseini and Khalidi, 2013). As a consequence, neither were Palestinian policymakers notified in advance by Israeli changes regarding its trade policies (or concerning its treatment of the Palestinian side), nor could issues that were supposed to be advanced by the JEC, such as reviewing quantities in Lists A1 and A2 or a fairer sharing of VAT and import tax clearance, be realized. Reviewing – and expanding – these lists to, as agreed in the PER, respond to growing Palestinian 'market needs', should have equipped the Palestinian side with greater leeway to reduce dependency on Israeli imports and diversify its trading partners.

Another area specific to the manner in which Israel chose to implement the Protocol with significant adverse repercussions on the Palestinian economy was the issue of refunding of import taxes, the imperfect – or rather deliberate – handling of which resulted into fiscal leakage. As calculated by UNCTAD (2014), these amounted to US\$ 310 million in 2011 or 3.6 percent of GDP, causing substantial drain on the PA's revenues and undermining its attempts to reduce its public deficit. More recent research by the World Bank (2016) has revealed additional sources of fiscal leakage that bring the total estimated leakage to a minimal annual amount of more than \$500 million. Fiscal leakage is caused by Israel's handling of what it constitutes as imports to the Israeli market even if ultimately transported to the Palestinian market by the Israeli importer. According to the PER, all imports from ROW destined to the

Palestinian markets are subject to import tariffs, collected by Israel and transferred to the PA. In reality however, Israel did not consider the following import practices as Palestinian imports and as a result transferred only a fraction of revenues associated with imports: foreign goods unambiguously destined to the Palestinian market through relevant invoices and bills but imported by Israeli traders (re-imports); imports of Israeli-manufactured goods that have however a high import content and thus should be considered as foreign imports (Al-Botmeh and Kanafani, 2006: 12-13). Palestinian trade relations to third parties have also been severely constrained by the PER. This cannot only be reduced to closure-related obstacles but must also account for Palestinian trade being subject to Israeli technical, sanitary and phytosanitary standards or Israel's non-recognition of preferential trade agreements signed by the PA

A third interpretation has emerged to explain the disappointing developments in the Palestinian external sector, based on a more structural explanation. Here, the argument advanced is that the PER was flawed from the outset and that *even a fully implemented* agreement in the best security and political circumstances would not have improved conditions in the Palestinian economy and its external sector. Rather than providing a basis on which the Palestinian economy could have overcome deleterious structures put in place under Israeli occupation since 1967, the PER merely institutionalized economic dependence on Israel (Roy, 1999). In particular, as has often been empirically observed in a CU, its terms are determined by the more powerful country, leaving the less developed country often with little leverage, or sovereignty, to enact trade policies more in line with its development needs (Arnon and Weinblatt, 2001; Heron, 2008). In the Palestinian case, with Israeli overriding security or economic factors at play, the exemptions provided by the Lists and the option for Palestine to maintain a less liberal tariff policy than Israel were never considered as part of an industrialization or broader development strategy since Palestinian trade policy could only mimic Israel's (Khalidi, 2014c).

Thus, at a historical juncture when a new trade arrangement for the Palestinian economy should have been equipped with more freedom to define sovereign trade policy as was for example suggested in the pre-Oslo economic development program prepared by the PLO under the stewardship of Yusif Sayigh (PLO, 1993), the opposite took place, leading to the detrimental trade outcomes as described above. However, it is not only the structural bias inherent in a CU that has been identified as a problem in this interpretation, but also the assumption of the benefits regarding economic integration between an economically backward and advanced economy.

That is to say, studies highlighting the potential benefits of a CU for the Palestinian economy have tended to understate the – equally potential – drawbacks. Naqib (2002: 5-7) and UNCTAD (1998: 48-50) argue that a CU within the structural relationship between the Israeli and Palestinian economy as it developed since 1967 cannot but ‘lock-in’ the Palestinian economy into an inferior position. While exports to the larger economy may increase, the CET can make imports of intermediate and capital goods more expensive, thus not only gradually wiping out the comparative advantage of the smaller economy, but also undermining its chances to construct a competitive advantage and undertake a process of structural economic transformation. Whereas much of the literature on CUs was written in an era when world trade was less liberalized and bilateral or plurilateral free trade agreements were not as widespread, the manner in which a CU today might deliver benefits (or not) to different partners depends on factors beyond the basic concepts of TC and TD between two partners to the union. Indeed, had the glut of studies making the case for a CU on *theoretical* grounds been more attentive to *empirical* evidence regarding the mixed if not poor effects of trade integration on smaller economies (Agosin and Tussie, 1993; Thirlwall and Pacheco-Lopez, 2008), a more forceful consensus regarding the need for a different trade policy framework for the Palestinian economy could have been established.

2-5 Moving beyond the CU

As the previous section indicated, it would be inaccurate to portray the arguments advanced by the detractors of the CU as solely based on an *ex-post* assessment of the Palestinian external sector’s performance under the PER. Indeed, a certain skepticism about the trade-related aspects of the PER, if not outright disappointment about their potential to transform the Palestinian economy, was articulated as soon as the PER became public. This was exemplified by the number of studies (under the third interpretation of the PER’s failings) that either compared the potential benefits to the Palestinian economy under various trade regimes (in particular that of a FTA) or proposed amendments to the trade-related regulations of the PER. Whereas some of the criticism directed towards the PER was intended to amend and improve its operation (under the second interpretation), considerable efforts were put into advocating for a change in the trade policy framework and relation with Israel after independence. Such efforts began before the second *intifada* brought many to rethink the nature of economic relations to Israel in the wake of its “separation” policies and measures. The nature of the proposed changes varied but their common denominator was the assessment that the

Palestinian economy had more to gain by exiting the CU and institutionalizing a different trade policy framework.

The underlying rationale behind different trade policy proposals will be outlined in the next chapters in line with the basic trade regime they advocated. To conclude this assessment of the PER, however, four positions underpinning the longstanding engagement advocating for the need of trade policy change are worth highlighting. First, a series of studies conducted by MAS in the early 2000s showed that structural imbalances in the external sector can only be rectified by reducing the degree of economic integration with Israel and moving towards greater regional integration. This would not only imply moving away from the CU with Israel and setting up a different trade policy framework, but also the assumption of some degree of sovereignty over trade borders along with the expansion of policy space to allow Palestinian decision-makers to take control over matters pertaining to macroeconomic policies. To reduce the initial costs such a move would inevitably entail, a concomitant investment strategy boosting the Palestinian economy's export sectors and local productive capacity would have to be put in place (El-Jafari, 2000; El-Jafari et.al., 2002; Sulieman, 2002).

Second, of the international organizations that approached the question of an appropriate trade policy framework for the Palestinian economy, the only organization that consistently argued for a change in the trade policy framework along the lines proposed by research conducted by MAS, is UNCTAD. From its first substantial study on trade policy in 1998 to its most recent one in 2014, UNCTAD remained unwavering in its position that the type of economic integration institutionalized by the PER was harmful to the Palestinian economy and should be replaced by a trade policy that is linked to achieving the twin goals of economic development and statehood.

By contrast, research on the optimal trade policy framework conducted by the World Bank since the Oslo process vacillated between recommendations. Indeed, for the World Bank the CU (2006), FTA (1993) and NDTP (2002; 2012) were all regarded as the optimal trade policy framework at different times, largely reflecting the Bank's response to political developments on the ground following Israeli measures or changes in its own intellectual trajectory. However rather than continuously adjusting trade policy recommendations to ever-changing political conditions, it may be more pertinent to specify a trade policy framework that is best suited to achieve a given set of national economic development goals.

Third, not only has the PLO¹⁰ reiterated its preference to establish a FTA during various formal and informal talks with Israel but the position has also been advocated by the National Economic Dialogue Project in May 2000 that brought together the PA and private sector under the umbrella of Paltrade (Bouillon, 2004: 72, 126). Moreover, the civil society sector has also urged for a reevaluation of trade relations with Israel, recommended considering changing the trade policy framework ‘unilaterally’ and enlisting the support of international parties to do so (Miftah, 2011). Thus, there is a broad, firm and unequivocal consensus within key stakeholders to move beyond the CU.

Finally, although arguably sparked by a combination of grievances, the street protests in the West Bank that took place in September 2012 declared for the first time coherent popular criticism of the PER as inhibiting Palestinian economic freedom (International Crisis Group, 2013; Khalidi, 2012). The tight coupling of the Palestinian economy with Israel through the CU has not only institutionalized trade dependency, but has also meant that much of the inflation leading to high living costs was imported through Israel. In particular the rate of the Palestinian VAT – which as per the PER was to be set at no less than two percentage points below that of Israel despite the enormous difference in the size of the two economies – reduced much of available incomes. It comes as no surprise that one outcome of the protests was for the PA to request a review of some of the provisions of the PER with the intention to undo some of its negative repercussions on the Palestinian economy.

The next chapter explores the basis on which existing literature has advocated for rectifying the deficiencies in the current version of the CU to create the conditions through which the Palestinian economy could fully exploit the benefits of the CU with Israel.

¹⁰ As articulated by its Negotiations Affairs Department, see e.g.: <https://www.nad.ps/en/our-position/economy>

Table 1: Total Value of Trade and Trade Balance in Palestine*, 1997-2014, in current \$

Year	Trade Transactions Value	Total Exports	Total Imports	Trade balance	GDP	Exports/GDP	Imports/GDP	Trade Balance/GDP
1997	2,620,984	382,423	2,238,561	(1,856,138)	3,759,800	10.2%	59.5%	-49.4%
1998	2,769,948	394,846	2,375,102	(1,980,256)	4,067,800	9.7%	58.4%	-48.7%
1999	3,379,375	372,148	3,007,227	(2,635,079)	4,271,200	8.7%	70.4%	-61.7%
2000	2,783,664	400,857	2,382,807	(1,981,950)	4,313,600	9.3%	55.2%	-45.9%
2001	2,323,996	290,349	2,033,647	(1,743,298)	4,003,700	7.3%	50.8%	-43.5%
2002	1,756,475	240,867	1,515,608	(1,274,741)	3,555,800	6.8%	42.6%	-35.8%
2003	2,079,948	279,680	1,800,268	(1,520,588)	3,968,000	7.0%	45.4%	-38.3%
2004	2,685,936	312,688	2,373,248	(2,060,560)	4,329,200	7.2%	54.8%	-47.6%
2005	3,003,035	335,443	2,667,592	(2,332,149)	4,831,800	6.9%	55.2%	-48.3%
2006	3,125,435	366,709	2,758,726	(2,392,017)	4,910,100	7.5%	56.2%	-48.7%
2007**	3,797,014	512,979	3,284,035	(2,771,056)	5,505,800	9.3%	59.6%	-50.3%
2008	4,024,614	558,446	3,466,168	(2,907,722)	6,673,500	8.4%	51.9%	-43.6%
2009	4,119,140	518,355	3,600,785	(3,082,430)	7,268,200	7.1%	49.5%	-42.4%
2010	4,534,025	575,513	3,958,512	(3,382,999)	8,913,100	6.5%	44.4%	-38.0%
2011**	5,119,308	745,661	4,373,647	(3,627,986)	10,465,400	7.1%	41.8%	-34.7%
2012	5,479,725	782,369	4,697,356	(3,914,987)	11,279,400	6.9%	41.6%	-34.7%
2013	6,064,515	900,618	5,163,897	(4,263,280)	12,476,000	7.2%	41.4%	-34.2%
2014	6,626,917	943,717	5,683,199	(4,739,482)	12,715,600	7.4%	44.7%	-37.3%

Source: PCBS, Registered Foreign Trade, 1997-2014

(*): The data excludes that part of Jerusalem which was annexed forcefully by Israel following its occupation of the West Bank in 1967.

(**): Revised Figures.

Table 2: Value and Trade Balance of Palestinian* Trade with Israel, 1997-2014, in current \$

Year	Trade Transaction Value	Value of Imports with Israel	Value of Exports with Israel	Trade Balance with Israel	% of Total Imports	% of Total Exports	% of Trade Deficit with Israel of Total Trade Deficit	Trade Balance Israel/GDP
1997	2,212,246	1,852,380	359,866	(1,492,514)	82.7%	94.1%	80.4%	-39.7%
1998	2,214,638	1,833,123	381,515	(1,451,608)	77.2%	96.6%	73.3%	-35.7%
1999	2,214,110	1,853,648	360,462	(1,493,186)	61.6%	96.9%	56.7%	-35.0%
2000	2,109,221	1,739,541	369,680	(1,369,861)	73.0%	92.2%	69.1%	-31.8%
2001	1,624,563	1,351,581	272,982	(1,078,599)	66.5%	94.0%	61.9%	-26.9%
2002	1,333,455	1,117,129	216,326	(900,803)	73.7%	89.8%	70.7%	-25.3%
2003	1,565,623	1,309,642	255,981	(1,053,661)	72.7%	91.5%	69.3%	-26.6%
2004	2,028,999	1,747,850	281,149	(1,466,701)	73.6%	89.9%	71.2%	-33.9%
2005	2,163,438	1,872,880	290,558	(1,582,322)	70.2%	86.6%	67.8%	-32.7%
2006	2,328,715	2,002,150	326,565	(1,675,585)	72.6%	89.1%	70.0%	-34.1%
2007**	2,763,215	2,307,987	455,228	(1,852,759)	70.3%	88.7%	66.9%	-33.7%
2008	3,244,252	2,794,829	449,423	(2,345,406)	80.6%	80.5%	80.7%	-35.1%
2009	3,104,623	2,651,129	453,494	(2,197,635)	73.6%	87.5%	71.3%	-30.2%
2010	3,361,739	2,873,343	488,396	(2,384,947)	72.6%	84.9%	70.5%	-26.8%
2011**	3,734,875	3,091,022	643,853	(2,447,169)	70.7%	86.3%	67.5%	-23.4%
2012	3,989,979	3,350,799	639,180	(2,711,619)	71.3%	81.7%	69.3%	-24.0%
2013	4,481,177	3,694,821	786,356	(2,908,465)	71.6%	87.3%	68.2%	-23.3%
2014	4,749,799	3,958,259	791,540	(3,166,719)	69.6%	83.9%	66.8%	-24.9%

Source: PCBS, Registered Foreign Trade, 1997-2014

(*): The data excludes that part of Jerusalem which was annexed forcefully by Israel following its occupation of the West Bank in 1967.

(**): Revised Figures.

Table 3: Composition of Palestinian imports, in percentage and current US\$ (thousand)

SITC groups	1997	1999	2001	2003	2005	2007	2009	**2011	2013	2014
0-Food and Live Animals	488,165 22%	524,314 17%	408,615 20%	305,184 17%	452,224 17%	493,296 15%	628,429 17%	758,528 17%	1,046,504 20%	1,125,367 20%
1-Beverages and tobacco	71,327 3.2%	104,929 3.5%	97,172 4.8%	90,612 5.0%	102,389 3.8%	134,503 4.1%	137,133 3.8%	171,033 3.9%	196,321 3.8%	196,799 3.5%
2-Raw materials, inedible, except fuels	76,136 3.4%	73,321 2.4%	42,094 2.1%	62,663 3.5%	62,034 2.3%	27,142 0.8%	36,815 1.0%	84,086 1.9%	66,545 1.3%	84,038 1.5%
2-Mineral fuels, lubricants metal, and related materials	378,304 17%	391,547 13%	377,478 19%	425,745 24%	718,269 27%	1,291,654 39%	1,141,421 32%	1,382,174 32%	1,613,433 31%	1,868,878 33%
4-Oils and fats, waxes animal and plant	23,880 1.07%	23,528 0.78%	15,930 0.78%	37,887 2.10%	20,343 0.76%	15,893 0.48%	17,656 0.49%	23,049 0.53%	27,401 0.53%	29,283 0.52%
5-Chemicals and related products	170,136 7.6%	225,559 7.5%	163,519 8.0%	182,412 10.1%	222,988 8.4%	223,137 6.8%	294,338 8.2%	370,139 8.5%	450,380 8.7%	491,034 8.6%
6-Manufactured goods classified by material	587,691 26%	715,674 24%	498,404 25%	353,096 20%	490,493 18%	448,250 14%	553,484 15%	729,250 17%	892,526 17%	889,317 16%
7-Machinery and transport equipment	277,312 12.4%	616,903 20.5%	248,323 12.2%	211,896 11.8%	433,895 16.3%	466,311 14.2%	571,155 15.9%	622,346 14.2%	630,745 12.2%	706,555 12.4%
8-Misc. manufactured goods	151,574 6.8%	321,232 10.7%	180,962 8.9%	124,351 6.9%	147,529 5.5%	183,848 5.6%	220,354 6.1%	232,789 5.3%	240,026 4.6%	291,923 5.1%
9-Unclassified commodities	14,036 0.6%	10,220 0.3%	1,150 0.1%	6,422 0.4%	17,428 0.7%	– –	– –	252 0.0058%	16 0.0003%	5 0.0001%
Total	2,238,561	3,007,227	2,033,647	1,800,268	2,667,592	3,284,035	3,600,785	4,373,647	5,163,897	5,683,199

Table 4: Composition of Palestinian exports

SITC groups	1997	1999	2001	2003	2005	2007	2009	2011**	2013	2014
Food and Live Animals	57,240	60,878	34,073	34,226	36,180	68,537	61,324	107,676	140,406	145,308
	15%	16%	12%	12%	11%	13%	12%	14%	16%	15%
Beverages and tobacco	19,639	14,567	13,478	12,980	14,322	15,649	21,957	30,403	45,206	46,858
	5.1%	3.9%	4.6%	4.6%	4.3%	3.1%	4.2%	4.1%	5.0%	5.0%
Raw materials, inedible, except fuels	17,237	13,406	12,887	13,357	13,165	13,242	7,183	95,908	139,762	83,266
	4.5%	3.6%	4.4%	4.8%	3.9%	2.6%	1.4%	12.9%	15.5%	8.8%
Mineral fuels, lubricants metal, and related materials	6,175	4,952	2,161	3,871	12,220	8,163	2,709	1,624	2,153	2,198
	1.61%	1.33%	0.74%	1.38%	3.64%	1.59%	0.52%	0.22%	0.24%	0.23%
Oils and fats, waxes animal and plant	7,907	4,133	5,755	7,214	12,276	17,777	14,628	20,111	12,753	28,108
	2.1%	1.1%	2.0%	2.6%	3.7%	3.5%	2.8%	2.7%	1.4%	3.0%
Chemicals and related products	22,701	30,250	27,594	26,028	28,866	66,650	67,747	52,731	49,387	46,869
	5.9%	8.1%	9.5%	9.3%	8.6%	13.0%	13.1%	7.1%	5.5%	5.0%
Manufactured goods classified by material	165,578	151,241	120,473	110,530	129,788	222,014	210,548	256,047	279,699	328,844
	43%	41%	41%	40%	39%	43%	41%	34%	31%	35%
Machinery and transport equipment	21,715	20,758	16,920	14,767	18,522	28,297	30,025	32,182	40,140	37,583
	5.7%	5.6%	5.8%	5.3%	5.5%	5.5%	5.8%	4.3%	4.5%	4.0%
variety articles	58,877	71,545	56,496	51,024	64,645	71,734	102,233	148,979	191,114	224,684
	15.4%	19.2%	19.5%	18.2%	19.3%	14.0%	19.7%	20.0%	21.2%	23.8%
Commodities and transactions not classified elsewhere	5,354	418	512	5,683	5,459	916	—	—	—	—
	1.40%	0.11%	0.18%	2.03%	1.63%	0.18%	—	—	—	—
Total	382,423	372,148	290,349	279,680	335,443	512,979	518,355	745,661	900,618	943,717

Table 5: Destination of Palestinian imports

International Groups	1997	1999	2001	2003	2005	**2007	2009	**2011	2013	2014
Total of Arab Asian Countries	25,563 1.1%	60,886 2.0%	23,779 1.2%	26,643 1.5%	36,399 1.4%	50,274 1.5%	56,475 1.6%	127,632 2.9%	171,484 3.3%	218,043 3.8%
Total of Remaining Asian Countries	1,947,951 87%	2,285,629 76%	1,534,842 75%	1,514,979 84%	2,250,059 84%	2,845,158 87%	3,044,078 85%	3,625,895 83%	4,350,773 84%	4,712,764 83%
Total of Arab African Countries	30,583 1.4%	20,185 0.7%	13,002 0.6%	19,078 1.1%	32,601 1.2%	36,041 1.1%	35,500 1.0%	34,675 0.8%	43,561 0.8%	56,332 1.0%
American Countries	29,294 1.3%	98,806 3.3%	52,009 2.6%	42,891 2.4%	51,077 1.9%	48,350 1.5%	70,270 2.0%	76,303 1.7%	87,142 1.7%	94,328 1.7%
Total of European Union Countries	178,903 8.0%	484,644 16.1%	358,829 17.6%	154,564 8.6%	250,356 9.4%	246,352 7.5%	348,467 9.7%	443,818 10.1%	455,472 8.8%	516,116 9.1%
Total of Remaining European Countries	17,691 0.8%	41,340 1.4%	32,743 1.6%	27,204 1.5%	33,107 1.2%	52,907 1.6%	36,946 1.0%	53,018 1.2%	38,768 0.8%	65,075 1.1%
Other Countries	8,576 0.38%	15,737 0.52%	18,444 0.91%	14,908 0.83%	13,993 0.52%	4,953 0.15%	9,049 0.25%	12,306 0.28%	16,696 0.32%	20,542 0.36%
Total	2,238,561	3,007,227	2,033,647	1,800,268	2,667,592	3,284,035	3,600,785	4,373,647	5,163,897	5,683,199

Table 6: Destination of Palestinian exports

International Groups	1997	1999	2001	2003	2005	2007	2009	**2011	2013	2014
	Total of Arab Asian Countries	19,043 5%	9,278 2%	14,497 5%	14,796 5%	23,155 7%	33,044 6%	38,449 7%	66,504 9%	81,472 9%
Total of Remaining Asian Countries	358,367 94%	360,469 97%	273,164 94%	256,355 92%	292,475 87%	456,018 89%	454,119 88%	645,767 87%	790,978 88%	769,032 81%
Total of Arab African Countries	15 0.00%	360 0.10%	79 0.03%	181 0.06%	2,701 0.81%	1,728 0.34%	11,832 2.28%	7,498 1.01%	2,873 0.32%	1,472 0.16%
American Countries	17 0.00%	365 0.10%	128 0.04%	961 0.34%	4,321 1.29%	3,616 0.70%	8,825 1.70%	10,570 1.42%	11,204 1.24%	13,115 1.39%
Total of European Union Countries	878 0.23%	1,519 0.41%	2,453 0.84%	7,041 2.52%	11,556 3.44%	18,076 3.52%	4,720 0.91%	14,463 1.94%	13,153 1.46%	20,005 2.12%
Total of Remaining European Countries	2,103 0.55%	7 0.00%	28 0.01%	327 0.12%	173 0.05%	127 0.02%	203 0.04%	786 0.11%	547 0.06%	1,248 0.13%
Other Countries	2,000 0.52%	150 0.04%	1 0.00%	18 0.01%	1,063 0.32%	370 0.07%	157 0.03%	73 0.01%	391 0.04%	706 0.07%
Total	382,423	372,148	290,349	279,680	335,443	512,979	518,355	745,661	900,618	943,717

Chapter 3. An improved Customs Union

As discussed in the preceding chapter, the view that the CU is the optimal trade policy framework for the Palestinian economy in *theory* still carries significant weight given the potential benefits that a small economy should derive from integrating with an advanced one under normal conditions of sovereignty that delineate two distinct economies (however much joined they might be in trade). To realize these benefits, proposals for amending and improving the actual working of the PER were articulated soon after the agreement came into effect and, indeed, remain high on the agenda of many plans aimed at strengthening the Palestinian economy. Such proposals are geared towards finding new mechanisms, or reviving old ones, and modifying regulations to make the PER work more seamlessly and to the advantage of the Palestinian economy. The regularity with which such proposals are presented not only indicates the enduring institutional problems facing the Palestinian external sector as outlined earlier. It also gives support to the view that the PER is an ‘incomplete contract’ in the sense it failed to address a range of issues or did so only imperfectly (Arnon, 2002) and hence, more than often, worked towards the advantage of Israel as the stronger party.

In line with the three schools of thoughts assessing the causes of the failure of the PER to strengthen the Palestinian economy, proponents of improving the CU belong to an intersection of the first and second, locating the reasons of failure either in the deteriorating security situation and political relations between the PA and Israel or in Israel’s deliberate exploitation of vague regulations and loopholes in the PER. Key to creating a momentum for negotiations in which PER regulations could be modified and amended is the restoration of the spirit of trust and cooperation that characterized the initial diplomatic encounter between the PLO and Israel in the early 1990s. Such a spirit, in which the creation of a prosperous Palestinian economy becomes a mutual interest, would supposedly also counter many of the factors that have contributed to the worsened security situation in the past.

The proponents of fixing the Protocol approach the matter from two angles. One considers that if the political conditions are right, the shortcomings of the current arrangement can be fixed and new commitments adopted addressing some core issues and the optimum policy for Palestine would be an improved CU as a permanent arrangement with Israel. This is the position suggested by the World Bank (2006), though other voices from Israel and elsewhere have also advocated this (reviewed in Husseini and Khalidi, 2014). Another

position seeks an improved CU as a transition until a final political solution is reached, after which Palestinians could decide on a new trade policy regime. This has been considered, for example, as part of proposals to improve some of the most detrimental aspects of the current situation until circumstances permit a bolder departure that might be warranted (PLO/NSU; n.d.)

The arguments underpinning the theoretical and potential advantages of the CU have already been discussed in the previous chapter and the range of suggestions for changes that fall under the rubric of ‘trade facilitation’ aimed at improving Palestinian trade performance within current constraints have been recently and exhaustively examined elsewhere (UNCTAD, 2015). For some analysts, these are the major impediments that mostly explain the dismal export performance. But the discussion on an improved CU has often also conflated the need to address trade facilitation constraints imposed by Israel on Palestinian trade with proposals related to improving the design of the PER/CU, even though the former largely fall outside the specific texts of the Protocol and are largely justified by Israel on security grounds.

Hence, this chapter focuses on the main institutional reforms aimed at improving the design and/or the implementation of the literal provisions and mechanisms of the PER that, it is argued, could enable the Palestinian economy to fully exploit the benefits it promises. This will be done in section 3.2 while section 3.3 considers the feasibility of these proposals and assesses to what extent they are conducive to achieve wider goals of autonomous economic decision-making and political sovereignty. Before that in section 3.1, we will briefly consider the empirical underpinnings of the recommendation for an improved CU.

3-1 Empirical background

As a baseline framework, the CU in its current and improved format is subject to simulations in studies addressing the question of an optimal trade policy framework. Yet, there have been very few studies that explicitly made the case that an improved CU would have greater advantages for the Palestinian economy than any other trade policy framework. Indeed, the notable study that falls within this category is one of the annual World Bank’s *Country Economic Memorandum* (2006; see also Sadan and Lowenthal, 1997 for a less substantiated plea). The analytical basis on which the World Bank makes the case for an improved CU as the best path to sustained Palestinian economic growth is underpinned by a gravity model that measures the difference between actual trade flows between the two economies and those predicted on the basis of the economic size (GDP) and geographical distance between

them, as well as with reference to other variables such as population size or cultural and linguistic proximities. The Bank's simulation exercise shows, contrary to widespread assumptions, that the Palestinian economy does *not* overtrade with Israel (2006: 41). This conclusion is corroborated by an earlier study undertaken by the IMF (Bannister and Erickson von Allmen, 2001: 91) concluding that "no significant evidence is found that trade between Israel and the West Bank and Gaza is higher than what we might expect on average given their proximity, GDP, population, and other variables. In fact, to the extent that the actual bilateral trade flows are over recorded, the two economies may actually under trade with each other."

One implication of such a logic is that the demand to reduce Palestinian trade dependency on Israel actually misses the point. If anything, the trade flows between the two economies are within the realm of what would be expected given their geographical proximity. Therefore, the imbalances within the Palestinian trade sector are seen from this vantage point to arise from the undertrading with the ROW rather than overtrading with Israel. Consequently, continued, or even closer integration with Israel as the proposal of an improved CU implies would, in itself, not undermine the developmental potential of the Palestinian economy.

Both the IMF's and World Bank's conclusion in these studies were questioned on the basis of their robustness (Kanafani and Cobham, 2007: 54; Cobham, 2004: 46) and also contradict with the conclusions of an earlier study by the Bank according to which the Palestinian economy *does* overtrade with Israel (World Bank, 1993: 45-46). Curiously, a recent Bank of Israel report suggested the opposite of the World Bank's conclusions and implies that the Palestinian imports from Israel actually exceed what might be expected, stating that "a simple gravitation model can be used to estimate Israel's expected share of Palestinian imports. The expected share of Palestinian imports from Israel according to the model—about one third of total PA imports—is significantly lower than the actual share, which is about two-thirds. It is likely that factors that were not included in this model—including the uniform customs envelope and currency area and the fact that the transfer of goods from abroad to the PA is mainly via Israel's sea and air ports—may explain the difference between the results of the model and the actual figure" (Bank of Israel, 2010: 9).

To complicate matters further, while the World Bank takes the conclusions of the gravity model as an empirical justification for seeking an improved CU as the optimal framework for Palestinian trade policy, the IMF takes such conclusions to make the case for a non-discriminatory trade regime with low,

uniform tariffs (Bannister and von Allmen, 2001: 98-99). Nevertheless, the wider dynamic gains of integration supposedly offered by a CU outlined in the previous chapter, together with the Bank's interpretation of the results produced by its gravity model remain the essential basis on which an improved version of the CU is advocated. While the extent to which the dismal Palestinian growth path of the past twenty (or fifty) years can be imputed to the existence of a lopsided, imperfect and discriminatory CU is not part of this assessment, the CU has not been able to initiate a process of convergence. To a great extent, any attempt at a purely economic analysis of that subject misses the point stressed here throughout: as long as the political/security trumps the economic, any framework that accords Israel control and pressure points to deploy against the Palestinian economy will be sub-optimal, even if perfect in design, and its impact adverse as it has been to date.

3-2 Institutional changes

There are three main areas in which institutional changes to the functioning of the PER are considered as a way to create conditions through which the Palestinian economy can realize the potential benefits of an integrative process with Israel in the context of a CU-type framework. The fact that some of these proposals were already articulated in the 1990s, and continue to be on the PER-reform agenda, is testament to the enduring dysfunctional nature of the PER. The unceasing assumption behind such proposals however, now and then, is a determined effort to re-negotiate the PER underpinned by the spirit of trust, cooperation and mutual interests, while this essentially political assumption is often buttressed by economic theoretical arguments, as mentioned above. Such efforts may take place within a broader final status negotiation framework but do not necessarily have to be linked to it. Hence, whereas some advocates see in these institutional changes the necessary preconditions for the CU to function as a long-term trade arrangement for the Palestinian economy, others understand them merely as a transitional movement towards improving economic conditions in the short-run with the eventual possibility of breaking away from a CU once political conditions permit to do so. The counter-factual of whether full implementation of the PER would deliver significant benefits to Palestine requires an in-depth empirical assessment that is beyond the scope of this study, which in any case calls for political assumptions which are more in the realm of wishful thinking than realistic prospects.

a) Reactivating and reforming the Joint Economic Committee (JEC)

As stated in Article II of the PER, the original function of the JEC was “to follow up the implementation of the Protocol and to decide on problems related to it that may arise from time to time.” Made up by an equal number of economic experts on both sides, the JEC should have been an appropriate venue to discuss and decide on improvements in the implementation of the PER. However, such formal gestures of parity, within a much wider and imposing structure of asymmetric power, did little to empower the Palestinian side or equip it with mechanisms to compel Israel to fulfill its obligations as defined in the PER. It is also important to recall that the dysfunctional performance of the JEC was not only a result of the worsening nature of political cooperation between the two sides, but also due to vague stipulation of the authority vested in the JEC in the first place and, more crucially, to the fact that the PER itself failed to provide the JEC with unassailable means of enforcement. On the whole, Palestinian officials and others have long argued that there was a tacit decision by Israel as the stronger party to disempower the JEC, overburden it with security considerations within the overall strategy to condition any economic progress on the PA’s ability to meet Israel’s security demands that were impossible to meet in a credible manner (Aix-Group, 2013: 13; Khan, 2005). Palestinian experts have argued that “Israel used the JEC as a forum where the PA could raise implementation hiccups and, depending on how urgent they were or how accommodative Israel was at any moment, some “treatment” would be decided. Follow-up usually entailed the establishment of a “new” JEC sub-committee at the technical level that met for months before agreeing or not on any given step, incrementally, in a piecemeal and discretionary manner responding to commercial demands as they arose, not as part of any strategic economic cooperation process. ... Thus, Israel succeeded in manipulating the JEC as another of the “bilateral” instruments for prolonged occupation, drawing PA officials into a collaborative logic instead of a state-building process” (Husseini and Khalidi, 2013).

Such problems have long been argued as the key factors undermining the purpose and function of the JEC. One of the earliest and comprehensive assessment of the JEC was undertaken by Kanafani et.al. (1998: n.p.) who argued that the JEC was “totally incapable of rectifying [any] issues” pertaining to the structural improvement of trade-related provisions in the PER. Two decades later, the IMF (2015: 13), among many other international organizations throughout, once again reminded its readers of the importance of revitalizing the JEC as a forum of joint, and binding, economic cooperation and decision-making. To create a fully functioning

JEC, however, efforts have to go beyond cosmetic changes that would alter the form, but not the substance of its functioning. Thus, recommendations such as establishing a strict timetable for meetings, preparing mutually agreed on agendas or documenting and publishing the minutes of meetings (Kanafani et al., 1998: n.p.) are helpful but clearly insufficient in what is now a much-transformed environment. Instead, a number of observers also have argued that a key component to a revitalized and effective JEC would be the involvement of a third party as a neutral arbiter such as the WTO, EU or the UN Quartet to ensure “that the JEC does not turn what is supposed to be a bilateral forum into a unilateral tool for Israel” (Aix-Group, 2013: 40; see also Kanafani et al., 1998: n.p.; Nashashibi et al., 2015: 51; Toaldo, 2013: 9-10). In many studies, a functioning JEC is seen as a precondition for addressing a range of other institutional problems that need to be solved for the improved CU to materialize. Two of the main issues will be reviewed below.

b) Reviewing and expanding import lists

Like many other proposals as to how to improve the CU, the recommendation to expand import lists (Lists A1, A2 and B) has been on the agenda for a considerable time (see e.g. Kanafani et al., 1998: n.p) and – like many other proposals – has yet to be put into practice (Nashashibi et al., 2015: 51-52). Indeed, it has been firmly demanded by Palestinian negotiators throughout many formal and informal negotiations but – so far – to no avail. An amendment of these lists would undoubtedly increase the space for an independent Palestinian trade policy by providing Palestinian importers with cheaper sources to purchase their goods, reduce import dependency on one trading partner and also allow for taking greater steps towards regional integration. When the PER came into effect, Palestinians assumed, or expected, that the basic set-up of the list would soon be amended to account for ‘horizontal’ (increasing quantities) and ‘vertical’ (adding more goods) expansions. Such a development would have been neither a gesture of goodwill on behalf of Israel, nor a modification of the CU since the PER itself stipulated that one function of the JEC would be to decide on proposals, brought forward by the Palestinian side, to add goods to the lists, continuously review ‘market needs’ as well as changes in tariff rates and import procedures (Article III.16). These rounds of consultations were supposed to take place every six months to assess and update Palestinian ‘market needs’. It is testament to the dysfunctional nature of the JEC that these lists have been updated only once since 1994: in 1997, the ‘agreed quantity’ for seeds was updated to reflect, for once, the ‘market needs’ of the Palestinian economy (Toaldo, 2013: 4). Meanwhile, the supplement to the

PER Article 6 added several products to list A2 (cigarettes, alcohol, iron and cement), to be imported applying Israeli tariffs and taxes; rendering its inclusion meaningless.

There are, in addition, two other problems associated with the lists that will not be discussed here but should be cited. First, for some goods Palestinians are allowed to import on their terms, even the limited ‘agreed quantities’ are not fully exploited by Palestinian importers. This may be explained by the close commercial relationship that developed between Israeli and Palestinian traders, the advantage of door-to-door delivery and advantageous payment schedules that, all together, reduce transaction costs for Palestinian importers. Second, the existence of quotas, as is often the case, has given rise to rent-seeking practices and price fixing by Palestinian importers with exclusive import permits. While the former problem could be addressed by the provision of special and relaxed credit facilities to importers, the latter requires policies and laws for effective market deregulation and the creation of a competition authority. Besides the amendment of the lists, they also need to be comprehensively reviewed given that they were rather hastily compiled in 1994 and lack logic in some respects (MAS, 2015). For instance, goods in List A1 and List A2 significantly overlap: 31 out of 41 goods in List A2 are also included (in the same quantities) in List A1. Likewise, Article III.4 of the PER refers to List B as containing “basic food items and other goods” when in fact no food items are part of List B. Such poor or wrong specification creates unnecessary confusion, if not willful ambiguity, adds another layer of import impediments and enables Israel to enforce the interpretation it sees fit. The demand to expand these lists can also be understood in the context of attempts to liberalize the import market and reduce the monopolization of the Palestinian economy by Israeli suppliers.

It is instructive to sketch out how the ability, or inability, to purchase imports from other sources hinders or facilitates the creation of positive multiplier effects for the Palestinian economy. As already noted, while economic integration with Israel could provide the Palestinian economy with potential benefits, there are also drawbacks to the extent that a common CET is relatively high and that the CU limits importing goods from cheaper third parties, a situation that effectively reduces Palestinian purchasing power. On the other hand, were Palestinians allowed to import greater quantities and a wider spectrum of goods – that is, if the lists were to be expanded – gains would reverberate across the Palestinian economy: consumers would benefit from cheaper goods especially to the extent that

the expansion of the lists includes basic goods and food items, while producers could reduce their production costs and raise their competitiveness to the extent that the expansion of the lists includes raw materials and capital goods. However, an assessment of which goods on which Lists should be amended, the direction in and degree to which current tariffs could be modified in line with Palestinian development needs and assumptions about the welfare and structural effects of such changes are beyond the scope of this study.¹¹

In a related vein, albeit not strictly part of the discussion on reforming the Lists, there is also an urgent need to relax restrictions on so-called ‘dual use’ goods (goods that may be used for both civilian and military purposes) which Israel bars from importing due to its ubiquitous justifications of ‘security’. For instance, the agriculture sector is only allowed to import a type of fertilizer that is deemed ineffective with negative consequences for their competitiveness, while the ICT sector has had placed restrictions on it by the ban to import key telecommunication devices and technology. Restrictions on industry relate to classifying as ‘dual use’ a range of materials, machinery and equipment such as steel pipes, lathe, optical equipment or milling machines (Ministry of National Economy and ARIJ, 2011: 5-7). Many of these goods are essential for upgrading the Palestinian productive capacity and indeed, must be freely accessible so as to provide Palestinian producers with a level playing field. As argued in UNCTAD (2015: 8): “Even though the Israeli authorities have permitted the entry of some dual use goods to the West Bank, the procedures for import licensing and acquiring security clearance entail significant disadvantages to Palestinian shippers and an extended period of time... The Israeli authorities have applied the dual-use import system to prevent the entry of hundreds of items to Palestinian markets, thus weakening the Palestinian productive sectors especially metal, engineering, food and pharmaceutical industries, which face numerous restrictions”. Proponents of an improved CU are in agreement that for the CU to be viable, and for the potential benefits of the PER to be fully realized, a review and amendment of the three Lists is urgent, alongside removal of the dual-use lists restrictions.

c) A fairer revenue-sharing mechanism and an end to fiscal leakage

An equally problematic area that has marked the disadvantageous nature of the PER as a CU is the issue of revenue sharing and clearance. Just as the previous two areas in which improvements to the PER have been put

¹¹ These issues are the subject of research currently underway separately at MAS.

forward, proposals for tackling problems associated with revenue sharing have a long history and, given that progress has yet to be made, continue to be put forward (see e.g. IMF, 2012: 17; Jawhary, 1995; Khadr, 1999: 116; UNCTAD, 1996: 35).¹² As explained by Kanafani (2001: 287), revenue-sharing within a CU denotes a system “where all fiscal charges, including customs duties, import taxes and levies are redistributed on the basis of some aggregate variables related to consumption in different parts of the customs union” and should, in theory, compensate the smaller CU partner(s) for the effects of trade diversion and the loss of economic sovereignty. Revenues generated through the clearance system have consistently accounted to up two-thirds of the total Palestinian public revenues, thereby creating significant dependencies – itself a systematic flaw within the PER and Palestinian tax system (Adam et.al., 2004). Any delay in revenue transfer creates dangerous macroeconomic imbalances through a toxic mix of multipliers that destabilize public and private consumption and investment and compels public authorities to accumulate arrears to finance basic services (UNCTAD, 2011: 8-9). As the World Bank (2006: 35) put it bluntly, “many governments would find it difficult to exist, let alone manage their resources effectively, in the face of uncertainty and fluctuations of this magnitude. For the PA, to be a viable institution, it needs to receive the revenues it is entitled to in a timely and predictable manner.” Consequently, enhancing the collection of customs revenues is of great importance, just as securing Israel’s commitment to end its practice to, as it were, *weaponize* the revenues by politically motivated delays (Al-Haq, 2015).

However, proposals for a fairer revenue-sharing are not primarily aimed at improving its *current* procedures, but to find a *new* mechanism that more adequately, and fairly, compensates the Palestinian side as the smaller partner in the CU. To be sure, immediate steps to correct for problematic revenue-sharing procedure that have resulted into ‘fiscal leakages’ acquire great urgency. Fiscal leakages are in effect an income transfer from the smaller, poorer economy to the more advanced economy and their existence, and the challenges it is causing, have long been identified (Dumas, 1999).¹³ Such fiscal leakages are caused by a number of factors, ranging from the ambiguity of the PER itself to particular mechanisms of its implementation. In what is to

¹² It is instructive, if somewhat frustrating, to observe that virtually all reports submitted to the Ad Hoc Liaison Committee by international organizations over the past years have urged Israel to cooperate with the PA to improve collection of customs revenues and secure their transfer.

¹³ See Kanafani (2001: 286) for various attempts by the PA to confront fiscal leakages, such as a ban on Palestinian traders to sell goods in Palestinian markets that were not directly imported by Palestinian traders and raids on shops that were selling unregistered imports.

date the most detailed study on the issue, UNCTAD identified two main causes for fiscal leakages(2014: 28-31; see also more recently, World Bank, 2016). One relates to the deficient VAT collection system established by the CU that makes it easier for Palestinian traders to evade submission of their clearance bills and engage in outright evasion of customs duties and forgery of clearance bills. The other relates to what has come to be known as ‘indirect imports’, whereby Palestinian importers purchase imports from third countries via Israeli wholesalers to bypass costly delays at Israeli ports. Customs duties on these goods, which are effectively destined to Palestinian markets, go to the Israeli treasury instead into the Palestinian budget. According to one Palestinian estimate (PNA, 2016), fiscal leakages resulted in losses to the public purse of US\$ 3.6 billion over the last fifteen years while UNCTAD estimates that they exceeded US\$ 310 million annually (based on 2012-2013 import data), equivalent to 3.6 percent of GDP.

One rare occasion in which Israel signaled a willingness to cooperate with Palestinian authorities to reduce the extent of fiscal leakages was an understanding repeatedly reached between Prime Minister Salam Fayyad and Finance Minister Yuval Steinitz in July 2012. Both sides agreed on a number of steps to improve the sharing of information and tracing of trade flows as well as the intention to review the existing revenue sharing practices (Israeli Ministry of Finance, 2012). One element of the scheme agreed but never implemented was the establishment of “customs stations” at major crossings between Israel and PA administered areas. While such understandings could lead to mechanisms for tackling fiscal leakages or, potentially, provide a platform for wider-reaching improvements of the CU, it comes as no surprise that its actual implication is patchy at best (Toaldo, 2013: 5). According to Khalidi (2014b: 47), the understanding purports “superficial, technical ‘trade facilitation’ solutions” with economic peace as a palliative “for what all acknowledge is a problem of much deeper structural dependency.”

One longstanding proposal that would go beyond procedural changes to tackle the structural deficiencies creating fiscal leakages is to put in place a new mechanism of revenue-sharing. Just one year after the PER was signed, research conducted by Jawhary (1995: ii) recommended to rectify the revenue-sharing mechanism of the CU in light of its failure to stop the resource transfer to the Israeli economy which was, it must be remembered, a practice intrinsic to the period of direct occupation. Jawhary projected that for the period between 1994 and 1996, this revenue transfer or fiscal leakage which the PER should have reversed amounted to four to six percent of GDP. Drawing on the comparative experience of other customs unions, Jawhary

proposed reforming Israeli-Palestinian revenue-sharing along the model of the South African Customs Union (SACU).

Formed in 1910, the SACU comprises South Africa, Botswana, Lesotho and Swaziland. Namibia joined after gaining independence in 1990 (Maasdrop, 1982; McCarthy, 2003). The value of drawing comparative lessons from the SACU is not only that it is the world's oldest existing CU, but also that the economic relationship between the participating countries is not unlike that between the Israeli and Palestinian economy in so far as the differences in the economic structure is concerned. As the politically and economically most powerful member of the SACU, South Africa determines trade policy and the CET, but the CU also includes a revenue-sharing mechanism that compensates the other, economically less advanced, members for adverse effects created by it. Collected by South Africa, the custom revenues are put into a single pool and redistributed on a basis of a formula that explicitly takes into account each member state's different stage of development. The customs revenues distributed for the smaller countries are made on the basis of their share of goods imported by SACU members and then multiplied by a factor of 1.42 – the difference of which effectively coming out of South Africa's revenue share (Grynberg and Motswapong, 2003; Hanlon, 1986: 82).¹⁴ For the weaker members, the public revenue thus created were considerable: Lesotho's customs revenues, for instance, made up 70 percent of the total government revenue in the 1980s (Williams and Hackland, 2016: 254). This recognition of the need to compensate the weaker economies for the polarization effects of the CU is a distinctive difference to the CU between the Israeli and Palestinian economy.

In addition, two other distinct features of the SACU are of relevance for proponents of the SACU model vis-à-vis the current CU. First, revenue allocation in the Israeli-Palestinian CU is based on, as previously noted, the submission of invoices by Palestinian traders and must include information on the declared destination of imports (in this case, the Palestinian economy). Such a procedure is called the micro-approach to clearing customs revenues and constitutes an important factor for the existence of fiscal leakages. In the SACU however, customs revenue clearance follows a macro-approach, ensuring that revenue allocation is based on the ultimate destination of imports as assessed by national accounts estimates of consumption and production. The second advantage is that revenue allocation within the SACU

¹⁴ In 1969, this factor was raised to 1.77. These factors are, by all accounts, rather generous to the other members in the union, posing the question just why South Africa would agree to it. Beyond the official, economically altruistic explanations of wanting to compensate poorer members, it should not be forgotten that apartheid South Africa was internationally isolated and therefore in great need to acquire regional allies, with the SACU providing one such incentive.

also includes a development component whose share is relative to the deviation of member states' per capita GDP to the SACU average. The aim of this component is to move towards convergence within the CU (Adam and Bach, 2004: 36; Jawhary, 1995: x). Various studies that have assessed the SACU model as a basis for an improved CU are in agreement that its revenue-sharing mechanism would signal a marked advance to the current procedure that disadvantages the Palestinian economy and public finances (Diwan, 1999: 87; Kanafani, 2001: 287-288; Schiff, 2003: 18-19). From the viewpoint of advocates of CU-reform, a fully functioning and empowered JEC could provide the institutional basis to negotiate a move towards a fairer formula of revenue-sharing and end fiscal leakages.

3-3 Assessment and feasibility

Recurrent efforts by donor organizations to think about ways through which the existing CU could be improved (reviewed in Husseini and Khalidi, 2013) recalls a quote, attributed to Einstein, according to which insanity is “doing something over and over again and expecting a different result”. Insane or not, the assessment of such proposals can be made on several levels: the feasibility of the recommendations within themselves, their economic rationale and within a wider context that recalls Sayigh's ‘dual imperative’ discussed in Chapter 1.

The three essential recommendations to improve the CU – a functioning JEC, an expansion of the three lists and a fairer revenue-sharing mechanism – have been made with varying degrees of detail. Devising formula for revenue-sharing that counters fiscal leakages, for instance, is – in theory – merely a technical question; concrete suggestions exist for updating and improving independent import policies for the three Lists (MAS, 2015). However, the discussion how these recommendations can be pursued concretely rests more on the assumption that, historical evidence notwithstanding, Israel would voluntarily cooperate in removing policies and practices that are holding back sustainable improvement in the Palestinian economy. For a CU to be successful and beneficial to the smaller partner, a close relationship built on trust, mutual interest and a spirit of cooperation has to exist. These are conditions that many in the early 1990s had hoped would develop, but both the experience of Palestinian negotiators and Israel's concrete actions over the past decades provide ample evidence to the contrary. Thus, it is unclear, and no clear suggestions are offered, as to what political conditions would be needed for the JEC to be revived to provide the institutional platform to discuss proposals to improve the CU, just as it is unconvincing to assume that Israel would ever allow for effective third-party arbitration with the power to issue sanctions in it.

As to the updating of the three Lists, the issue of ‘market needs’ which these should reflect is vague and therefore bound to be determined by the stronger partner in the CU. Even if data to estimate ‘market needs’ exist, they can be contested – in particular if a proposed reform of the Lists would increase quantities or add more goods and thus threaten to undermine market shares of Israeli companies. Finally, even with a customs-revenue sharing formula devised to the advantage of the weaker members in the CU, such as in the SACU, the effective decision-making power pertaining to CET and regulations remains with the most powerful member within the union (Hanlon, 1986: 82-83). Reflecting, again, on the experience of the SACU, it has been argued that for Botswana, even the ‘generous’ factor multiplying customs revenues has been too little to offset the negative repercussions stemming from high tariffs on certain goods. It can also be debated as to whether monetary compensation is an adequate means to mitigate long-term and structural disadvantages created through trade diversion and the weakening or disappearance of entire industries within the weaker economies (Harvey, 1998: 233). These are all problems that are likely to occur in the Palestinian economy given its nature of the relationship with the Israeli economy (World Bank, 2012: 72).

These questions of feasibility aside, if we were to follow the key assumption behind such proposals, namely a complete and dramatic transformation in the relationship between the two sides, the assessment based on their economic rationale and implications is, stripped to its core, a question regarding the advantages and disadvantages of close or even closer integration with the Israeli economy. Proponents of the PER stress that integration with Israel, forged through decades of occupation and imposed economic practices, is an asset that should not be squandered by populist motivated strategies of de-linking. Close trade relations with neighbors, so the argument goes, is a natural state and should be encouraged, even more so when the neighbor is an advanced economy that can induce technological and other growth-related spillover effects for the smaller economy. If however, geography is indeed destiny, then this argument can also be turned into a different direction: that the destiny of Palestine, its historical roots, shared common interests and cultural links has always been linked to the wider Arab world of which it is an integral part and with which it might achieve greater complementarities, opportunities for competition and economies of scale. Trade policy that would be geared towards attaining such a destiny could, in the long-run, produce much more sustainable and beneficial results than placing trade policy faith in a CU with a dominant trade partner that continues to pursue colonial interests. A case in point is Israel’s refusal to recognize preferential trade agreements of the Palestinian economy other than those it also participates in. Thus, it is

hard to see how Palestine can reap the full benefits of the Greater Arab Free Trade Area (GAFTA) in a situation in which the CU with Israel overrules all other trade agreements.

That the Palestinian economy can, under certain conditions, achieve dynamic gains in a CU with Israel is not disputed; nor that the export sector can play an important role in generating economic growth. However, proponents of an improved CU often overlook or minimize the associated costs and risks this could entail for the Palestinian economy. These belong not only to the category of static and dynamic costs but can also occur due to viewing export-led growth, and the far-reaching trade liberalization that goes with it, as a panacea for tackling other and wider challenges in the Palestinian economy, often at the cost of planning and investment aimed at supporting a strong domestic base of the economy. There is ample evidence, historical as well as empirical, that most developmental success stories, including Israel's, were based on building a strong domestic economy through a coherent strategy of import substitution and export promotion. Moreover, while proponents of an improved CU see a strong causal relationship between integration with Israel and Palestinian welfare, the possibility of a causal link between trade policy independence and political sovereignty is rarely considered (Astrup and Dessus, 2001). Trade policy should not be placed at the top, assuming that it will create a dynamic out of which wider economic development or even political independence will 'trickle down'. Rather, trade policy should be development-driven in the sense of addressing the economy's longstanding structural weaknesses. By extension, trade policy can only be successful if brought in within a wider development strategy (UNCTAD, 2006). Above all, as suggested earlier, an appropriate trade policy framework must prioritize the 'dual imperative' of providing a sound economic basis from which to mount the challenge of achieving political independence.

Lastly, it is pertinent to situate proposals to improve the CU within a wider context. As a study by UNCTAD (2001: 31) contended early on in the debate, "renewing the Israeli-Palestinian CU arrangement as currently structured could lead to no more than an 'association agreement' through which the Palestinian economy would adopt, and adapt to, most of the elements of the current Israeli foreign trade regime, without any reciprocal adjustments by the Israeli partner." Whether intentional or not, however, it might well be that one reason (or twisted 'advantage') for repeated calls for an improved CU is that this could be achieved *irrespective* of progress in the political track since it would not, as in the case of other trade policy frameworks reviewed below, change the status quo pertaining to Palestinian economic and political sovereignty.

Chapter 4. Free Trade Area (FTA)

The literature on the Free Trade Area (FTA) as an institutional regime regulating Palestinian trade with Israel and such a regime's impact on trade with the rest of the world is vast. Research on FTA alternatives began even before the PEP was concluded in the World Bank's *An Investment in Peace* study published in September 1993. The study simulated, *inter alia*, three variations of a FTA consisting of a bilateral arrangement with either Israel or Jordan and a FTA bloc made up of all three parties. Advocacy for the FTA at this moment was driven by wider strategic aspirations generated by the Madrid multilateral negotiations after 1991 to foster regional cooperation, peace and prosperity through regional integration that could initially commence with a FTA and then move towards a higher degree of economic integration in the form of a CU or a common market. It is in this vein that a successful Palestinian-Israeli-Jordanian FTA was thought to form the optimal nucleus from which further economic integration and political cooperation in the region as a whole could converge.

The idea of establishing regional free trade areas, including Israel, was also implicit in the form of the US's attempt to negotiate individual FTA's with countries or trading blocs and, so the ambition was, to eventually establish a FTA between the region as a whole and the USA.¹⁵ While such a design came with clear economic imperatives, there is no doubt that the US intended to use the incentive of a bilateral FTA with select trade partners in the region as a 'reward' for countries in the region to participate in the wider Middle East peace process and eventually normalize economic and political relations with Israel (Rosen, 2004). Various conferences, workshops and seminars that took place to achieving these aims, based on the assumption of generating region-wide 'peace dividends' through economic integration, give an indication of the immense, misplaced hopes, that were attached to deliberations around a regional trade framework (Darrat and Hakim, 2002; Hever, 2006).

Buried under the euphoria, when first proposed in the 1990s, there was a more cautious approach towards regional or bilateral trade integration, which would have taken into account lessons learned from a range of other trade integration agreements: that is that only credible, enforceable and mutually beneficial trade arrangements can facilitate achieving objectives (Schiff and Winters,

¹⁵ A similar process was promoted by the European Union under its Barcelona Process initiative whose aim was it to create a FTA by 2010 between the European Union and a select group of countries in the MENA region.

2003: 25). Similarly, critics alleged that Israel's gesturing to pursue regional integration was merely a cover to achieve political normalization; while it was primarily interested in targeting global and not regional markets (Murphy, 1996: 72; Roy, 2001: 368). Another issue raised in some assessments of the prospects of a regional FTA, bringing a more realistic perspective to the discussion, was that the differences in market and demand structures, as well as of incomes, would always limit any significant trade expansion between Israel and Arab states participating in a FTA of which, in this design, the Israeli-Palestinian FTA would be part of (Sagi, 1999).

There are, however, two more concrete and relevant factors that explain the extensive literature on the FTA. First, as noted in chapter 2.4, the FTA was the preferred Palestinian option during the PER negotiations, and hence fueled numerous studies and concrete FTA proposals (see e.g. DATA, 1995; Kanafani, 1996; Shtayyeh, 2000). The most substantial and advanced of these proposals was the *Economic Permanent Status Model* (EPS), a research project on the long-term Israeli-Palestinian trade and economic relations. Conducted under the auspices of the Government of Norway, the project brought Israeli and Palestinian experts together and its recommendation, while not proposing a pure FTA, provided a blueprint for a trade regime with strong FTA elements (ECF-DATA, 1998). The Palestinian preference for a FTA was reiterated during the talks leading to the Camp David negotiations in 2000; and has since been brought up again in various proposals underpinning economic plans.

Second, given increasing doubts about the suitability of the CU to engineer or facilitate economic recovery, and the fact of the rapidly worsening conditions in the Palestinian economy; numerous studies made use of the FTA as a default framework against which an alternative economic scenario was assessed. The most rigorous studies undertaken in this regard was the one by Kanafani (1996), pointing to the shortcomings of the CU and the potential advantages that could be derived by establishing a FTA. A testament to the continued, and unsuccessful, pursuit of the PLO to abandon the CU and move towards a FTA, and of the further weakening of the Palestinian economy's trade performance is that research advocating an FTA as an alternative trade regime continues to be a regularly undertaken (the most recent by Nashashibiet.al., 2015).

This chapter follows the evolution of the FTA proposals, the variety of its formulations and the different underpinning rationale, as a potential trade policy framework for the Palestinian economy. Section 4.1 discusses the institutional distinction between a FTA and a CU; as well as pointing out the

theoretical arguments that have been brought forward highlighting the potential advantages of FTA. Section 4.2 examines various concrete FTA proposals that have suggested by diverse institutional actors; pondering in particular the EPS Model given that it is, to date, the most detailed proposal to establish a FTA trade regime. Finally, Section 4.3 assesses whether the FTA provides a favorable trade regime to improve the Palestinian economy's trade performance.

4-1 The theory of the FTA

Like the CU, the FTA is a preferential and thus discriminatory trade framework; and yet sanctioned by the WTO, under certain conditions, by Article XXIV of the GATT (1995) (see further below). Worldwide the number of FTA's, both bilateral and plurilateral, has significantly increased over the past decades. Consequently, their relevance for international trade theory and policy has gained greater importance. However, while there are many economic advantages that could be derived from participating in a FTA, and that in fact may be an important motivation for joining one, political factors and circumstances often outweigh much of the economic reasoning. Indeed, while there may exist FTA's that have a weak economic rationale but strong political motivations, it is difficult to find FTA's that make strong economic sense but are not supported politically (Asian Development Bank, 2008: 6).

To a certain extent, the advantages associated with a FTA are of a similar nature to those associated with a CU. Trade integration expands markets, and with enlarged and unrestricted market access, economies of scale, technological spillovers and FDI are stimulated. Unlike the CU however, the FTA preserves the autonomy of participating members in determining their trade policy with respect to countries that are not part of the preferential trade arrangement. Concurrently, such trade policy autonomy allows for, or in fact is based on, the full jurisdiction over borders; and thus enabling a greater convergence between economic and political sovereignty than the CU. On the other hand, sovereignty over borders also translates into having to bear the costs of border administration and maintenance, and putting in measures and dedicated personnel to prevent the smuggling of goods by those wanting to exploit the price differences of goods imported from countries outside the FTA. While these are one-off costs and unlikely to be large, a creation of a FTA will inevitably lead to the loss of tariff revenues as trade with FTA member(s) becomes duty-free. More significantly, the costs associated with the need to establish and enforce Rules of Origin (RoO) are more likely to be significant, and, RoO themselves have the potential to induce TD (see further below).

When assessing the economic effects of a FTA much of the analytical tools used to assess the impact of a CU can be readily applied in these cases too (Robson, 1993: 23). This relates in particular to the issue of aggregate and market-specific trade creation and diversion and the welfare effects they give rise to. Like the CU, the FTA provides for trade free of custom duties between its members. Both trade arrangements are preferential in nature as they discriminate against non-members, thus expanding trade flows between members at the expense of trade with non-members. Just as the Israeli-Palestinian CU (and others) takes a form which diverges from the textbook model –so too do the scope and terms of FTA's differ in practice. For instance, FTA's may include investment flows but not extend to free trade in protected sectors like agriculture or services.

However, as elaborated in section 2.1, a CU represents a higher degree of integration than that provided by a FTA. The main difference to the CU is that a FTA does not bind its members to a common external tariff (CET) and instead allows each member to set its trade relations with third parties independently. As such, a FTA demands less stringent levels of cooperation, therefore is often easier to establish, and maintains the country's trade policy sovereignty with the rest of the world, preserving at least some policy space in the area of international trade. This key distinction to the CU is that a FTA requires not only clearly defined trade borders, but also the application of RoO to confine the free trade status to goods originating in the economies of the FTA members. RoO can be cumbersome to apply and may even be used as a tool of protection, thus slowing down free trade and reducing the potential gains derived from it (Schiff and Winters, 2003: 79-80). Concerning the optimal structure of tariffs on third-party imports, the empirical evidence does not point towards a conclusive direction. The external tariff in a FTA may be lower than the CET in a CU in a bid to reduce trade diversion away from more efficient non-FTA member states. Conversely, there are also pressures that may increase tariffs on third-party imports. This is in particular the case since trade with the preferential trading partner becomes exempt from tariffs, thus increasing the likelihood that local producers start lobbying for tariffs on imports from non-FTA markets (ibid: 83-84).

Following Kanafani (1996: 40-51) and Robson (1993: 23-30), the analytical assessment of a FTA, in particular in its comparison to the CU, can be undertaken in line with four criteria: a) the extent of trade diversion (TD) and creation (TC); b) the dynamic effects created through the FTA; c) the need to establish and enforce RoO, and, d) wider institutional requirements. To illustrate the effects of the FTA, we will focus on only one economy in the FTA that is assumed to be a small, price-taking economy thus resembling the Palestinian one.

As elaborated in section 2.1, TD occurs when a preferential trade arrangement diverts trade away from more efficient producers outside the trade area towards less efficient producers within it for a particular good or market. On its own, such a process would reduce global welfare as the FTA grants special privileges for less efficient producers while discriminating against the more efficient producers that are not part of the FTA. On the other hand, TC occurs when the FTA enables more efficient producers of a member of a FTA to displace less efficient producers from other members of the FTA, as compared to (prior to the FTA) when these goods were imported from higher-priced, and therefore less efficient third party producers. Thus, TC can increase national welfare and, by extension, global welfare. Depending on what effect carries more weight for each partner, the result of forming a FTA can either increase or reduce national welfare. However, this rather aggregated assessment on TC and TD needs to be expanded to assess the FTA's effect on consumer and producer surplus as well as government revenues which, together, determine the net welfare effect of the FTA.

For consumers in the importing economy, a FTA will generally reduce the price of imports due to the removal of tariffs and thus increase the consumer surplus. Moreover, the reduced price of imports will also induce competitive pressure for domestic producers of substitutes and compel them to reduce their prices to sustain market shares, thus further increasing the consumer surplus. To the extent that trade diversion occurs, however, importing at higher prices from partners in the FTA will reduce the consumer surplus. A net gain for domestic consumers means, conversely, the loss for domestic producers in the importing economy as they will face competitive pressure from more efficient producers within the FTA. Such a process does not only translate into a reduced producers' surplus, but is also likely to trigger a number of effects that manifest themselves in reduced profits, production shutdowns and increased unemployment. This results holds in a situation of both, TD and TC - in the latter scenario, it simply means that the FTA enables an increase in or creates trade that did not exist before the establishment of the FTA.

In the case of government revenues derived from customs duties and tariff revenues, the consequences following the establishment of the FTA have to be distinguished between situations in which TD or TC dominate. In the former case, the import of goods from less efficient producers from within the FTA will lead to a reduction in government revenues and is likely to reduce public spending or increase government debt if the levels of spending are to be maintained. On the other hand, in the case of TC, the FTA will have a

neutral effect on government spending since it creates trade flows that previously did not exist and hence did not contribute to tariff revenues.

To assess the aggregate welfare effect of the FTA, the net effect of the gains and losses sketched out above has to be summed up and then extended for all markets and goods that are affected by the FTA. As a general axiom, a FTA is said to increase national welfare if TC outweighs TD but a FTA as such could actually make participating economies worse off than before— even though it removes various barriers for the efficient allocation of resources. According to Lipsey and Lancaster (1957) the elimination of some market distortions (in this case the removal of trade barriers for FTA members within a wider context of market distortions such as the existence of trade barriers for non-FTA members) might not necessarily lead to efficiency improvements. This would be the case if the partial removal of tariffs following the creation of the FTA raises the negative welfare effects caused by the remaining tariffs with non-FTA members.

Consequently, a number of economists who are otherwise in favor of free trade are opposed to the creation of FTA's since they would undermine global trade liberalization. Moreover, the necessity to comply with RoO might lead producers within the FTA to purchase inputs from within the FTA partners even if non-FTA suppliers offer it at cheaper prices, a likelihood that by definition implies TD (see e.g. Bhagwati, 2000: 240-245; Krueger, 1999). In practice, therefore, FTAs violate the spirit of the basic principle of the GATT enshrined in Article I according to which any trade advantage granted to one country must be granted to all other trading partners too. However, FTA's, similar to CU's, have also been understood by GATT members as a stepping stone towards global free trade, are thus permitted as stipulated by rules outlined in Article XXIV. Specifically, these rules aim to minimize the extent of TD by, *inter alia*, requiring that tariffs for non-member FTA trading partners cannot be higher than those that existed prior to the establishment of the FTA, that the agreement should cover all trade, and that all trade restrictions within the FTA must be eliminated with a period of no longer than ten years. In 1979 however, this Article was qualified, by the Enabling Clause, allowing developing countries more flexibility when entering into preferential trade agreements (Miller, 2004: 12-13).

On other hand, proponents of the FTA often point out that conventional criticism against it – in particular the likelihood of TD dominating over TC – fails to consider dynamic effects that can be created by the FTA. Such effects, similar to the ones created by the CU, pertain to efficiency gains triggered by increased competition, economies of scale, technology transfer and larger

flows of FDI. These effects are said to be more pervasive, spread across the economy as a whole, and far more significant than the static 'one-time' effect of price changes triggered by the initial adoption of a FTA. However, much of these dynamic gains are difficult to conceptualize, hard to actually measure and, as Kanafani (1996: 49) points out, their realization depends to a great extent on supportive economic reforms and complementary policies, as well as on the level of political cooperation between FTA members.

Similar to the theoretical assessment of the CU, therefore, an *a priori* position on which trade effect will dominate in a FTA cannot be taken. What can be said, however, is that with a number of conditions in place, there would be a higher probability that TC would outweigh TD in a FTA. These are: a) the higher the tariffs are among members *before* the FTA is formed; b) the lower the tariffs with non-members once the FTA is established; c) the greater the number of countries participating in the FTA; d) the more competitive and less complementary (in produced goods and services) its members are; and, e) the closer the economic relationship among the members prior to joining the FTA (Salvatore, 1995: 305-306).

RoO constitute an essential but complex element of any FTA. Their application are key to preventing trade deflection, and thus increase the prospects for TC; but also could be used as a protectionist measure, often inducing TD. Indeed, the existence of stringent RoO can be seen as generating a rent that domestic producers aim to capture increasing their level of protection. Still, RoO constitute a core and necessary instrument of a FTA. Its function is to determine the origin of a product, that is the domestic value added content, and other criteria that might be established, to assess whether it is eligible to benefit from zero tariffs as specified in FTA regulations. Specifying RoO and the negotiations associated with their establishment is often a contentious process, with different RoO's defined for different industries and goods. Even where RoO have been agreed on; the requirements for documenting 'origin' can be arduous and expensive, so much so that an importer may prefer to pay tariffs on intermediate goods rather than incurring the cost and experiencing delays because having to prove origin (Krishna, 2004: 5-6).

Given that the effect of RoO on TC and TD depends on the precise content of these rules and enforcement, a prior assessment is difficult to undertake. In general, costs associated with RoO tend not only to be higher the more complex these are, but also tend to disproportionately fall on small and medium-size enterprises in general and those in low-income countries in particular. RoO tend to be more complex, if not opaque, the more the process

of trade policy negotiation is influenced by political lobbying. Indeed, if the purpose of RoO is merely to prevent trade deflection, a simplified RoO specification would be sufficient (Krishna, 2013).

Hence, there are certain best practices that RoO should fulfill in order to reduce trade deflection and avoid being used as non-tariff barriers to trade. Thus, RoO specifications should be defined in a clear, transparent and simple manner to avoid different interpretations or administrative discretion. They should also aim to be consistent across different sectors and goods to ensure simplicity and reduce costs associated with enforcement. Moreover, as a general rule, FTA's with a less local content requirement for RoO tend to reduce the extent of trade diversion (Brenton, 2011: 164; Kanafani, 1996: 47). While simpler RoO are important to reduce the likelihood of TD that may be created through a FTA; it is equally important for them to be credibly and transparently enforced so as increase the welfare maximizing effects of a FTA.

Finally, running a separate customs administration does not only require sufficient administrative capacity, but also comes with costs. These go beyond the costs associated with increased public employment needed to organize and run trade borders and the technological equipment needed to register trade flows and enforce other domestic regulations related to standards and sanitary measures. More significant are the costs associated with enforcing RoO. As a rule, the more complex they are and the greater their technical requirements, the higher the associated administrative costs incurred by traders. These costs stem from the need to secure and prepare RoO documentation or delays caused by verification procedures at the border (Hayakawa et.al., 2009: 2). Such procedure creates fixed costs for firms but they tend to be less binding the greater the size of the firm (Hayakawa, 2015). Nevertheless, if fixed costs exceed profits, firms are more likely to trade outside the FTA framework despite having to pay general tariffs. Thus, the lower the rate of tariff for trade with the rest of the world compared to the FTA ('tariff margin'), the more likely it is that firms will opt out of FTA framework and trade with partners outside of it. To illustrate, in the case of the NAFTA, RoO compliance costs for Mexican exports to the United States are around 6 percent in ad valorem equivalent and, at this proportion, undo the tariff preference (4 percent on average) for a large number of goods (Anson, 2005).

To conclude, and similar to the CU, an *a priori* evaluation of the FTA based on theoretically deducing the relative weight of TC and TD is unlikely to contribute to conclusive trade policy recommendations. The choice to pursue a FTA depends on a number of factors: the structure of exports and imports

and trade volume with the FTA partner as well as external tariff rates on third party imports, whose relative impact has to be established empirically. Moreover, the potential extent of dynamic gains of a FTA is far more significant for assessing the effect of a FTA; even though frustratingly, empirically sound methods to measure them continues to elude the economics profession. Consequently, the decision to form a FTA, while it comes with a number of far-reaching economic consequences, it is more likely to be influenced by political considerations.

4-2 Discussion of various FTA proposals in the Palestinian context

An Israeli-Palestinian FTA has been seen as an attractive option to Palestinian negotiators at different stages and joint think tanks have elaborated proposals for future Palestinian trade policy, manifested in an array of permutations with the basic FTA concept at their core.

Israeli-Palestinian negotiations on an FTA

As mentioned, the preferred trade policy option with which the PLO approached the negotiations culminating in the PEP was a FTA. At the time, such a position would have been viewed favorably, both regionally and internationally. The World Bank (1993) provided an encouraging assessment of the FTA as a potential trade policy option assuming certain political and economic conditions to hold, such as the definition of a trade border and the gradual harmonization of external tariff to avoid TD on either side.

In approaching the Paris negotiations, the PLO saw in the FTA a practical vehicle to pursue several goals. A FTA would institutionalize close market integration with a larger, more advanced economy, thereby securing not only market outlets but also promising a range of technological spillovers. At the same time, a FTA would provide Palestinian decision-makers with sovereignty over defining trade relations with other parties (especially the wider Arab world), thus also laying the foundations to reverse the longstanding dependency on the Israeli economy by diversifying trade partners. Moreover, with a FTA in place, the bargaining position of Palestinians in future trade negotiations with other potential trade partners would be boosted as the Palestinian position would no longer be bound by the tariff ceiling it would have to commit to in a CU with Israel.

Palestinian negotiators also assumed that a FTA would continue to provide Palestinian labor with access to the Israeli labor market even though a FTA does not necessarily guarantee open access to labor markets. Moreover, the delineation of custom borders, as a FTA would have required, was also

perceived as coherent with establishing political borders under Palestinian sovereignty. The reasons Israel was opposed to such a proposal, and instead favored a CU, were both economic and political. Politically, it argued that with the PEP merely being interim in nature, delineating custom borders would pre-determine the direction of the final status negotiations. Economically, some Israeli business sectors highly reliant on the Palestinian market were concerned that Palestinians could replace Israeli imports with less costly goods from third countries or that Palestinian imports from third parties would enter Israeli markets through smuggling and thus undermine Israeli business interests (Arnon and Spivak, 1998: 4; Awartani and Kleiman, 1997: 223).

While the asymmetric relationship between the two sides gave Israel the negotiating upper hand, it also introduced a bargaining chip that ultimately dissuaded the Palestinian from its FTA preference. According to Arnon and Spivak (1998: 5), Israel signaled its willingness to a FTA but warned that such a regime could curtail the flow of Palestinian workers to the Israeli labor market, whereas a CU would not – arguing that a trade border would also establish a border for labor. Whether Israel’s offer of a FTA was serious or just a ploy is unclear. The outcome of this trade-off, was the PER: a CU with some qualifications that were meant to address some of the demands for (limited) trade sovereignty. In a sense then, it could be argued that the resultant Palestinian trade policy was at least partially determined by considerations of the Palestinian employment situation. To some extent, this was understandable given that the newly established PA hoped to quickly gain popular legitimacy through improving socio-economic conditions on the ground. Balancing this short-term necessity with the long-term goal of reducing economic dependency on Israel was, in any case, a difficult undertaking. However, rather than accepting trade sovereignty and access to the Israeli labor market as conflicting goals, the trade-off could have been reconciled by a comprehensive investment program aimed at domestic employment generation that would have assisted the gradual reduction of dependency on the Israeli labor market – along the lines of the Palestinian Development Program designed by the PLO under the leadership of Yusif Sayigh.¹⁶

Be this as it may, in anticipation of final status talk, the Israeli side hinted once again in 1999 that it would be willing to form a FTA with the Palestinian economy as concluded by the Israeli “Committee to Discuss Principles of a

¹⁶ See also UNCTAD (2009: 35-44) for a range of labor market policies aimed at reducing labor market dependency with a strategy of reforming the trade policy regime.

Permanent Economic Agreement Between Israel the Palestinian Authority". The Committee, while explicitly rejecting a CU as a long-term bilateral trade arrangement, argued that a FTA with defined trade borders (but once again, without guarantees for Palestinian labor access) would be in the best interest of the Israeli economy. However, this unofficial recommendation was more likely driven by the ideal world scenario often assumed by economists as opposed to the highly politicized considerations that determine Israel's actual decision-making on policy towards the Palestinian economy (Arnon, 2007: 591-592).

For the PLO, the FTA remained the preferred trade policy option, and could find validation for it in a number of studies that have been published over the years that have emphasized the potential advantages of a FTA, in its various forms, and in particular when compared to the CU. Early on, for instance, a joint research project between Palestinian and Israeli economists found that the FTA would, in theory, be beneficial for the Palestinian economy provided that it would include the Palestinian agriculture sector (DATA, 1995: 23-25). Due to the porous borders between Israel and the West Bank however, some Israelis have argued that a FTA would be more feasible for the Gaza Strip with its better enforceable boundary to Israel. On the other hand, Panagariya and Diwan (1996: 22), while ruling out a FTA for the Palestinian economy on terms of feasibility and welfare effects, entertained the idea that, in case other trade options are not attainable, the Gaza Strip could be turned into a free trade zone similar to Hong Kong.

Similarly, Diwan (1999: 93-94), without firmly supporting one or another trade policy framework, argued that a CET (as necessitated in a CU) would confine the Palestinian economy to existing protectionist tendencies of the Israeli trade regime. For Diwan (*ibid*), this meant that the Palestinian economy could set lower tariffs and therefore become more open which would boost economic growth, assuming a causal relationship between openness and growth. On the other hand, sovereign decision-making over the external tariff structure could also be used to set tariffs more in line with the aims of building up economic capacity in selected sectors (Al-Botmeh and Kanafani, 2006: 15, Shtayyeh, 2000: 22). Potentially, too, the ability to set selective tariffs could also reduce the extent of TD by ensuring that more efficient third country produces are not discriminated against. Significantly, given the concrete flaws of the trade related provisions of the PER, a FTA would also do away with the problem of tax leakages given the presence of custom borders. By closing this leak, and setting tariffs to third parties at a low or even zero level, public revenues are still expected to rise given the capture of purchase and excise taxes (Diwan, 1999: 94).

The appeal a FTA has for Palestinian decision-makers is apparent: privileged market access to an advanced economy while retaining independent trade policy vis-à-vis third countries, and an end to tax leakages due to Palestinian management of a trade border. However, proponents of a FTA are also keen to stress additional benefits a FTA would have which, admittedly, could also be attained in a CU. Given the spirit of cooperation and integration a FTA would be based on, close trade relations could also provide incentives to cooperate on infrastructure projects and gradually converge on trade standards to reduce the extent of TD (Aix Group, 2012: 478; Nashashibiet.al., 2015: 46).

a) Hybrid FTA schemes: Aix Group

In assessing proposals for a FTA as a Palestinian trade policy framework, we will largely disregard earlier research recommending a regional FTA for the economies of Israel, Jordan and Palestine. Such plans were widely considered in the early days of the Middle East peace process, well before the optimistic (or naive) views of regional stability turned into dark clouds. However, in one recent study by the World Bank (2012) and, to some extent, that of Nashashibiet.al. (2015), the idea is being proposed in a more limited context: that a bilateral FTA would be mutually beneficial for the Israeli and Palestinian economies. For the latter, the advantages have been discussed above. For the former, it has been suggested that Israel could be incentivized to agree to a FTA through seeing it as a gateway for wider Middle East markets if the FTA is linked to Palestine's FTA's with Arab economies (so-called interlocking FTA). Rather, our analysis will be limited to discussing the FTA as a framework for regulating trade between the Israeli and Palestinian economies as a first step towards any other outcomes it might allow. It should be noted that none of the detailed proposals for a FTA propose a generic FTA model but instead suggest variations or extensions which are generally similar to each other. These have been variously termed as 'hybrid' (ECF-DATA, 1998, also known as EPS model), 'quasi' (Kleiman, 2001), 'asymmetric' (Aix Group, 2004, see also Vaggi and Baroud, 2005) or as 'FTA-plus' (Nashashibiet.al., 2015).

Since its inception in 2002, the Aix Group – an EU funded joint study team consisting of Israeli Palestinian and international economists – has consistently argued for Israeli-Palestinian trade relations to be modelled around a FTA. Its *Economic Road Map* (2004) was written to accompany the contemporary political/security "Road Map" launched in 2002, with an understanding of the need to establish independent Palestinian economic decision-making, while acknowledging that the Palestinian

economy can reap significant benefits from its proximity to, and integration with, the Israeli economy (see also Aix Group, 2007: 194-205 and 2012: 478-484). The Aix Group assumes once the two parties come together in a spirit of cooperation and good faith, negotiations to gradually manage a transition from the CU as the current trade regime to a FTA can be conducted. The success of these negotiations would be, needless to say, integrally tied to advances in the political negotiations track. In proposing a FTA as the optimal trade policy regime, the Aix Group sees a number of advantages: tariff free trade, including of agricultural produce, with an advanced economy while conferring Palestinian decision-makers the freedom to decide on trade relations with third parties. In addition, barriers to the free trade in services will be gradually eliminated; and areas of cooperation from tourism and environmental protection to bank supervision will help to enhance the viability of the FTA.

However, for the FTA to work for the Palestinian economy and create a level playing field between the two economies, it would have to be asymmetric in nature, at least for some period. This asymmetry would manifest itself in less demanding RoO for the Palestinian economy compared to the RoO that would apply for Israeli traders. In effect, under this asymmetric FTA, the Palestinian economy would be allowed to place restrictions, on a MFN basis, on Israeli imports for a grace period. Conversely, Palestinian traders would benefit by being able to export to the Israeli economy within a FTA framework and under less strident RoO. Again, assuming a spirit of mutual trust, the Aix Group recommends that a revived, but empowered JEC, would be the appropriate venue to decide on the length of the grace period, the affected sectors and supervise implementation of the FTA – ideally under the presence of a third party overseeing implementation and acting as an arbiter of last resort.

While assuming that the two sides would work closely together to assure effective and efficient border management, coordinate indirect taxation and harmonize standards according to WTO recommendations, the Aix Group recognizes that the FTA as an institutional framework, on its own, would do little to boost the prospects of the Palestinian economy. The Aix Group stresses four preconditions that need to be in place to exploit the benefits the FTA promises. First, construction of a territorial link between the West Bank and the Gaza Strip. Such a link would not only boost internal trade and contribute to the development of a domestic economic base or open up new trade routes via Egypt, but it would also provide West Bank traders with access to an air- and sea-port which the Aix

Group studies assume will be built in Gaza. Second, the Aix Group sees industrial estates located on the border an ideal vehicle to encourage FDI in the Palestinian economy, enhance its productive capacity and support cooperation between entrepreneurs on both sides.

Third, the Separation Wall undermines the economic viability of a future Palestinian state and, if it became permanent, would significantly diminish the benefits of a FTA for the Palestinian economy. Finally, resolving the issue of Palestinian labor transfer to the Israeli economy is of great importance, and close coordination is needed to take into account macroeconomic and security considerations of both sides. While it is agreed that the long-term development of the Palestinian economy rests on substituting the export of labor with the export of goods, its presence is of significant importance in the medium-term to facilitate an orderly economic transition and socio-economic stability. It is recommended that the Palestinian labor transfer takes place unencumbered through designated border passages but regulated to permit and or taxes and that they should be given preferential access over migrant workers given their lower negative externalities for the Israeli economy and state.

With these conditions in place, and with the Palestinian economy now in a position to fully exploit other FTAs (such as the GAFTA) and proactively pursue trade agreements with other bilateral or regional economies, trade could be diversified and the dependence on the Israeli economy be gradually reduced. The position of the Aix Group towards an optimal Palestinian trade policy regime is corroborated by Vaggi and Baroud (2005), who add industrial policy to the areas in which asymmetries should be established. Specifically, they argue that an asymmetric FTA between Israel and Palestine should allow the latter to temporarily apply infant industry policies to boost create dynamic comparative advantages in specific sectors (ibid: 21-22).

The challenge to reconcile sovereign Palestinian trade policy and continued access to the Israeli economy is also taken up by Ephraim Kleiman (2001), reputedly the intellectual godfather of the Paris version of the CU. While the former goal requires movement towards separation, the latter is based on the principle of integration. These two diverging interests can be, in principal, reconciled through an institutional framework that Kleiman terms 'quasi-FTA'. The form of such a FTA takes its cue from the existing quasi-CU that allowed exceptions to the CU trade arrangement in the form of lists of goods that were exempt from the CET and allowed Palestinians to apply tariffs independently. While a

CU, quasi or otherwise, centres around the principle of integration, a FTA would allow for a freer association – and preserve Palestinian trade policy sovereignty – but may undermine bilateral trade, and access to the Israeli labor market, through the necessity of an economic border.

While Kleiman submits that the “question of economic borders will most probably be decided on non-economic grounds” (ibid: 15), a quasi-FTA could introduce a less rigid category of ‘notional borders’. With notional borders, the two sides could agree on a list of imports from third parties that would move freely through the borders without checks on RoO and be excluded from the discretion of both authorities to fix its own tariff on them. Admittedly, Kleiman does not specify how large the list of exemption should be on which a CET should apply but he reasons that not all goods outside the list “would require a tangible, physical border in order to allow” both sides to apply their own import policy (ibid: 17). For instance, in the case of cross-border trade of motor vehicles or any other goods where registration of ownership is required, tax collection can be organized at the point of registration rather than at the border. The ‘quasi-FTA’ satisfies three goals: the negative repercussions of a hard economic border could be minimized (at least for those third-party imports on the agreed list), the Palestinian side could preserve trade sovereignty and secure privileged access to the Israeli economy, while the notional economic border still enables the Israeli side to protect its markets from cheaper third-party goods imported by Palestinians.

b) Hybrid FTA schemes: FTA-plus

The Palestinian International Business Forum (PIBF), in conjunction with the International Council of Swedish Industry, published in 2007 a report that also explored how a future Palestinian trade policy regime could combine the best of both worlds, the trade sovereignty bestowed by the FTA and the areas of integration and cooperation provided by the CU. The trade arrangement the report comes up with is termed ‘FTA-plus’ which is essentially a FTA but with elements facilitating a deeper level of integration. The report stresses that the trade arrangement would not only be the most advantageous for the Palestinian economy in terms of GDP and export growth, and employment generation. This best possible trade arrangement would be in Israel’s advantage too, as Palestinian economic recovery is linked to political stability and more specifically, Israeli access to Arab markets through joint-ventures.

Deeper elements of integration are not uncommon in many FTA’s around the world and can refer to, for instance, agreeing on a CET on certain

goods or harmonizing standards under WTO rules. The nature of the features that make up the 'plus' in the FTA are a matter of negotiation between the two sides. The report suggests a number of elements that could be pursued to the benefit of sustaining the economic relationship between the two economies (ibid: 50-51). These could include harmonization in technical regulation and standards for sanitary and phytosanitary measures; synchronized and joint customs and border control procedures to reduce the likelihood of RoO being used as administrative barriers to trade; institutional cooperation in competition regulation, intellectual property administration, anti-dumping or bank supervision; the creation of Qualified Industrial Zones (QIZ) so that each side can take advantage of FTAs with other partners; and mutual recognition of work qualification and licensing to facilitate the movement of skilled labor across the border. As for the important issue of Palestinian labor transfer to the Israeli economy, the report only notes that a FTA, unlike a CU, does not provide provisions for the free movement of labor. Instead, the report suggests that if labor transfer is not covered under the service component of the FTA-plus, then it would have to be separately negotiated. Either way, all measures aimed at furthering the FTA should be agreed on and supervised by a revamped and empowered JEC that will also be used as an effective venue for dispute settlement.

Motivated by the resumption of political negotiations between the two sides in 2014, a sequel report sponsored by the same organizations was produced (Nashashibi et.al., 2015). It employed much of the same economic modeling approach to provide an updated answer on the question of the optimal trade policy regime for the Palestinian economy. The choice of the FTA-plus framework was upheld on the basis of the general advantages produced by continued access to the Israeli markets and trade sovereignty and a sectoral impact analysis following the transition to the new trade regime. The report then appraises the impact on economic sectors with a high and under-utilized export potential - tourism, manufacturing and agriculture - and argues that with the 'plus' elements provided by the FTA, considerable export growth would follow with impressive improvements in employment and incomes.

A further justification of the FTA-plus option is the positive experience of post-conflict Bosnia that applied a similar trade policy framework. Ironically, or rather tragically, the Palestinian economy was designated as 'post-conflict' after 1993. The 'post-conflict' label is not a matter of semantics but allows donors to pursue 'standard' economic projects and advocate for economic strategies oblivious of the degree of ongoing

conflict or military occupation. Within the wider literature on developments in the Palestinian economy, the 'post-conflict' assumption and the donor practices, advocacy for institutional reforms and trade policy has been criticized extensively (Khan et.al, 2004; Le More, 2009; Rad-Taghdisi, 2011).

Moreover, as impressive as the economic impact of the FTA-plus may be, the report mistakes the presentation of quantitative results for quantitative analysis, and the methodology employed to model trade policy options remains unclear, making it therefore more an exercise in political advocacy than economic research. This should come as no surprise given that both reports are written from a perspective that explores the potential benefits for, and prioritizes the interests of, Palestinian and Israeli businesses. Both PIBF reports are at pains to emphasize that the FTA-plus is not only the best possible trade policy option for the Palestinian economy, but would also generate significant benefits for Israeli businesses. Such an approach is at odds with the development-driven approach to trade highlighted in chapter 1, fails to prioritize that any economic strategy should be in line with the 'dual imperative' of achieving economic and political sovereignty and simply assumes that a sound Palestinian economic base will be achieved through export growth. The underlying approach in these reports echoes the assumptions of much of the hopeful economic advocacy in the early period of the Oslo process. As so often in the history of Israeli-Palestinian rapprochement in the past three decades, business is seen as the more pragmatic and hence could lead the way towards political reconciliation once the political leadership on both sides recognizes the economic gains that could be achieved by cooperation. Thus, any economic policy pursued by Palestinian decision-makers can only be assessed as 'good' to the extent that it jointly benefits Palestinian and Israeli business interests.

Unresolved in the 2007 report is the tricky question of how to advance economic negotiations in the absence of final status negotiations or else, how to delink these two tracks (economic and political) so that progress on the economic front could be achieved. By contrast the 2015 report, takes an explicit position on this, arguing that a FTA-plus agreement "can be achieved without concurrently reaching a final status" as long as there is an understanding that a 'good faith' political process will resume - presumably at some point in the future (Nashashibi, 2015: 5). The past three decades however have given ample evidence that a 'good faith' political process remains a chimera and recommending advancing trade cooperation with Israel on this basis risks falling into the trap of

‘economic peace’ - a strategy long promoted by successive Israeli governments but rejected by the Palestinian leadership (Khalidi and Rad-Taghdisi, 2009).

c) Hybrid FTA schemes: Economic Permanent Status (EPS)

The final proposal for a trade policy framework modeled around a FTA discussed in this Chapter is the one that has come out of the EPS model (Economic Permanent Status). Deliberations around the EPS model took place in the late 1990s with the aim to produce a basic understanding for the long-term relationship between the Israeli and Palestinian economies. The EPS takes the form of joint ‘understandings’ presented in the form and language of an agreement. As articulated in its Preface, its guiding spirit was that of ‘political separation and economic cooperation’ (10). It covered areas of fiscal and trade relations, investment promotion, labor market access, and monetary and currency issues - for the latter, it envisaged the creation of a Palestinian currency as a legal tender. Its recommendations were understood to inform negotiations to transform the interim period, governed by the PEP, into a final status agreement - hence economic permanent status - but its creators were cognizant that their blueprint was merely a starting point for further, and more detailed negotiations.

Its specifications for future trade relations indicate an arrangement that was more cooperative than a FTA, but less integrative than a CU – thus its hybrid form. Similar to the other trade proposals rooted in the framework of the FTA discussed above, the EPS sought to combine the advantages of each trade framework, political as well as economic, while minimizing its drawbacks. One of the main challenge that it attempts to tackle is the right balance between Palestinian trade policy sovereignty and continued access to Israeli markets for goods and labor. Moreover, such a trade framework would not only be compatible with international trade standards stipulated in the GATT, GATS and TRIPS, but should also allow for flexibility and exceptions to take into account the gap between the two economies and thus the need for Palestinians to apply special economic measures.

Concretely, the CU features envisaged in the EPS model are provided through the free bilateral flow of goods, capital, services and labor while the existence of an innovative notion of a flexible and permeable economic border, and trade policy sovereignty vis-à-vis third countries, make up the FTA element. Unlike the basic model of a FTA or a CU, the EPS model also allows for the free movement of factors of production (Art. J1) including the “(f)ree, normal, and reciprocal cross-border movement of labor” (Art. D1).

The EPS model is cognizant that the envisaged economic integration is between two economies in a different state of development (Art. A2.1) and that for the Palestinian economy to reap the full benefits of integration and rebuild its productive capacities, several measures of differential treatment would be necessary. Some of these measures were also considered when the Aix-Group proposal for an 'asymmetric' FTA was discussed several years after EPS was already accumulating dust on the shelves. They can pertain to temporary or sector-specific government support in the form of promotion or protection. Preferential treatment of Palestinian labor as against labor services imported from third countries also belongs in this category (Art. D1.5). Likewise, the somewhat novel creation of an Israeli Economic Assistance Program (Art. K) to support and invest in joint-ventures and provide other forms of technical and financial assistance also intends to institute measures to reduce the economic gap between the two sides.

Two other, more conventional measures of differential treatment the EPS provides belong to the realm of RoO (Art. C2.3e) and government assistance to infant industries (Art. C7). The latter allows Palestinian decision-makers to employ various methods to encourage and promote the development of industries by providing grants, loans, direct tax-benefits and assistance for research and development. However, the EPS explicitly bans indirect tax rebates for Palestinian producers and any quantitative restrictions or duties on Israeli products. It further calls on Israel to assist such Palestinian measures by the transfer of technology, human resource development and marketing of exports abroad. With respect to RoO, the EPS recognizes that the different state of each economy's development means that local content requirements would have to be different for Palestinian producers in order to benefit from free trade with Israel. Therefore, the Palestinian side is allowed preferential RoO treatment, i.e. the value of local content in a Palestinian good can be lower than the value of local content for the identical Israeli good. Such a measure will however be only temporary, following a jointly agreed timetable of gradually phasing out differential RoO treatment.

4-3 Assessment and feasibility

As this chapter has shown, the general drawbacks associated with moving towards a FTA can affect any economy, irrespective of its size or the nature of the relationship it has with the country with which it plans to have a FTA. These relate to the potential for TD leading to efficiency and welfare losses for producers and consumers alike. There are also costs associated with the management of the trade border that would no longer be compensated by the associated tariff revenue since imports from the FTA partner would be duty

free. Moreover, and importantly, the costs of determining and implementing RoO can often be significant, just as it can take many years to actually conclude RoO negotiations. The transactions costs, especially for small economies, and in particular when they enter into FTA negotiations with larger ones, can be prohibitive.

Conversely, with FTA's and similar preferential trade agreements becoming widespread in the past decades, it is obvious that the trade regime also carries significant benefits, ranging from greater market access, FDI, economies of scale and technological transfer. Where the choice is between a CU and a FTA, such as in the Palestinian case, additional advantages lay in the avoiding fiscal leakage and retaining trade policy sovereignty vis-à-vis third countries. It is in particular these latter two aspects, combined with the potential dynamic gains of integration with a more advanced economy, that makes the appeal of the FTA for Palestinian decision-makers understandable, especially when compared with the existing trade policy framework.

Continued access to Israeli markets, including, perhaps, an agreement for Palestinian labor, are assets that cannot be discounted, in particular in a situation where other viable options are scarce and short-term political considerations trump. However, the basis on which the PLO has articulated its preference for a FTA on purely economic grounds remains unclear. Once again, the issue of RoO is significant enough to create room for doubt. With the historical de-development of Palestinian industry, producers will need to continue to import inputs to produce goods for export and have therefore little room to add substantial local value added. To benefit from the FTA, these inputs would have to be sourced from Israel even if they would be cheaper elsewhere. Both the low level of industrialization and the historical, and imposed, channels of import dependency create high potential for trade diversion. Rather than attempting to develop the industrial base through a FTA, it would make more sense to first build a strong domestic base on which basis greater local content could be produced and greater benefits from a FTA be reaped. Lastly, it is also questionable the extent to which Israel would include agriculture or labor in the FTA – two areas in which Palestinian exporters could substantially benefit – given the strong agricultural lobby in Israel.

All these aspects would have to be negotiated. A successful, mutually beneficial outcome of any negotiations depends on negotiation partners having some bargaining power. Yet, as has been observed throughout the history of bilateral or multilateral trade negotiations between unequal partners, the weaker side usually ends up with a raw deal. In the Israeli-

Palestinian context, with a trade arrangement far more important for the Palestinian economy than it is for the Israeli one, the deck is stacked against Palestinian negotiators. It is for these reason, inter alia, that FTA's between unequal partners has often locked-in poorer economies in low-value added exports and high-value added imports.

In addition, the PLO's preference for a FTA also seems oblivious to the empirical work that has been produced studying the impact the trade regime would have on the Palestinian economy. While, admittedly, the World Bank's position on what constitutes an optimal trade regime has been shifting throughout the last three decades, its research since the early 2000s has been unequivocally in opposition to the FTA based on welfare and efficiency losses and transaction costs for the Palestinian economy. In fact, even the CU, equally regarded as detrimental to the Palestinian economy, scores better – a conclusion should make Palestinian advocates ponder about or at least compel to invite greater trade policy consultation (World Bank, 2002: 31; 2006: 51). More recently, the World Bank (2012: 81) suggested that the trade relation with Israel could be based on 'interlocking-FTAs' in the long-term, but only after establishing a NDTP through which the Palestinian economy could create the necessary precondition to benefit from a FTA.

Even the much vaunted hybrid FTA's discussed in this chapter bear risks, leaving Al-Botmeh and Kanafani (2006: 16) to conclude that such an arrangement would be "a non-tried novelty that would probably bring with it new areas of conflict and clashes of interests, even more than those the unfortunate quasi CU of the PEP brought." This is because such an arrangement would require a great deal of arbitration, two demands made by Palestinian negotiators that have yet to be met by Israel as the discussion around the JEC in chapter 3 has highlighted. Hybrid trade policy regimes combining elements of a FTA and CU have all been proposed under the appealing motto of economic cooperation and political separation. To what extent this represents a clear break from the existing de facto trade relation with Israel is open to discussion. It is also questionable whether this could be achieved in reality, in particular given the experience throughout the more stable years of the Oslo process when Israel used Palestinian's economic dependence to shape and control their political decisions. It is, indeed, difficult to foresee a possibility in which political independence and sovereignty could be crafted through economic cooperation that, is more realistically understood as dependence and domination given the unequal balance of power.

Chapter 5. Non-Discriminatory Trade Policy

Of the three variants of trade policy regimes that have been considered for the Palestinian economy, the NDTP has not received the same attention or support as other trade options since much of the research until the 2000s pivoted primarily around investigating the trade-offs between the CU and FTA. Still, the NDTP was first considered in the matrix of trade policy with the comprehensive *Investment in Peace* study by the World Bank in 1993, and was also subsequently also discussed in studies by Panagariya and Diwan (1996), Diwan (1999) and the IMF (Barnett et.al.,1998). Between 1993 and 2000, not a single study advocated for the NDTP as the best possible trade policy framework, with the exception of IMF that considered it the best possible trade option for the long-term. The relative marginalized standing of the NDTP throughout this period may be explained by most research focusing on the effects of *what was*(the PER) and what, on the other hand, Palestinians were hoping to *achieve* (FTA). This situation began to change with the findings of a study by World Bank economists Astrup and Dessus (2001) that expanded the horizon of deliberations around preferable trade policy regimes. Like many other authors before, they concluded that a CU with Israel induced significant distortions and precluded the Palestinian economy from reaching its full potential. Considering alternative trade policy regimes, they also argued that under certain conditions, a FTA might be just as preferable as a NDTP. Kanafani and Cobham (2007: 52) view their conclusion as a starting point for a series of studies conducted by the World Bank that put the NDTP firmly on the research agenda of that influential institution (Schiff, 2002; World Bank, 2002 and 2012; see also Dessus and Ruppert Bulmer, 2004).

Outside the Washington institutions, the NDTP option also garnered increasing support. A study conducted by MAS (Naqib and Atyani, 2003) recommended a NDTP to pursue a more independent trade policy and facilitate the integration into regional markets. Support for the NDTP as a more favorable trade policy framework however, does not necessarily signal agreement as to the nature of the tariff system that should be adopted. This can be illustrated by the contrasting views in De Melo et.al. (2003) and UNCTAD (2009). Whereas the former study advocates a NDTP with a low tariff across the board (5 percent suggested as a convenient upper limit), the latter allows for the imposition of an autonomous tariff exceeding the level simulated in other studies. Indeed, UNCTAD's study is the only one that does not endorse the idea of a low, liberal or close to zero uniform tariff structure as most appropriate for the Palestinian economy. Consequently, apart from

assessing the advantages and disadvantages of the NDTP and comparing it with other trade options, there is also a need to investigate the merits of different tariff structures.

This chapter is organized as follows: section 5.1 provides some rationale and context behind the NDTP, while section 5.2 assesses the trade policy option against various disadvantages that have been brought up in other studies, concluding with section 5.3 that reviews the core disagreement within studies favoring a NDTP.

5-1 Purpose and rationale of the NDTP

As the term implies, the essence of the NDTP consists of non-discriminatory trade practices and regulations advanced through the principle called ‘most-favored nation’ (MFN) as enshrined in Article I of the General Agreement on Tariffs and Trade (GATT). It has also been adapted by the WTO as a central principle of the international trading system: members of the WTO must grant other members MFN status. With MFN as a practice, a state ceases to discriminate between different trading partners and offers each one the same treatment in terms of tariffs and other trade measures applied to its ‘most-favored’ trading partner. The MFN principle is thus an important pillar in international trade as it provides for a level playing field between trading partners irrespective of their economic power (Yanai, 2002). With every nation given the same competitive opportunity of market access, the need to form bilateral preferential trade agreements such as CUs or FTAs or accord unilateral preference schemes is redundant (or, by definition ruled out). More to the point, without regional trade agreements, which are inherently discriminatory to non-members, global trade can increase and maximize global welfare, assuming appropriate tariff levels. The tension between the MFN principle as advanced by the GATT and the proliferation of regional trade agreements is reconciled with the view that regional integration is expected to complement multilateral trade liberalization and, eventually, dissolve into the non-preferential global trading framework (Srinivasan, 1996). Indeed, as per Article XXIV of the GATT, countries participating in a FTA or CU were exempted from the MFN obligation as a right, under the condition that ‘substantially all trade’ between them was free and that trade with non-members was not more restrictive than prior to the forming of the preferential trade agreement.

GATT also recognizes that a level playing field, within given historical structures of global inequality and uneven levels of development, would not necessarily be adequate for developing countries to catch up. Therefore,

Article XVIII allowed those countries with ‘low standards of living’ that are ‘in the early stages of development’ protective measures and flexibility in reducing their tariff structure. This so-called ‘special and differential treatment’ (SDT) for developing countries has been a constant bone of contention between developing and developed countries in multilateral trade negotiations. In the WTO Doha Round that began in 2001, the Ministerial Declaration agreed to review SDT provisions with a view to strengthen them, but remained vague on concrete proposals and deadlines for implementation, in particular in the area of increased market access for trade in agricultural goods and textiles (Gallagher, 2007). Yet, there are good reasons to strengthen SDT provisions. Beyond the stated goal to promote global development through international trade, WTO provisions are often too overwhelming for poor countries lacking institutional capacities (Hoekman, 2005: 213).

Despite a vast body of research around the issue of regionalism *versus* multilateralism (see Schiff and Winters, 2003), conclusive evidence regarding their respective outcomes for regional and global welfare is still elusive (Srinivasan, 1996: 13-15). Assessing the pertinence of the MFN principle for developing countries trade performances is further complicated by the chasm between the principle in theory and a host of non-trade barriers applied by developed countries to protect their markets against cheaper products from developing countries. Thus, the conventional view that MFN helps to stabilize the world trading system and the claim that it should maximize global welfare (see e.g. Bagwell and Staiger, 2001) should be qualified when disaggregating global welfare into that of developed and developing countries (see e.g. Shafaeddin, 2009).

Still, in theory, developing countries can reap a number of advantages by pursuing a NDTP. The main benefit derives from the ability of a country to pursue trade policy autonomy and apply trade policies that are appropriate to the level of its development rather than having to adopt a CET of its main trading partner (as in the CU) or leaving its markets unprotected from more competitive producers in an FTA. Just as for many post-colonial countries in the South, the value of sovereignty in devising autonomous trade policies for a future Palestinian state cannot be underestimated. In both the FTA and CU, there is a strong bias to import goods from the preferential trading partner even if it might not be the most cost effective choice on the world market and consequently leads to trade diversion. With MFN treatment however, that is with all trading partners treated equally in terms of tariffs and other trade measures, a country chooses to import from the most efficient producer, thus boosting trade creation. On the other hand, to the extent that MFN treatment

also increases market access for exports (depending on how favorable the MFN regime of targeted markets is), it can thus induce dynamic economies of scale along or beyond the comparative advantage. The MFN principle is also argued to have positive implications for political economy by aligning a country's trade regime with WTO compatibility and harmonizing the tariff structure, since the same regime will be applied to each trading partner. This not only ultimately provides a disincentive for rent-seeking associated with lobbying for higher tariffs for domestic industries, but also eliminates costly assessment of rules of origin since MFN removes any regional or bilateral preferential treatment (for a theoretical basis of these points, see Ghosh et.al., 2003).

From another vantage point (the political geography of trade), Krugman (1991) has argued that pursuing a MFN trade regime can nullify the relation a country otherwise has with its 'natural' trading partners – often its geographically (or politically) close neighbors, by abandoning any preferential trade relations a country might have with its main trading partner. Krugman adds that a MFN also risks cancelling out welfare gains and competitiveness generated through reduced transportation costs in the absence of trade relations determined by geographic proximity. Finally, just as the MFN option has the potential to reduce rent-seeking once a tariff regime and policy is established, it could, in other conditions, also increase such practices as the process of determination of MFN tariffs could encourage interest groups to influence decision-making in an attempt to protect inefficient industries. Likewise, in economies where tariffs revenues constitute a significant portion of public revenues, politicians will always be tempted to keep tariffs as high as possible, decreasing welfare as compared to a low-tariff regime (Krueger, 1974). A MFN regime, therefore, needs not only a transparent decision-making process on how tariffs are determined, but also a credible mechanism to 'lock-in' decisions on tariffs once established.

5-2 Assessing the NDTP option for the Palestinian economy

As noted above, it took some time for the NDTP as a viable trade policy option to come to the fore, with interest stimulated by changing political realities on the ground. While the idea of a cooperative economic relation between the two partners was widely embraced during the early period of the Oslo process, Israeli unilateralism and disregard for Palestinian economic interest became the norm. Therefore, as reform of the trade policy framework premised on economic integration with Israel became seemingly impossible once Israel began applying its physical "separation policy" during the second intifada, the NDTP began to appear as a more viable, and feasible, solution.

While some equate a NDTP with a policy of ‘economic separation’ (World Bank, 2002: xxi), it may be rather understood as a strategy of economic neutrality in particular when juxtaposed against the background of economic integration that was historically imposed on, and detrimental for, the Palestinian economy. These political contingencies can be set aside however since, as was argued in chapter one, trade policy independence and a reduction in economic dependency on Israel are in themselves *intrinsic* goals that should be pursued in the interest of Palestinian political and economic independence. Pursuing the strategy of trade policy independence is inevitably attached with a number of risks, but it would also end a long history of the Palestinian economy being subservient to Israeli trade policy priorities and on the receiving end of economic and political shocks that emanate through Israeli decisions.

All studies assessing the NDTP as an option for the Palestinian economy agree that its implementation would represent a dramatic departure from the existing trade relation with Israel. It is worthwhile spelling out, and reflecting for a moment, why this would be the case. First, a NDTP would mean sovereignty over trade policy and second, it would treat Israel as just another trading partner and therefore remove the institutional framework that has sustained trade dependency on Israel. Thus assessed, it appears difficult to consider the NDTP as disadvantageous since it provides the institutional framework through which long-standing Palestinian development policy goals can be met. Yet, those advocating the NDTP option disagree on the crucial question on the nature of the tariff system that should be adopted. As Schiff argues (2002: 5, 25), the trade option that is likely to provide the best benefits to the Palestinian economy is also the one that provides the greatest degree of political autonomy, but it does so *only* if the tariff structure adapted corresponds with a liberal trade regime. On the other hand, it is equally instructive to consider that many studies rejecting the NDTP as a preferable trade policy option do so for the same reason other studies support it: namely that it would translate into the loss of Israel as the main trading partner and that would leave trade policy in the hands of Palestinian politicians who – in the context of weak institutions and a lack of public transparency – may be too easily swayed into politicizing tariff rates by being too susceptible to pressure from lobby groups or as a means to quickly increase public revenues.

Studies assessing the NDTP against other trade policy options commonly include different versions reflecting low or medium tariff structures and simulate a range of macroeconomic changes. They resort to partial, static or dynamic computable general equilibrium (CGE) models and are as such, primarily driven by identifying empirical evidence that supports a particular

trade policy preference. As argued throughout this research, trade policy studies for the Palestinian economy reviewed in the preceding chapters have come up with different and fundamentally diverging conclusions. CGE models in particular rely on a number of strict assumptions that are normally difficult to make for any normal economy, and in particular in the context of the Palestinian economy. Moreover, economic modelling is not a neutral exercise. Assumptions, hypotheses and the inclusion or exclusion of certain variables all depend on choices that have to be made. Modelling, to the extent that it intends to forecast performance is furthermore made difficult due to the sheer unpredictability of events in the Palestinian context (see e.g. Capelli, 2010). Therefore, while the empirical results produced in various trade policy studies will inform our assessment in this section, more emphasis will be put on assessing the NDTP in a qualitative manner.

Fundamentally, then, the question about the merits of a NDTP is one about whether the wider macroeconomic gains derived from a reduced dependency on the Israeli economy and trade policy sovereignty can offset the costs associated with losing preferential trade relations with Israel. Indeed, in studies discounting the NDTP as a viable option for the Palestinian economy, the detrimental effects of losing preferential market access to the Israeli economy figure prominently (see e.g. Kleiman, 2013; Nashashibi et.al., 2015: 46; Palestine International Business Forum (PIBF), 2007: 53; World Bank, 2006: 54 and 2012: 77). The opportunity to benefit, in theory, from positive externalities and dynamic gains generated through integration with a more advanced and larger economy would no longer exist. The ‘home market’ for domestic producers would shrink as their exports to Israel would now have to be subject to a tariff and competition from international suppliers. The upshot, according to PIBF (2007: 53), would be “substantial decline” of Palestinian exports to Israel, depending of course on Israeli tariff levels. Consequently, a decision to abandon the CU in favour of a NDTP would be at best counterintuitive given the centrality of export-led growth for development for a small economy like the Palestinian and even more so given that there is a natural tendency for trade to be significant between geographical neighbours. However, it should be stressed that these arguments can only be validated empirically and that despite decades of integration in the pre-Oslo era, no trend towards convergence as actually occurred (Hamed and Shaban, 1993).

The problems, or opportunities, presented in a tariff structure that is relatively high is discussed further below. For now however, we briefly consider a different set of risks associated with the ‘freedom’, as it were, of public authorities to set custom rates. To recall, the CU absolves the PA of this challenge for most goods (except those in the Lists) given that it has a CET

determined by Israel. As Schiff reasons (2002: 18), the “discipline imposed on the trade policy...that results from a CU with Israel may well be the major benefit of maintaining the present trade arrangement.” Removing this imposed discipline by the introduction of tariffs on all goods may well generate uncertainty, within a situation that is likely to remain politically charged, and potentially represses private investment. Such uncertainty would be magnified if investors accord little credibility that tariffs will not rise once they have been set since, as has been noted above, tariffs are subject to interference by lobby groups or officials seeking to increase public revenues for political purposes (World Bank, 2012: 75).¹⁷ Moreover, in the situation in which a sophisticated tariff structure is adopted, i.e. different level of tariffs on a different range of imports, effective and efficient public institutions with the sufficient policy-design and enforcement capacity are needed. Where they do not, such as in the Palestinian case, the introduction of tariffs poses considerable risks for governance and the business environment (Schiff, 2003: 17).

Another argument cited against a NDTP is that to the extent that it entails or is accompanied by a separation between the two economies physically, administratively and fiscally, this would impede the deepening of close relationships between the respective business communities, considered to be a key constituency for achieving a sustainable peace. In the same respect critics of the NDTP option assume that separate trade regimes could hamper bilateral cooperation on issues of common concern such as infrastructure, environment or tourism. In addition, both a CU and FTA provide a more appropriate vehicle for realizing a number of joint economic projects such as industrial estates that have been long on the economic agenda (Nashashibi et.al., 2015: 46, 67; PIBF, 2007: 52); whereas it is argued that a NDTP might make finding shared interests more difficult. Admittedly however, such projects have not advanced under the current CU and even if they would in future, would likely to be characterized by a relationship of domination rather than cooperation (Selby, 2003).

Finally, the operative costs of implementing a NDTP – establishing a customs border and running the customs authority – are likely to be higher than those associated with the CU since the latter does not impose tariffs on bilateral trade. In 2000, these costs were estimated to amount to US\$50 million annually or around 1.5 percent of the value of Palestinian imports (Dessus and Ruppert Bulmer, 2004: 24; World Bank, 2002: 24). For illustrative purposes,

¹⁷ It should be clarified however that uncertainty ultimately would be reduced by binding tariffs in the process of WTO accession.

extrapolating these costs to the value of imports in 2014, would mean costs above US\$85 million (though economies of scale in custom administration and learning by doing reduces costs over time).

These, then, are the real and potential downsides associated with the NDTP. The position of the World Bank's *Economic Memorandum* (2006: 52-54) in this regard is interesting to note. After assessing a range of trade policy options, including the NDTP (which it terms 'full autonomy under multilateralism'), it concludes that the latter "is always a winner under partial or general equilibrium simulations runs" and that it "always produces the highest welfare returns" (p. 54). *And yet*, the recommendation it makes for the future Palestinian trade policy framework is that of a CU on the claim that it – unlike the NDTP – provides the Palestinian economy with the opportunity to benefit from the (theoretical) dynamic gains of integration with Israel and because it avoids the political economy risks associated with autonomous determination of tariffs. Such a counterintuitive conclusion requires a leap of faith over theory in favour of politics and fails to appreciate the (equally theoretical) dynamic benefits that can be gained from pursuing a NDTP.

With the value of Palestinian exports to Israel reaching US\$ 792 million (or 84 percent of its total exports for 2014), a restricted, tariff-hampered, access to the Israeli market would indeed cause significant losses for Palestinian exporters. On the other hand, a sense of proportion is needed as exports to Israel – as important as the Israeli market is – constitute only six percent of GDP, a level that maybe could have been greater had Palestinian exporters exploited the full potentials of better marketing and improved product quality. However, the tone of many studies highlighting the ostensibly dramatic consequences for the Palestinian economy should it lose preferential access to Israel seems somewhat overblown. While market shares in the Israeli economy might shrink, it is also possible that a NDTP (assuming MFN cross-border access) would increase incentives to penetrate much larger international markets that hitherto have been neglected due to preferential access to Israel. To argue that a NDTP would significantly weaken the Palestinian export sector is to be oblivious to the range of deep-seated structural problems – some of which *caused* by the CU – that must be addressed *irrespective* of the trade policy framework in place (UNCTAD, 2011). It is, indeed, questionable how export-led growth can be achieved when the export sector has to be restructured to begin with. Nor should it be discounted that a NDTP would provide Palestinian importers the freedom to import a range of cheaper goods from some Arab and Islamic markets they are prohibited from dealing with (despite the Lists that allow some goods to be imported from such markets which do not trade with Israel). Indeed, even

if imports from Israel are without tariff in a CU, they are not necessarily the most cost-efficient ones given the various measures raising transaction costs for imports from other parties. The trade diversion and the associated welfare loss should be eliminated through a NDTP.

The issue how Palestinian employment in the Israeli economy may be affected by a NDTP is not assessed here. In general, a CU or a FTA may provide greater access to the Israeli labor market. Institutionally, the NDTP has no provisions for the free flow of labor and a customs border could lead to significant reduction in Palestinian employment, in particular for those without a permit. However, it is reasonable to assume that labor flow will not be affected by any trade framework as its fundamental driver is the cheap demand for Palestinian labor and security considerations, rather than any particular framework for relations between the two economies. There is, moreover an increasing recognition in the Israeli political establishment that for reasons of preserving the 'Jewish nature' of the Israeli state, it would be preferable to import Palestinian day-laborer rather than labor from elsewhere that would have to be integrated socially (Nathan, 2011).

Despite the significant interaction between the two economies under a CU for the past decades, technological 'learning', spillovers and outsourcing have in the past often consisted in, or were underpinned by, subcontracting activities with limited productivity gains and little creation of forward and backward linkages (MAS, 1997; Roy, 2001: 238). Furthermore, to the extent that Israeli outsourcing to Palestinian suppliers is driven by the 'asset' of cheap Palestinian labor, it should be noted that cheap labor is not, as such, an asset for the economy and society as whole and that, indeed, in the globalized world, labor costs are often cheaper elsewhere. True, if the Palestinian trade policy regime would embark on a strategy to reverse integration with Israel through moving towards a NDTP, this might impede the cultivation of business contacts and joint economic projects that may facilitate political rapprochement. However, more critical analysis of Israeli-Palestinian business relations has long argued that the joint interests of Israeli and Palestinian capital may not always be conducive to dismantling the structures that undermine the Palestinian economy as a whole (Bouillon, 2004). Moreover, since the earliest days of the Oslo process, Israeli capital has been increasingly globalized and its interest in the Palestinian economy has become increasingly marginal.

A significant advantage of the NDTP could come through controlling customs borders and collecting tariffs without interference, deduction or manipulation by Israeli authorities (World Bank, 2012: 76). While these, as noted above,

would carry some operation costs, they would also end or significantly reduce fiscal leakages and thus result into gains that outweigh the operation costs. Given the difficult topography of the area however, even the most effective custom authorities would find it difficult to detect all smuggling activities and result in some losses in collection of border taxes. Schiff (2003: 13) contends that this loss may be estimated at around 20 percent of total trade revenues which may render the NDTP a less attractive option. However, as estimated by Schiff, even if the loss would be 40 percent, the NDTP would still perform better than the CU.

In addition, the credibility of Palestinian governance in fiscal matters is perhaps much better than it is reputed to be in some analysts' view. For instance, international organizations have repeatedly praised the effective operation of ASYCUDA (Automated System for Customs Data) in handling post-clearance revaluation of declarations and computerizing customs data (see e.g. USAID, 2009). Moreover, at least according to the IMF (2011) and World Bank (2011), the quality of government institutions has long passed the institutional threshold of statehood. Still, the risks associated with politicizing the determination of tariffs and the associated costs of rent-seeking are real and should not be underestimated, just as the institutional demands for collecting differential tariffs can be overwhelming. Pervasive rent-seeking can lead to protecting inefficient producers with high tariffs, removes incentives for domestic innovation, competition and productivity spurts and can thus create a path-dependency of economic stagnation and, ultimately, government failure (Krueger, 1990). However, to jump from the *possibility* of, and admittedly empirically often observed, misuse and inefficient introduction of tariffs to promoting a position of low or zero tariffs is unfounded. As Chang (2005) argues, the case against tariffs is based on a double-standard, historical amnesia and a selective reading of empirical evidence. True, as the saying goes, 'for every South Korea there are plenty of Zaires' but it should also be remembered that many countries suffered from the hasty reduction of tariffs and trade liberalization (Mosley and Weeks, 1993; UNCTAD, 2012). Instead of highlighting the failures of 'above-low' tariffs, there is now a rich experience, expertise and research that can be consulted to learn from the mistakes and emulate lessons that can work within the particular context of the Palestinian economy.

Going beyond the advantages of the NDTP, in itself or as compared to the CU, we can also briefly assess it in relation to the FTA. Both the NDTP and the FTA would require clearly defined customs border, rather than soft or provisional borders that are sufficient to run a CU. However, since the FTA implies a preferential trade relation with Israel, this would also require

specifying RoO to determine which country the imported good comes from or the value added produced by the FTA partner to qualify for trade free of tariff. The issue around RoO is by some considered as an important factor making the FTA a potentially inferior trade option when compared not only to the NDTP, but also the CU. These rules have to be negotiated between the two (asymmetric) partners, have to be monitored and are often cumbersome in particular when there are multiple and overlapping FTAs. These costs would be borne out by Palestinian consumers. Importantly, applying RoO may contribute to the already existing pattern of trade diversion whereby Palestinian producers would import more expensive intermediate goods from Israel – rather than less costly alternatives from other countries – so that they meet the RoO that enables them to export final goods to Israel duty free. It can, likewise, be costly for Palestinian producers to prove compliance with RoO in case some content of their product was sourced from outside the FTA. Finally, RoO can be used as a non-tariff barrier to prevent the free flow of cheaper goods (Dessus and Ruppert Bulmer, 2004: 17; Schiff, 2003: 21-24).

5-3 NDTP and the tariff structure

To the chagrin of many non-economists, economic analysis often tends to be two-handed. Thus, it should not come as a surprise that advocacy for the NDTP comes with two hands. At the center of contention is the issue of the tariff structure. Since the NDTP provides for autonomous tariff determination, a country can opt for any degree of high or low tariffs for good or bad economic reasons. Studies that have concluded with the NDTP as the preferable trade policy framework for the Palestinian economy have however found no common ground on the tariff structure that would best suit the Palestinian economy.

On the one hand, Dessus and Ruppert Bulmer (2004), Schiff (2003), the World Bank (2002) and to some extent de Melo et.al. (2003) agree with a range of arguments in favour of the NDTP but condition their support on the NDTP being ‘open’ or ‘liberal’ with a low, and uniform, tariff structure. Indeed, in case a NDTP were to be adopted with a tariff structure that would be ‘above-low’, in these economists’ books, the NDTP could no longer be assessed as the most favourable option. They base their position on pragmatic grounds, such as the incentive high tariffs would provide for rent-seeking, the high institutional capacity needed to administer differential tariffs or the risk of trade deflection caused by smuggling of (assumed) cheaper Israeli goods. A strong argument against high tariffs (often kept tacit in the above referenced studies, presumably because it is widely accepted) is that it is considered as a distortion of the efficient functioning of markets by shielding

inefficient domestic producers, reducing competition and consumer welfare and, in total, holding back total factor productivity. The downside is magnified for small economies since competition is by definition limited.

For studies cited here, the optimal tariff structure has been defined at 5 percent on all imports and a purchase tax at zero percent. The neoclassical ideal of free of tariff trade notwithstanding, the studies justify their 5 percent tariff base on the grounds that it matches the average rate of tariff for comparable economies. The study by de Melo represents the most liberal version of research proposing the NDTP, taking the conventional advocacy for free trade to its logical conclusion by recommending a uniform tariff as low as zero on purely efficiency grounds.

On the other hand, without dwelling on the theoretical controversy around tariffs, UNCTAD simulates a NDTP option with what can be considered a tariff structure ‘above-low’. Specifically, it assumes a gradual increase in the average tariff rate on Israeli imports “from its current zero level to the average tariff on a typical Palestinian basket of imports from the rest of the world (16.6 percent)”(UNCTAD, 2009:29). This tariff mirrors the *effective* tariff rate (at the time) which is comprised of the tariff on a typical Israeli import basket of 8.3 percent, which the Palestinian economy has to adopt in the CU, and reflects the higher tariffs on Palestinian imports due to its import basket consisting of goods subject to higher (protective) Israeli tariffs. The simulation assumes that the 16.6 percent tariff structure is uniform but adds the option to design a differentiated tariff structure appropriate to address challenges and opportunities of the Palestinian external sector should be seriously studied (p. 32). For UNCTAD, is a moot point to discuss whether 16.6 percent is ‘high’ and represents a ‘closed’ NDTP (it certainly is above what the World Bank and others consider a ‘liberal’ or ‘open’ NDTP) since this rate simply reflects the effective import tariffs as it currently existed. While the simulation results show that the loss of preferential market access does reduce the export/GDP ratio in the Palestinian economy, it underscores the value of trade policy autonomy as the NDTP trumps the other two trade policy options in terms of the impact on a range of macroeconomic and trade-related variables, including GDP and unemployment, and UNCTAD argues, would facilitate the reduction of dependency on Israel and integration into regional economies alike.

Tariffs exceeding the arguably arbitrary notion of ‘low’ have been justified on a number of grounds. Historically, post-colonial states in the developing world – but also it should be recalled, the USA –applied tariffs to reverse the penetration of colonial capital and provide a protective shield for domestic

industries to develop. While raising tariffs in some of the countries produced disastrous results by protecting inefficient, rent-seeking industries, for others, industrialization and catching-up could only commence once they had the autonomy to decide on tariffs and other economic policies (Amsden, 2001). Before they became the advanced economies they are today, European states also had a number of protective tariffs. Indeed, as argued by the eminent economic historian Paul Bairoch (1993: 46), Britain's technological lead that enabled it to unleash the industrial revolution and shift to a regime of free trade was achieved "behind high and long-lasting tariff barriers." Even during the assumed 'golden age of free trade' between 1875-1914, it has been shown that protective tariffs positively correlated with economic growth (O'Rourke, 2000). Clearly Israel's economic success is due in no small part to the highly protective tariff system that sustained it through the first four decades of its impressive state-building experience (Kleiman, 1997; Jones and Murphy, 2002: 61-90).

The importance tariffs played for today's developed countries, amidst their pressure on developing countries to reduce it, has often been used to charge the former with a double-standard along the lines of 'do as we say and not as we did'. The point here is not that tariffs should be raised and remain high, but that at a certain stage of development, higher-than-low tariffs might be a suitable tool as part of a wider strategy aimed at industrialization when coupled with other tools such as export promotion, tariff rebates on capital goods or the extension of credit facilities.¹⁸ Moreover, the latter category of support has to be temporary, based on performance indicators, and be provided only when public institutions can enforce rules and credibly withdraw support in case of under-performance.

In another study however, UNCTAD (2006: 22) takes direct aim at suggestions that prospective trade reform should pursue a NDTP with a low, uniform tariff. While agreeing that the NDTP framework could produce better results than any other trade policy option, adhering to a low, uniform tariff would automatically deprive the Palestinian economy of the SDT (as accorded to the group of Least Developed Countries - LDCs) it could claim, as it has been stipulated by the United Nations General Assembly in 1988 that the Palestinian economy should receive the same treatment as LDCs until the end of the occupation. This could allow it to set tariffs at a higher rate that suits its development goals and, in the context of eventual Palestinian accession to the WTO, SDT could be useful for the transition to NDTP, by legitimising temporary use of these advantages until phased out. A related

¹⁸ For an excellent discussion of tariffs in historical perspective, see the second chapter in Chang (2002).

point already made by UNCTAD (1998: 34, 51-2), argued that trade integration should be phased and carefully calibrated to match initiatives to rehabilitate productive capacity and diversify export markets, including low tariffs for critical inputs and a higher one for developing potential comparative advantages and industries in which import substitution would require little effort. However, a low tariff, much less if uniform, does not provide economic planners the means with which to achieve such a strategy. Instead, pursuing a differential, flexible tariff strategy is more likely to reverse the entrenched structures that have made the Palestinian economy rely largely on low value added production and boost the prospects to increase productive capacity to climb up the technology ladder to produce high-value goods.

In this respect the World Bank (2012: 74-75) argues that tariffs would constitute a distortion within an already distorted economy. Moreover, it is argued, by citing the low tariff structure of Kosovo, that precisely because the manufacturing base of its economy is so low, higher tariffs would not be justified. This is an interpretation that portrays a certain logic according to which de-industrialized economies are expected to remain with this status and should not pursue any efforts to reverse it. Likewise, the notion – particular pertinent in the Palestinian economy – that tariffs can have counter-distortionary effects is not considered. Rather, UNCTAD (2011) proposes that a ‘corrective import substitution’ should be pursued to rebuild the trade sector and improve competition. This measure should not be understood as limiting competition or free trade, but rather as a necessary corrective to tackle distortions and obstacles created by Israeli occupation by removing or compensating for cumulative effects that proved detrimental to Palestinian producers. It is, in this respect, also relevant to note the PA decided in 2013 to raise the tariffs for a number of products (leather products, shoes, aluminum and textiles) to protect producers that are efficient enough to compete in the Israeli market, though the impact of these partial measures have yet to be assessed.¹⁹

While studies advocating more a measured rate of differential tariffs for developing countries are plentiful, it is noticeable that in the Palestinian context only studies conducted by UNCTAD have made this case. This may well be due to it being wedded to some (but decreasing) extent to the Latin American School of Development and structural economics that stresses the need for active government policies to help developing countries to carve out space in the international economic order (Smith and Taylor, 2007). Such a body of thought translates into opposition to hasty trade liberalization and

¹⁹ Source: PNA Cabinet Order Nr 14, 2013

awareness that the mantra of ‘free trade’, first imposed globally by the British Empire and then by ‘Pax America’, has had devastating results for poor countries (Karshenas, 2016). The relative marginalization of UNCTAD structuralist economic thought has been caused by the ability of neoclassical development economics to impose its hegemony in international development organizations and, needless to say, their power in influencing Palestinian decision-makers.

Finally, two other reasons for the merits of a measured tariff must be mentioned. The first relates to countering fears that a Palestinian tariff would be excessively high. With a NDTP, a customs border eliminates the current problem of fiscal leakage that deprives the public budget of up to US\$ 300 million annually. True, a customs border might also increase incidences of smuggling which reduces the prospective tariff revenues but this could be countered by effective border controls. Thus, with this *additional* income stream for the budget, the incentive to raise tariffs might be reduced. The second reason considers a broader perspective pertaining to fiscal revenue policies and priorities. Currently, around two-third of public revenues are generated through custom revenues. While it is a tenet of neoclassical economic theory not to use tariffs as means for fiscal purposes, public revenues under a CU or FTA would be significantly lower than they would under a NDTP with a measured tariff structure. That the PA budget depends more on trade taxes than direct taxes is a structural problem that needs time to be reformed, and most likely restructured economic relations with Israel, to be solved. It thus is questionable how the PA would compensate public revenues in the event of a low tariff NDTP. Ideally, of course, public revenues would be boosted through a growing economy. But to create it, significant public resources must be mobilized to support productive sectors – a strategy that can be facilitated by allocating public revenues created through a NDTP with a measured tariff structure to public investment needs.

Chapter 6. Conclusions and the way forward

In concluding this exhaustive review and assessment of the past two decades of the intellectual and political contortions by a vast array of players in the field of analyzing and advocating future Palestinian trade policy options, a number of findings are apparent, though not all definitive or signaling to an end to this debate. In fact, even without the benefit of the extensive economic analysis to which this matter has been subject, the cumulative experience with the application of the PER is such that we can safely conclude *a priori*, that the Palestinian economy would be better off with “*Anything But The Protocol*” on the assumption that none of the possible options can be worse than the regime in place today.

Indeed, the extent to which analyses begin with an apparently distinctive theoretical option and conclude with proposals that imply a significant departure from the textbook model, is dazzling and can blur the significant technical borders between one and another. The creative ambiguities and nuance that makes a NDTP with low tariffs the most optimal trade policy, but rule out one with higher tariffs or that give rise to FTA’s resembling CU’s and vice versa, show how sensitive results based on conventional trade theory are. In the complex world of real multilateral and regional trade policy negotiation, outcomes are driven by political interests rather than notions of efficiency, trade creation or diversion. This resonates in particular in the specific Palestinian context, whereby even the most perfect trade arrangement might well entail the most imperfect political outcome from a Palestinian vantage point.

Certainly, the literature reviewed here has provided plenty but rather generalized arguments for and against the three principal trade policy options discussed for the Palestinian economy – the CU in its current or improved version, an FTA with Israel or non-discriminatory MFN treatment. Some of these arguments are more theoretical and abstract in nature and provide adequate conceptual background for any deliberations around the future Palestinian trade policy framework. Other analyses have taken the concrete experience of Palestinian trade performance under the PER into account and are more in tune with the particularities of the developmental (and political) challenges facing the Palestinian economy.

As a corollary, it is difficult to pinpoint what exactly the community of researchers on trade options or Palestinian decision-makers has concluded

from the vast number of contributions to the theme. Instead, our knowledge on what constitutes an improved institutional framework for Palestinian trade policy remains fragmented. It is clouded not only by competing research that produces conflicting findings and by positions that seem to shift back and forth as time goes by and conditions on the ground change, usually for the worse. Research on trade policy has not even produced agreement on one of the principal assumptions that has guided this research, namely that the current form of a CU trade policy regime has been demonstrated over the past 20 years to be at best dysfunctional from a Palestinian vantage point and at worst detrimental to pursuing Palestinian strategic national economic and political interests.

The cumulative body of research aimed at improving Palestinian trade policy has proceeded along three tracks: proposals for piecemeal improvement of (some would say cosmetic changes around) the present trade policy framework; work assessing the optimal trade policy based on various economic theories and assumptions that has often abstracted from real world constraints on the ground; and, research that has taken these constraints into account with the assumption that the Palestinian economy should either chart its future from within these constraints or attempt to set itself free from them.

Despite these established research approaches to Palestinian trade policy options, most analyses are flawed, in one or more of the following ways.

First, the bulk of trade policy analyses has focused on the three conventional policy options and assessed their applicability in their pure model form, assuming the normal functioning of markets and trade dynamics. While these options cover most of the theoretical literature on trade and include most of global trade experience, hence allowing for plenty of empirical comparison, it is also the case that most actually-existing trade agreements initially conceived around such ideal frameworks ultimately include many exceptions and modifications. As a result, the usefulness such studies may provide for the nuts and bolts of setting trade policy and negotiating trade agreements is limited. In reality, therefore, any reasonable Palestinian decision-making aiming to comprehensively address the challenges of the Palestinian economy, will most likely opt for a hybrid scheme consisting of trade policy elements from more than one pure model.

Second: Any future trade agreement that could be reached with Israel, whatever form it takes short of complete separation, will only have any chance of generating positive results for Palestine to the extent that two conditions are strictly met. First, that the security exceptions under the

agreement, classical provision in almost every agreement, are strongly disciplined to avoid abuse. This will demand at least the incorporation of the proportionality principle, and the condition that Israeli security measures that might be taken under the exception shall be the least trade distortionary alternative. Secondly, the agreement must incorporate an effective dispute settlement mechanism, guaranteeing that the commitments adopted by the parties will be duly respected; and if violated provides adequate instruments to oblige remedy implementation. In the absence of these two conditions, as the history under the PER has clearly demonstrated, the letter of the agreement could be at the best just a rhetoric declaration of good intentions.

Third, much of the literature is based on quantitative approaches framed around comparative simulation models and static equilibrium analysis that each employ different parameters, time-series and specifications of what is exogenous and endogenous to the model. There is however, often a gap between the abstract foundations of the theories employed and the empirical results they are supposed to generate. For instance, the question whether CU is better than a FTA as a trade policy framework for the Palestinian economy has been subject to numerous studies. For this question to be answered on purely economic grounds, it would be necessary to assess whether TC is more dominant in a CU or FTA, or alternatively, whether TD can be more minimized in a CU or FTA. In other words, these questions that can only be assessed empirically. Surprisingly, inadequate empirical research has been undertaken outlining the actual TC and TD in the existing or an improved CU or its potential contours in a FTA, not to mention how those effects might play out in a NDTP regime without preferences. Similarly, studies emphasizing the potential dynamic gains of various trade policy frameworks do so without giving adequate consideration to the divergence between abstract, theoretical benefits and the concrete challenges on the ground that would have to be overcome to realize them.

Fourth, all too often, studies on the optimal trade policy framework for the Palestinian economy have been pursued with a trade-driven approach to development that subordinates questions regarding economic strategy to trade policy which is understood as the main engine of macroeconomic recovery and economic growth. It is, in a sense, a form of trickle-down approach that is informed by a view that once trade liberalization is in place, enduring economic weaknesses will be rectified. Such an approach, moreover, is hostile to a range of government supported initiatives to ensure inclusive growth or aimed at boosting trade capacities or interventions that are market-creating and growth-enhancing.

The alternative position, a development-driven approach to trade recognizes not only that any effective trade policy will have to be part of a comprehensive macroeconomic strategy, but also that what constitutes an effective trade policy is likely to diverge from the conventional blueprint of “best-practice” trade reform. Instead, while this approach takes its cue from the historical lessons provided by the rapid catching up of East Asian economies, it recognizes that each economy will have to develop a trade policy that is unique to its developmental challenges and potentials. In other words, then, most studies have suffered the weakness of starting from the question of what the best possible trade regime for the Palestinian economy (and its relation with Israel) would look like and then reconstituted the various elements of economic policy to fit any given trade policy accordingly. An extreme example of this approach is the idea advocated by some of needing to make the Palestinian economy “WTO-compatible” regardless of whether such instant compatibility is the best option for its sustained growth, productive sector development or social welfare.²⁰

Fifth, trade and economic strategy for much of the past decade, if not longer, has been conducted on positive assumptions about the outcome of the political process that would deliver statehood, sovereignty and peace. It thus became standard practice to analyze future options in the context of relaxed assumptions about the critical political constraints. Since 2001, if not before, these assumptions are no longer given, are unlikely to be in place in the foreseeable future, and have therefore scuttled the possibilities for a cooperative Israeli-Palestinian economic and trade relation in efforts to explore the optimal future economic regime or advocate one solution as preferable to another. Sustaining benevolent political assumptions in order to explore hypothetical future trade regimes is no longer helpful, especially in the harsh political circumstances faced by Palestine in its relations with Israel and the region. Such an approach simply passes the ball down the line, so to speak, to a hopefully better political climate for the next generation, hence delaying hard decisions today about the direction in which the Palestinian economy and trade should be oriented, beginning now.

So any future research on trade policy options should perhaps take as a starting point the status quo of limited political relations with Israel and a complex and challenging Arab regional economic environment. The next stage of research in this area should be rooted in a realistic, empirically

²⁰ The history of Palestinian efforts to obtain observer status in the WTO and the economic policy arguments underlying the approach to bringing the Palestinian economy in line with multilateral trading system requirements has been fully reviewed in a recent study by MAS (Khalidi, 2015d).

substantiated assessment of the exact costs and benefits to the national economy of the current regime geared to integration with Israel (or even in an improved CU). This should be compared to the impact on key strategic economic goals of a tariff and trade regime that would discount the supposed premium of an integrative regime and allow for separation of the two economies if need be, with or without preferential exemptions.

Sixth, the manner in which the question of integration or separation is addressed in the literature is incoherent. Forced integration has been tried and tested (since 1967) and the results continue to be negative and contrary to theoretical expectations. Moreover, under the PER, economic integration or dependence has been used to tie the hands of Palestinian decision-makers politically. The arguments against CU or FTA and in favor of MFN should not be understood necessarily in the context of political separation, but rather as trade neutrality vis-à-vis Israel and trade integration with the wider region and globally. Such a strategy will entail adjustment costs however, losers must be compensated, new sectoral growth poles with job-creation must be created and new institutional discipline in managing the trade and fiscal regime will be called for.

The key question remains however, as to how a separate tariff and trade regime, were it to be deemed empirically to be superior to other options, could be pursued under current political conditions of occupation and the continued legal applicability of the PER. Exploring the other side of this same argument, however, might lead to a logical conclusion that if political separation (independence) is not a real option for the foreseeable future, then trying to elaborate a “separatist” trade policy would be equally futile. Instead, and especially if the “one-state reality” that now exists persists on the ground and politically, a vigorous and all-out pursuit of economic integration, indeed full economic union with Israel, might be an option that offers the shortest path to Palestinian economic development and social welfare, however unpalatable the long term political costs of such a strategy choice (Khalidi,2014a).

Seventh: Palestinian decision-making institutions have yet to form a uniform position around trade policy proposals on the table and to pursue reform strategies consistently. Too much of the deliberations on trade policy options have been conducted in the closed rooms of a few Ministries, donor-funded project teams and narrow, generally fragmented, joint Israeli-Palestinian academic or private sector initiatives, or other recurrent efforts that have proceeded in fits and starts. This is not only a matter of inadequate stakeholder and public consultation in policy-making processes, admittedly a weak point in Palestinian institution building. Indeed, as a roundtable

organized by *Miftah* (2011: 3) recommended, “(t)here is a need to reevaluate the network of relationships and committees that are working independently on economic agreements with Israeli ministries and commissions without an official unified framework that organize the process”.

More critically, the question of whether to move away from the PER (either to more or less integration with Israel) and how that should be determined by a larger and deeper development and economic building vision has yet to be formally addressed. Instead, Palestinian politicians, experts and public continue to voice a range of complaints about the design and implementation failings of the PER (related to trade facilitation obstacles, its inappropriate tariff structure, its limitations on trade diversification, insufficient access to Israeli markets, denial of pursuit of an independent monetary or macroeconomic policy, and, most recently, fiscal leakage). They fail, however, to accord serious consideration of what immediate future optional regime would be preferable, much less show signs of moving towards either abrogating or amending the Protocol. It is timely for this strategically critical Palestinian debate to be launched and promptly concluded, if the Palestinian economy is to escape from the development limbo into which it has been cast.

Indeed, if development is not possible under occupation, it is imperative for economic policy, including trade policy, to carve out space with a greater degree of independent economic decision-making so that the economic and political leverage of the occupying power is undermined – a necessary condition for Palestinian development to move into the realm of the possibilities. In order to facilitate a powerful role for trade in this process, Palestinian economic policy-making should be rooted in a development-driven approach to trade. Such an approach would necessarily reduce emphasis on Israel as the predominant (but not inevitable) trade partner in any future trade regime and would respond first and foremost to Palestinian imperatives of economic and social development.

In order to understand which trade regime might be feasible for a sovereign Palestinian state, a full empirical assessment is needed on the impact of the current tariff schedule on the Palestinian economy and of the potential impact of alternative tariff structures. Such research should move on from this review and previous studies both in terms of the quantitative sectoral analysis of trade data that it should employ and of the link it will seek between economic sovereignty, political independence and a trade policy that emphasizes strategic economic development needs and social equity goals. This is not simply a matter of promoting sound and researched public policy-making processes, but is necessary to ensure the best possible quality of economic

development awaiting the Palestinian people after a century of dispossession, a goal that the PLO has been pursuing since the peace process began. As suggested earlier, an assessment of tariff and customs policy impacts on economy should address these with reference to three indices:

- The impact on local productive capacity and structure: This relates to the potential use of tariff to shelter and promote promising industries, either via higher tariff on competing imported final products or lower tariff on imported intermediary inputs.
- The impact on the standards of living and poverty, particularly in light of large rural population and high Palestinian dependency on imports of food stuff.
- The impact on the fiscal revenues of the government.

These impacts incorporate trade-off relationships, meaning that increasing one effect may be at the cost of other effects. The experience of other countries should be examined with regard to the possible effects of excessively high and permanent protection tariff. Furthermore, because tariff is a discreet and relatively easy to implement tool, new research should also examine the effect of raising import tariffs on export capacity and on the public deficit – a tempting measure by governments in poor countries to increase fiscal revenue.

Along with finding the right balance among the above-cited impacts, research on an optimal Palestinian tariff and customs policy should consider possible international trade obligations of Palestine, whether multilateral trade agreements (such as the WTO) or regional and unilateral free trade arrangements. It should also take full advantage of preferential treatment and exemptions for developing economies until such time as international agreements acquire binding force in the Palestinian context. The overall impact of such research would be to consolidate the PA's effort in designing, assessing and implementing a sound, sovereign trade for development policy for an independent Palestinian state.

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