Mercantilism or Liberalism? Economic Autonomy and State-Building in Palestine

¿Mercantilismo o liberalismo? Autonomía económica y construccióndel Estado palestino

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Received: September 27, 2016
Approved: October 24, 2016

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How to quote: Kattan, F. y Alonso, R. (2016). Mercantilism or Liberalism? Economic Autonomy and State-Building in Palestine. *International Journal of Cooperation & Development. 3*(2):59-98

Revista Internacional
DE COOPERACIÓN & DESARROLLO
International Journal of Cooperation & Development

Abstract

Can economic integration succeed between one rich and relatively powerful partner and one poor and relatively powerless partner in the context of security tensions between them? This paper evaluates the economic reality resulting from peace treaties conceived between Israel and Palestine, countries with intentions of integration and interdependence, but that has resulted in a de facto situation of de-development and a higher degree of economic dependence. The context of the study was evaluated based on the mercantilist and liberal theories of the 17th century. The actual conditions prevailing in Palestine-Israel relations are far from those of a liberal context. Neither are sovereign states at peace. Rather, Israel is a well-established sovereign state with an impressively developed economy and a strong army, while Palestine is an occupied nation with no formal state, fledgling institutions, a developing economy and no army. Moreover, the context of Palestine-Israel relations is not one of peace, but one of military occupation and war. Due to this power gap between the two parties and the context of occupation and war, the de facto regime and policies regulating and updating the economic relationship between them have been very different from what is established de jure under existing economic integration agreements. Therefore, the results in terms of economic development and institution building for Palestine have not been at all what one would expect from a process of economic integration between two free well-established states at peace with each other.

Keywords: Palestine, Israel, mercantilism, liberalism, de-development, economic integration.

Resumen

¿Puede tener éxito la integración económica entre un socio rico y relativamente poderoso, y un socio pobre y relativamente impotente en el contexto de tensiones de seguridad entre ellos? Este documento evalúa la realidad económica resultante de los tratados de paz concebidos entre Israel y Palestina, países con intenciones de integración e interdependencia, pero que ha dado lugar a una situación de facto de desarraigo y mayor grado de dependencia económica. Se evaluó el contexto del estudio con base en las teorías mercantilistas y liberales del siglo XVII,. El estudio muestra que las condiciones reales que prevalecen en las relaciones entre Palestina e Israel están muy lejos de las de un contexto liberal. Palestina e Israel no son dos estados soberanos y en paz. Más bien, Israel es un estado soberano y bien establecido con una economía impresionantemente desarrollada, con un ejército fuerte, mientras que Palestina es una nación ocupada sin estado formal, instituciones incipientes, una economía en desarrollo y sin ejército. Además, el contexto de las relaciones palestino-israelíes no es de paz, sino de ocupación y guerra militares. Debido a esta brecha de poder entre las dos partes y el contexto de la ocupación y la guerra, el régimen de facto y las políticas que regulan y actualizan las relaciones económicas entre ellos han sido muy diferentes de lo que se establece de jure bajo los actuales acuerdos de integración económica. Por lo tanto, los resultados en términos de desarrollo económico y construcción de instituciones para Palestina no han sido en absoluto lo que se esperaría de un proceso de integración económica entre dos estados libres y bien establecidos en paz unos con otros.

Palabras Claves: Palestina, Israel, mercantilismo, liberalismo, De-development, integración económica.

1. Mercantilism and Liberalism and their Times

Mercantilist and Liberal theories and economic policies have prevailed in the world at very different times. Mercantilist or nationalist economic theories have prevailed at times of war and insecurity, national rivalry, state-building and economic development. They are the policies of hard times led by fledgling states with not-yet-developed economies aiming at strengthening their economic autonomy and institutional structures. They were first developed by Colbert in the 17th century and implemented in France as well as throughout Europe as the post-Westphalia process of nation-state building and intra-European strife unfolded. They were equally espoused by Friedrich List and German policy-makers during the nineteenth-century period of German economic development and political unification as well as by Alexander Hamilton in the United States at a very similar time in the history of his country.

Mercantilism reflects the needs of economies and states whose neighbors are not their friends –except possibly tactically—and, thus, who cannot take security for granted. Its authors and implementers assume that there is no trade-off between politics and economics or between power and plenty. Rather, they believe that, in their circumstances, power and security considerations with their state-building and economic autonomy corollaries need to be the guiding principles of their economic policies. For them, overseeing long-term survival considerations for the sake of potential short-term economic gain would mean that there would be no plenty to be had (and possibly no state left either). In a mercantilist world, a state which depends economically on its neighbor is a weak and vulnerable state whose fragility will be used against it. On the contrary, a strong state is a state which is economically autonomous from its neighbor and, hence, does not depend on it. A strong state is also a state which has sound and efficient national institutions, needed both to ensure its security as well as underpin its economy.

Liberal theories and policies, on the contrary, have prevailed at times of peace and stability. They are the policies of times of trust between neighbors with relatively strong states and reasonably well-developed economies. They were first theorized by Adam Smith and David Ricardo. Both economists were not coincidentally born in England, one of the most well-established states and the most developed economy of the time. Liberal policies have been progressively adopted across the world as states and economies develop.[1] Even once states and economies have progressed from the mercantilist to the liberal phase, they can have relapses at times of economic recession and political insecurity (as was the case in the interwar period in Europe). When a certain level of economic development and state authority have been established, however, it is easier to revert back to liberal thinking and policies, especially within multilateral frameworks. At that stage of development, willing leaders can build institutions and international regimes to cement liberalism as they did in the western world after World War

[1] The World Bank Development Report (2009a) confirms this long-established relationship and its evolution: “Rich countries tend to have the lowest barriers to trade and factor mobility…as countries develop, they gradually lower almost all types of barriers.” (p. 96-97) “Each of today’s successful regions initially developed its manufacturing sector behind a fairly substantive wall of tariffs and other protections. Only as their economies matured…did they gradually open their borders and integrate regionally and globally” (p. 119).

II and in Western Europe first through the Common Market and later on through the European Union.

For mature states with relatively well-developed economies, economic integration also becomes possible and even desirable. For developed economies at peace, competition from their neighbors is not a threat to their autonomy, but a spur to economic growth. Similarly, institution-building at the national level is no longer the end in itself that it can appear to be to those establishing a new country. On the contrary, states can focus on building common regional institutions to cement shared interests and defend them in the rest of the world even at the expense of relative loss of national sovereignty. In this context, considerations of relative gain (relative economic growth rates, bilateral balances of trade, bilateral foreign investment flows, labor flows or even relative political power) become less important as the threat of war and the likelihood of use of economic leverage for political gain among neighbors fades. It is the time at which states can focus on mutual gain, believe in and implement systems that foster positive-sum gains and concern themselves with security and prosperity for the region as a whole.

Economic integration, in short, is based on mutual trust, belief in joint economic benefits and a sense of security by those involved. It requires abiding by the rules of the game of economic integration which the economic and political benefits it generates help to reinforce. For these conditions to prevail and regional integration to proceed even in a context of peace, however, there needs to be a rough parity between the integrating parties. In fact, states that have engaged in economic integration processes are either typically all large (e.g. US, Canada, Mexico) or all small (Benelux). Other agreements have included particular guarantees and incentives for small states within a non-threatening multi-lateral regional framework (as in the EU).

In no case has economic integration willingly proceeded between one rich and (relatively) powerful and one poor and (relatively) powerless partner in the context of security tensions between them. This is probably so because, in such a context, what is likely to develop is economic and political dependence --rather than inter-dependence-- and the weaker party would not wish to place itself in such an economic and politically vulnerable situation in a conflict situation. The case of the economic relations between Israel and Palestine, however, offer a case study of what can transpire in such a situation.

For the transition phase between a mercantilist and a liberal framework to start, war needs to be over. Fostering cooperation in a context of war and occupation leads to an increase in the areas of friction and in the tools available for each side to inflict damage on the other. This situation creates incentives for aggression through economic means and conflict escalation, hence delaying the day in which true conflict resolution can begin. Moreover, in a context of inequality between two sides, attempts to enhance cooperation between them actually lead to deepening the dependence of the weaker on the stronger partner, distorting its economic relations and de-legitimizing its institutions.

2. Palestine-Israel Relations –A Mercantilist or a Liberal Context?

Since the 1990s, many analysts and policy-makers have been operating as if the relevant framework to apply to Palestine's economic relations with Israel were that of liberalism.

The economic regimes and policies which they have propounded and implemented have reflected the assumptions of a liberal world. They have focused on stepped up economic integration in trade, labor flows, revenue management and private sector economic relations, including in such strategic sectors as energy. These economic integration goals have been reflected in the Oslo Agreements of 1993 and, in particular, in the Paris Protocol of 1994 and the Agreement on Movement and Access of 2005. These blueprints outline a *de jure* customs union (CU) bordering on a common market, including free trade in goods and services, a common external tariff and, to a certain degree, free flows of labor.[2]

The actual conditions prevailing in Palestine-Israel relations, however, are far from those of a liberal context. Palestine and Israel are not two sovereign and rich states at peace. Rather, Israel is a sovereign and well-established state with an impressively developed economy and the strongest army in the Middle East while Palestine is an occupied nation with no formal state, fledgling institutions, a developing economy and no army. Moreover, the context of Palestine-Israel relations is not one of peace, but one of military occupation and war. Because of this power gap between the two parties and the context of occupation and war, the *de facto* regime and policies regulating and actualizing the economic relationship between them have been very different from what is established *de jure* under existing economic integration agreements (which themselves reflect an uneven power balance between the parties). Therefore, the results in terms of economic development and institution-building for Palestine have not at all been what would be expected from a process of economic integration between two free well-established states at peace with each other.

This discrepancy between *de jure* agreements and *de facto* reality and its negative impact on the Palestinian economy has been increasingly acknowledged by economic analysts.[3] This paper builds on this literature and purports that the degree of economic integration with Israel that has been imposed on Palestine in the current context of war and occupation is counterproductive for the Palestinian economy. In this regard, it argues that the recommendations of mercantilists for economic autonomy from parties with which a country is at war are well-taken and constitute a better framework within which to analyze Israeli-Palestinian economic relations. In this guise, it recommends the enhancement of the economic autonomy of Palestine from Israel. In no way does the paper espouse attempting economic self-sufficiency or excessive protectionism, both of which would be impracticable and self-defeating, especially for such a small economy. Rather, it recommends building on own resources while diversifying economic relations, deepening economic ties with neighbors such as Egypt and Jordan when advantageous and maintaining open relations with the rest of the world.

[2] Arnon and Weinblatt (2001) have pointed out the discrepancy between the *de jure* and the *de facto* regimes prevailing in Palestine-Israel relations. In particular, they argue that, despite *de jure* economic integration, economic separation has prevailed *de facto*. In our view, however, speaking of "separation" in the context of occupation is a contradiction in terms. What we have, as will be argued, is an asymmetrical power relationship which allows *de facto* arbitrary use by Israel of the *de jure* framework to foster its perceived economic self-advantage and to use it as a political and economic bargaining chip including, periodically, to inflict collective punishment as retaliation on Palestine.

[3] In addition to Arnon and Weinblatt (2001) , see Diwan and Shaban (1999), and the various reports of the Aix Group (2004) and Arnon and Bamya (2007).

This chapter will aim at: a) summarizing the required conditions for successful economic integration to pan out; b) describing the *de jure* framework regulating Palestine-Israel economic relations; c) presenting the economic regime and policies which *de facto* regulate these relations; d) outlining the economic transmission mechanisms between regime and policies to economic outcomes; e) analyzing the economic and political consequences of the combination of the existing unimplemented *de jure* and implemented *de facto* frameworks (dependence, de-development and institutional de-legitimization); f) presenting some conclusions from the preceding analysis; and g) putting forth some recommendations for enhancing economic autonomy in going forward.

3. Required Conditions for Successful Economic Integration

Recent reviews of international trade and regional economic integration hold powerful lessons for the Palestinian-Israeli context. This section will briefly examine two of them –the 2009 World Development Report on *Reshaping Economic Geography* and a 2003 World Bank review of Regional Integration Arrangements. In both cases, the conditions the studies lay out for fruitful trade and economic integration to take place are not fulfilled in the Palestinian-Israeli context due to the circumstances of war and occupation.

The 2009 World Development Report identifies three basic variables determining trade between countries: density (size of the trading partner's economy), distance (physical market access between trading partners) and division (the effects of borders). The first two variables are promising for trade prospects between Israel and Palestine due to the size of the Israeli economy (density) and the geographical proximity between both countries (distance). However, the third variable (division) works in a unilateral direction making market access for Israeli goods into Palestine relatively easy, but market access for Palestinian goods into Israel extremely difficult. As we will see, this unevenness of access greatly reduces the potential gains from trade for Palestine and has critically impaired the development of the Palestinian economy, especially since the 1990s.

A 2003 World Bank study of regional integration and development is also enlightening in our context. The report reviewed worldwide empirical evidence on the impact of regional economic integration on growth and economic development (Schiff & Winters, 2003). At the end, the study draws a number of conclusions it calls "rules of thumb for regionalism." This section will summarize the rules of thumb that are most relevant to the Israeli-Palestinian context and assess how they affect the likelihood of the existing Oslo-backed customs union between the two parties to yield the expected gains from regional integration.

North-South RIAs are preferable--In principle, North-South RIAs are preferable to South-South agreements because, whereas there is empirical evidence that the former can stimulate growth, there is no evidence of this effect in the latter. A key reason why North-South RIAs tend to perform better than South-South ones is that they are more likely to increase competition and lead to better trade, greater investment and more foreign direct investment-related technology transfers. From this point of view, a regional economic agreement between Palestine and Israel sounds promising. However, the

2009 WDR points out that an important reason why South-South RIAs do not tend to generate much growth spillovers is that "despite regional trading arrangements, there is no real integration", chiefly because of lack of market access (World Bank, 2009a: 102).

RIAs need to foster real competition—A key route through which the economic growth effects of RIAs are channeled is greater competition. For this competition to occur, however, effective integration needs to take place and that requires more than simply reducing tariffs and quotas. It necessitates the removal of any other barriers that have the effect of segmenting markets and impeding the free flow of goods, services, investment and ideas. Namely, for a RIA to truly integrate economies, all barriers to trade and investment need to be eliminated between participating countries. This real integration is needed for the crucial competition effects between economies as well as industrial agglomeration effects to take place.

Credibility gains require explicitness--especially in North-South RIAs, a positive effect of regional integration is to enhance the credibility of the government policies of the developing country partner. This effect in turn often helps to encourage foreign direct investment. However, for this effect to pan out, the transition path to free trade needs to be fully specified, with a minimization of reversals in liberalization, the prohibition of application of instruments of contingent protection and the establishment of binding dispute-settlement mechanisms that are not contingent on foreign policy considerations.

Only efficient RIAs are likely to help politically—Regional integration is often used to foster political goals, such as enhancing the security of and political cooperation among partners. The review points out, however, that RIAs can help solve political problems only if they function well. On the contrary, if they do not, they can have the opposite effects.

As will transpire throughout this paper, the above-listed conditions do not hold in the Palestinian-Israeli context. First off, despite a customs union existing from a legal *de jure* point of view, there are a plethora of non-tariff barriers to trade between Palestine and Israel (checkpoints, the separation wall, permit systems, etc.). Moreover, these barriers go mostly in one direction creating a myriad of obstacles to economic activity within Palestine and for exports from Palestine into Israel leading to unfair competition for the Palestinian economy.[4] Hence, the "competition effect" predicated on real integration cannot pan out. The enormous and unpredictable barriers to economic activity between both countries as well as the context of occupation and war with the risk it entails also prevent cooperation across firms, foreign direct investment and any related agglomeration and technology transfer effects. Second, the "credibility" effect on PA government policies is impaired by the fact that the degree to which the *de jure* customs union is applied is *de facto* completely unpredictable and unilaterally determined by Israel. In reality, therefore, the effect is the opposite –delegitimizing the PA and undermining the credibility of its policies. Finally, the application of a peace-time regional integration framework in a context of war and occupation, far from building confidence and fostering peace, increases points of friction between the two parties, provides tools for economic aggression, exacerbates the conflict and delays the coming of the time in which true cooperation can commence.

[4] The result of this asymmetry has been dubbed as a "one-sided customs union." (Diwan & Shaban, 1999: 84).

4. De jure Economic Institutions and Assumptions Underlying Them

The *de jure* framework for the economic relations between Palestine and Israel is determined by the Oslo Accords and, in particular, by the "Protocol on Economic Relations" or "Paris Protocol" (subsequently incorporated into the Interim Agreement of 1995).[5] It was initially devised to regulate the economic relations between the Palestinian Authority and Israel during the interim period that was to last until 1999 when final status in the relations between both parties was expected to be reached.

The Agreement aims to establish a customs union between the PA and Israel by basically extending the Israeli trade regime to Palestine. According to the Agreement, the PA has to apply at least the same level of customs and other duties as Israel, except for goods included in three lists: A1, A2 and B. For goods under these lists, the PA is given some limited power to modify the basic Agreement. In particular, for some items it has the right to determine tariff rates and other import taxes. The items in list A1 are some goods produced in Jordan, Egypt and some other Arab countries. The items on list A2 are some basic foodstuffs from other countries. The items on list B are some equipment goods considered important for development purposes. Even for the goods on lists A1 and A2, however, import quantities need to be within the limits set jointly between the PA and Israel and determined according to Palestinian market needs. These items in the agreed quantities are also exempt from meeting Israeli standards and licensing requirements.

Therefore, *de jure*, the Agreement allows Palestinian goods free access to the Israeli market as well as to the markets of the countries with which Israel has free trade agreements (the EU, the US, EFTA member states, Canada, Turkey, Mexico, Romania and Bulgaria). Moreover, since the time of the signing of the Agreement, Israel has engaged in further economic liberalization and its trade regime is now very open. As Israel has been moving up the value added ladder in its manufactures, it has increasingly liberalized its markets toward low value added manufacturing imports in order to gain access from other countries for its high-tech and other high-valued added manufactures. As a result, the only remaining high levels of protection in its trade system apply to agricultural products (and, decreasingly, to some specific traditional manufacturing goods).[6] Overall, therefore, the regime features low tariffs on manufactures and relatively high tariffs on agricultural products. By 2005, the weighed average most-favored-nation (MFN) tariff rate applied to agricultural products was over five times that applied to industrial products.[7]

Unlike in typical customs unions (the ones existing outside contexts of occupation), the trade regime applied to the CU between Palestine and Israel is determined unilaterally by Israel. The PA –except in the very limited cases mentioned above—has no say in its trade policy toward third countries. Because the common external tariff of the CU is determined by Israel without the participation of the PA, it reflects Israel's economic interests and stage of deve-

[5] This section draws heavily from Calika (1998).

[6] Beverages, clothing, footwear and plastics industries are the manufacturing sectors with the highest level of protection (World Bank, 2006a: 48).

[7] The average applied MFN tariff was 8.9 percent in 2005. MFN tariffs on agricultural products were, on average 32.9 percent with rates varying widely and a maximum tariff rate of 560 percent (World Bank, 2006a: 48).

lopment rather than Palestinian development considerations. In addition, it imposes on Palestine Israel's political-economic limitations, as it locks out of Palestinian trade all the countries which have no diplomatic relations with Israel, including most of the Arab world. Also, and unlike in the case of customs unions between sovereign states, the PA does not collect its own customs revenue. Instead, the Agreement establishes that Israel will collect customs duties, VAT and excise taxes on imports ("clearance revenues") on behalf of the PA. Moreover, the PA can only receive customs duties and import taxes on those goods marked clearly for the WB and Gaza as the final destination. This limitation reduces the tax collections received by the PA due to leakage (as not all goods finally imported into Palestine are clearly marked as such).[8]

A further restriction imposed by the *de jure* CU between Palestine and Israel is that any imports into Palestine need to meet the exacting quality standards demanded by Israel –which, in addition to all those typical of a developed country, include *kashrut*[9] certifications for food products. These high quality standards may be neither appropriate nor necessary for a country of the level of development of Palestine. Very few developing countries have similar restrictions and it is unlikely that they would be imposed by the PA were it able to determine its own trade regime autonomously. These standards impose additional restrictions on the Palestinian trade regime as well as costs on the Palestinian economy.

Regarding labor flows, the wording of the Interim Agreement is exceedingly vague. Article VII states that: "Both sides will attempt to maintain the normality of movement of labor between them, subject to each side's right to determine from time to time the extent and conditions of the labor movement into its area." The article thus establishes a declaration of principle for the freedom of movement of labor between Israel and Palestine. However, this declaration of principle is legally rather vacuous as it is immediately qualified by its being "subject to" each side's ability to restrict this movement "from time to time." Since the conditions under which each side is allowed to impose restrictions are not defined and neither is their timing, the simple *de jure* upshot of this article is that there will be freedom of movement of labor when and as far as each side decides. Since it is labor from Palestine that typically seeks work in Israel rather than vice-versa and Israel has all the political, economic and military means in its hands to enforce decisions on labor movements whereas the PA has none, this article means that Palestinian labor will be able to work in Israel when and under the conditions that Israel decides.

Finally, the Paris Agreement includes some provisions which are unusual for liberal economic integration frameworks. In particular, it contemplates the operation of Palestinian monopolies in the telecommunications and electricity sectors and import monopolies in the cement and petroleum sectors (linked to Israeli firms). The impact of these monopolies on governance is addressed in the below section on institutional de-legitimation.

The 2005 Agreement on Movement and Access (AMA), in part reacting to the barriers to movement to goods and labor prevailing *de facto* since the Oslo Agreements, was an attempt

[8] "The extent of these (tax) leakages is unknown, but could be as large as 5 percent of GDP." (Diwan & Shaban, 1999: 87).

[9] Jewish dietary laws.

to make the CU regime between the PA and Israel more binding. Among other things, it specifies that: crossing points will operate continuously, Israel will urgently expedite the access of Gaza products for export, the Rafah checkpoint between Israel and Gaza will be open with third-party supervision and Israel will facilitate the passage of convoys between the West Bank and Gaza. These provisions are made in an unconditional fashion and hence seem directly applicable from a legal standpoint. The AMA also establishes that Israel will facilitate the movement of goods and people within the West Bank. This provision, however, is made conditional on "Israel's security needs." Since it is not determined who will establish what those are, it means that it is Israel alone who will define them as well as their consequences for movement and access within the West Bank. The AMA also establishes that the building of a seaport in Gaza can commence and it commits Israel "not to interfere" with its operation. Finally, the AMA states that: "The parties agree on the importance of the (Gaza) airport. Discussions will continue on the issues of security arrangements, construction, and operation." This last point, like that on freedom of movement within the West Bank, has hardly any meaningful legally-binding consequences.

In sum, the Customs Union envisaged by the Paris Protocol basically describes a *de jure* expansion of the Israeli customs envelope to Palestine with very limited room for maneuver by the PA in the determination of trade relations with third countries. This trade regime is a very open one with high tariff rates applying only to agricultural products and some low value-added manufactures. It also extends the exacting Israeli quality standards for imports to Palestine. According to the Agreements, any change to the trade regime is decided unilaterally by Israel and directly extended to Palestine. The provisions on labor movement included in the Protocol include a vague statement regarding the desirability of normal labor flows. More importantly, they legally allow both sides to determine the degree and conditions of access of labor into their area. The 2005 AMA embodies a greater degree of specificity regarding movement and access of goods and labor between Israel and Palestine as well as, in some areas, more binding legal language.

Therefore, the *de jure* customs union between Palestine and Israel is a rather *sui generis* one. It is unilaterally rather than bilaterally determined and some of its key provisions –in particular those regarding movement and access of goods and labor—are legally vague, dependent on political considerations and subject to the interpretation of the Israeli Government.

5. De Facto Economic Institutions and Policies

As limiting as the de jure context of Palestine-Israel economic relations may be, it only goes a limited way toward explaining their de facto nature and consequences. What lies at the basis of the actual nature of those relations is the fact that we are dealing with two unequal partners in the context of war and military occupation. One partner is a state and the other is not. One is independent and the other is occupied. One is rich and the other is poor. One has an army and the other does not. One has the de jure and de facto power to determine the trade regime and labor flows and the other does not. One collects trade revenues for itself and the other party while the latter is dependent on the for-

mer's political willingness to transfer or withhold its revenues at any point in time. One has export contacts and access throughout the world for its exports while the other depends on the former to grant access for transit as well as for export contacts themselves. One has its own roads, ports and airports while the other is enclosed, cannot control the roads even within its own territory and has no ports or airports. One has an autonomous source of electricity production while the other depends on the former for its electricity supply. The actual economic context of Palestine-Israel relations is thus one of utter dependence.

The *de facto* status of Palestine-Israel economic relations is determined not only by its lopsided *de jure* framework and the unevenness of the balance of power between the two parties, but also by its preceding history and, in particular, the previous four decades of occupation. The years comprised between 1967 and today de-linked the Palestinian economy from its ties with Jordan and Egypt and led it to a distorted integration with Israel.[10] Given the context of the occupation, integration was never complete or symmetrical. From the beginning, Israel imposed barriers to Palestinian agricultural imports and the overall access of products from one side of the 1967 borders to the other was never symmetrical and it systematically favored Israel. There was little public investment by the Israeli Government (the only one in charge at the time) in Palestine. Moreover, the Government of Israel (GoI) used administrative measures to hamper the establishment of any industrial firms in Palestine which could possibly compete with its own producers.[11] The Palestinian economy was also hamstrung by a lack of credit, as following the 1967 occupation, Arab banks withdrew and few Palestinians were willing to borrow from Israeli banks.

The first decade and a half of the occupation was one of rapid growth based on unskilled labor exports to the Israeli economy and its one-time effect of wage increases and relative convergence with Israeli wage levels, and remittances from workers in the Gulf countries. It also marked the beginning of a process of weakening of the productive structure of the West Bank characterized by declines in both agriculture and (an already precarious) industry and the over-development of the construction and services sectors.[12] In the 1980s and 90s, the Palestinian economy stagnated. Diwan and Shaban (1999) identify four main constraints to GDP growth during the pre-Oslo period: asymmetric market relations with Israel (imports into Palestine from Israel without borders, but with barriers to export for Palestinians into Israel and the rest of the world); regulatory restrictions (investment approval requirements by Israel; uncertainty in legal and tax frameworks); fiscal compression and institutional under-development (low tax receipts; fiscal leakages to Israel; limited public spending in infrastructure for

[10] This was the second "shock" to the Palestinian economy and one which in part and in a distorted manner undid part of the first shock. The first shock was the partition of Mandatory Palestine in 1948. After the 1948 war, the Palestinian economy of the West Bank and Gaza was split off from its historical links with the coastal areas of what became Israel. Between 1948 and 1967, the West Bank became increasingly part of the Jordanian economy while Gaza integrated with the Egyptian economy. The 1967 occupation of the West Bank and Gaza by Israel partially and in a distorted manner "re-unified" these areas with their previous historical *hinterland* (which was by then, of course, a completely different world).

[11] "A review of the various constraints imposed by Israel is extensively described in Awartani (1993) and Bahiri (1987)."(Arnon, Luski, Spivak & Weinblatt, 1997: 166; Awartani, 1993; Bahiri, 1987).

[12] See Roy (1999) and Dessus (2004).

development); and restricted access to natural resources (with confiscation of land and water) (Diwan & Shaban, 1999: 6).

The impact of all these barriers and asymmetries with Israel on the Palestinian economic was dramatic. By the beginning of the 1990s, the Palestinian economy had been severed from the rest of the world and turned into a dependent appendix of the Israeli economy. As the World Bank's Investment Climate Assessment succinctly describes:

> By the eve of the Oslo Accords, the occupied Palestinian territories had become completely dependent upon Israel and had little economic relations with other countries. Nearly 60% of the West Bank's exports and more than 90 percent of its imports were to and from Israel and the trade deficit was nearly 45% of GDP. The figures for Gaza were similar, but the trade deficit was even higher. Palestinian enterprises were heavily reliant on Israelis for inputs and most production was sold either locally or through Israeli distributors…The enterprises that did exist were dependent upon Israeli firms for inputs and almost all exports went to Israel or were exported through Israeli firms (World Bank, 2007e: 5).

Probably because of this pre-existing *de facto* dependence, the objective of the Oslo Accords was to "make the most of it" and attempt to realize the conditions and benefits of true economic integration in Palestine-Israel relations.[13]

As pointed out above, however, neither the *de jure* framework nor the balance of power between the parties or the context in which they were engaging were promising for these conditions to materialize. They did not. What materialized *de facto* was a regime characterized by three main features: a) pervasiveness of highly unpredictable restrictions on the movement and access of people and goods; b) continued confiscation of natural resources (in particular land and water) combined with restrictions on planning and use of resources; and c) an unpredictable *de facto* regime of military and administrative decisions affecting all aspects of economic relations including trade, labor flows, access to natural resources, fiscal revenue, transport networks and energy.

Movement and Access--The number of days of total closure[14] declined slightly at the beginning of the post-Oslo period, but increased dramatically since the onset of the second Intifada. The average days of effective total closure went from 17 in 1990-93 down to 11 in 1994-99 and up to 87 in 2000-2002 and 97 in 2003-2005 (World Bank, 2006a: 2 table 1). To the days of total closure need to be added the large amount of fixed and mobile checkpoints within the Occupied Palestinian Territories, which greatly curtail freedom of movement within the area itself. According to the UN Office for the Coordination of Humanitarian Affairs in the Occupied Territories (OCHA), in March 2007 there were 546

[13] This paper does not address the issue of whether Palestine "over-trades" with Israel. This is not an easy issue to establish and critically depends on the assumptions of the model used to estimate it. Diwan (1999) cites "various modeling exercises (which) have shown regional trade and trade with Asia would have been much larger, and trade with Israel much smaller, in the absence of the CU. By some estimates, imports from Israel may have been lower by as much as a half." On the other hand, a recent World Bank study argues that "no support can be found for the case that WBG (the West Bank and Gaza) overtrades with Israel given their proximity, GDP, population, and other variables" (World Bank, 2006a: 41).

[14] "General closure refers to the overall restrictions placed on the movement of labor, goods and the factors of production between the West Bank/Gaza and Israel and between the West Bank and Gaza, and is usually accompanied by prolonged delays and searches at border crossings. Total closure refers to the complete banning of any movement and typically is imposed in anticipation of, or after, an extremist attack on Israel. Internal closure restricts movement between Palestinian localities within the West Bank itself" (Roy, 1999: 69).

physical impediments to movement in the West Bank (World Bank, 2007b: 3). In addition, the separation wall being built by Israel in the West Bank is also imposing increasing restrictions on movement and access by Palestinians and will do much more so once its construction is completed and existing openings cannot be used. Gaza has been under a regime of full closure since the Hamas electoral victory of 2006. This regime has led to the almost complete banning of people from entering and leaving the strip as well as of imports and exports of goods–with very few exceptions for humanitarian cases.

In addition to these restrictions, the World Bank identified a number of other barriers to movement and access by Palestinians. These include administrative impediments (control of the population registry, permit regime, family unification and establishment of residency), restricted areas of the West Bank (settlements, restricted roads, the separation wall and the "seam zone," exclusion from the Jordan Valley and East Jerusalem and special restrictions in area C).[15] This combination of impediments, rather than the general principle of normal flows of a typical customs union, is what defines the actual context of movement and access between Palestine and Israel to this day. Therefore, the condition of the removal of tariff as well as non-tariff barriers necessary for effective economic integration has clearly been absent in the Israeli-Palestinian context. As the Aix Group of Israeli, Palestinian and international economic advisers remarked: "The new de facto economic regime that currently exists is a significant departure from the negotiated 1994 Paris Protocol… There is a clear contradiction between the basic requirements for economic recovery and the new regime. This contradiction is reflected in trade, labor, finance and other dimensions."[16]

Confiscation of natural resources-- The process of land confiscation, which had started right after the beginning of the occupation, accelerated after the Oslo Accords. Between 1996 and 2000, the area of Israeli settlements in the West Bank and Gaza doubled while, between 2000 and 2007, the confiscated area is estimated to have grown by a further 31 percent. The confiscated land was used for settlement expansion, the building of roads closed to Palestinians, as well as the security wall and its buffer or "seam" zone (an additional 8-9 percent of the West Bank)[17] (The Applied Research Institute - Jerusalem, 2008).. By the beginning of the Oslo Accords, it was estimated that, in the West Bank, Palestinians were only using 15-20 percent of the water resources (World Bank, 2007e: 4). Moreover, the additional Palestinian land confiscated for the construction of the separation wall has "included" in the "Israeli" side of the wall significant amounts of Palestinian water resources.

Fiscal regime. According to the Paris Protocol, the Government of Israel is responsible for collecting so-called "clearance revenues" (tariffs and VAT and excise duties on imports) on behalf of the PA and transfer them to it. This agreement was reached because of the reluctance of the GoI to establish "economic borders" or

[15] For a detailed description of these obstacles, see World Bank (2007b).

[16] *The Neglected Economic Dimension: Revitalizing the Economic Road Map. Brainstorming Session of the Aix Group*. May 30, 2006: 1. www.aixgroup.org

[17] See also, (The Israeli Information Center for Human Rights in the Occupied Territories (2008); and, "H. Ofran and D. Etkes, "Construction of Settlements on Private Land. Official Data" and (Ofran & Etkes, 2007) Peace Now 2008.

posts at which the PA Customs Department could collect its own trade revenue. This reluctance came from the Israeli view that, even the establishment of economic borders for the only purpose of tax collection, could be interpreted as an implicit recognition of those borders and weaken its negotiating position (Arnon & Weinblatt, 2001). *De facto*, the system of collection by the GoI and subsequent transfer to the PA has placed 60 percent of PA revenue in the hands of the GoI with the consequences described in the sections below.

Uncertainty and political leverage of the de facto regime regulating economic relations. One of the most important defining characteristics of the actual regime regulating economic relations between Palestine and Israel is uncertainty. As pointed out above, this uncertainty is legitimized to a large extent in the *de jure* regime. This regime, defined in the 1994 Paris Protocol and, to a lesser extent, the 2005 Agreement on Movement and Access, leaves ample room for interpretation of the conditions under which policies can differ from the established general principle of normal movement of goods and labor.[18] However, the regime itself appears to be irrelevant as *de facto* there is no difference in actual policies by the Government of Israel between issues where the legal framework is more binding and those where it is vaguer. For instance, the stipulation made in the AMA that "crossing points will operate continuously" as well as the duty of the Government of Israel to transfer to the PA clearance revenues collected on its behalf are both stated unequivocally and unconditionally. Despite that, they have not at all been respected and the same applies to similar AMA stipulations. Instead, they have been subject to a unilateral interpretation by the Government of Israel regarding when it is expeditious or not to implement them (according to security or other considerations). They have also been used as political leverage, with the GoI withholding clearance revenues from the PA as a tool to exert pressure on it or to "punish" it.[19] Moreover, the overall uncertainty surrounding the future status of the West Bank and Gaza creates an enormous amount of legal and political uncertainty which in turn has a dramatically deleterious effect on the Palestinian economy.

6. Economic and political consequences of applying a liberal peace-time framework on a mercantilist wartime reality

One can summarize the consequences of the combined application of the above-described *de jure* and *de facto* economic regimes and policies to Palestine-Israel economic relations

[18] The *de jure* regime includes clauses that allow Israel to interrupt the normal functioning of the customs union subject to political and security considerations. This contradicts the rule of thumb for successful economic integration which requires the prohibition of application of instruments of contingent protection and envisages the establishment of binding dispute-settlement mechanisms that are not contingent on foreign policy considerations. This is probably because economic integration frameworks are envisaged for contexts of peace and not war-time.

[19] As pointed out by the World Bank: "The GoI's decision to stop transferring clearance revenue is a violation of the Oslo accords, under which there is no clear provision for Israel to withhold clearance revenues. It is not illegal under Israeli law, which grants such discretion to the Minister of Finance and recognizes international agreements only to the extent that their provisions have been ratified by the Knesset. A case was brought to the Israeli Supreme Court in which the petitioners sought to force the GoI to release the funds. However, the Supreme Court rejected the petition, and in so doing agreed with the GoI that withholding the funds was within the discretion of the Minister of Finance to prevent the funding of terrorist activities. In terms of international law, the issue is open to debate." (World Bank, 2007d: 7).

as follows: a) dependence; b) de-development; and c) institutional de-legitimization.[20] For each of these three areas, this section will outline the various economic transmission mechanisms from the existing economic regimes and actual policies to their economic and political consequences.

Dependence

The above-described *de jure* and *de facto* economic regimes and policies make the Palestinian economy utterly dependent on Israel. This dependence can be seen at many levels. This section will briefly examine five of them –production, trade, labor, fiscal revenues and electricity. Other areas of dependence worth examining, but beyond the purview of this paper are currency, banking system, private sector business ties, the health sector and the environment.[21]

The production capacity and productivity level of the Palestinian economy depend to a large extent on Israeli policies. A key factor of production –land—is at the mercy of the Israeli Government and Israeli settlers. In part, this is because ownership and title issues in Palestine continue to be problematic. Lands with a clear title are limited to area A (the area where the PA is in full civil and security control). They are very scarce and constitute only 18 percent of the West Bank. On the other hand, the final status of lands in areas B (area of joint control between the PA and the GoI) and C (area under the full control of the GoI) is uncertain. In addition, the title for these lands is generally unavailable (World Bank, 2007e: 69). However, it is unclear whether having a clear title would make a significant difference in slowing down the process of land confiscation which has proceeded unabated throughout the past forty years of occupation. This ongoing process of confiscation has led to a decrease in the supply of land for the Palestinian economy –for either agricultural or industrial purposes—and has greatly increased its price (see below section on de-development). Water availability and prices are also a constraint to the development and competitiveness of the Palestinian agricultural sector.

The Palestinian industrial sector is also greatly dependent on Israel. After 1967, a number of Palestinian micro-enterprises developed to form the low-value added part of manufacturing chains integrated with an Israeli enterprise. In particular, Palestinian firms would sub-contract for Israeli firms in sectors producing labor intensive goods like garments and footwear (World Bank, 2007e: 5). Because the Israeli economy is transitioning out of these low-value added manufacturing products, there is decrea-

[20] This paper does not purport to analyze all factors affecting the performance of the Palestinian economy or of Palestinian institutions. Rather, it focuses on one variable --the imposition of a liberal economic regime appropriate for peace-time relations among sovereign, rich, well-established states on a mercantilist reality of war and occupation between two unequal parties.

[21] Currently, the Palestinian economy makes use to a large extent of the *shekel* as its main currency. This necessitates cooperation with Israeli Banks to work jointly with the Palestinian Monetary Authority on clearance arrangements. A future Palestinian state, on the other hand, may wish to establish its own currency. The Palestinian banking system, because of its heavy use of the shekel, is also dependent on clearance agreements with Israeli banks. This puts them in a dependent position, as has been evidenced in the current crisis in Gaza. Many large Palestinian firms, such as some of the monopolies, include agreements with Israeli firms (upon which they are dependent). The health sector relies heavily on sending medical cases which cannot be treated in Palestine to Israel. Future planning may wish to explore alternative locations in Europe and the Arab world to lessen dependence on Israel. This would, of course, require the provision of the necessary funding from these countries. The Palestinian environment is also heavily dependent on Israeli water management, sewerage and military refuse treatment and disposal as well as on Israeli industrial practices. This area will necessitate regulation and management between the two parties on an equal footing well into the future.

sing demand for Palestinian micro-enterprises sub-contracting in these sectors. In 2008 manufacturing output was nearly 20 percent and agricultural output 55 percent below their 1999 levels (World Bank, 2009b: 11). The Palestinian industrial sector is also dependent upon the Israeli economy in that a large number of Palestinian firms depend on Israeli firms for developing contacts with the outside world, including for marketing and exporting their products to third countries. This is in part because these contacts are more highly developed in Israel, but also because Israeli firms are at an advantage in dealing with the Israeli bureaucracy, including its export requirements and processes. As a result, under 10 percent of the manufacturing and IT sample of firms of the World Bank's West Bank-Gaza Investment Climate Assessment sells directly to the international market while most of the remaining firms sell through Israeli companies (World Bank, 2007e: 29).

Palestinian productivity is highly dependent on developments in Israel-Palestine relations and on the conflict in particular. Productivity growth is largely driven by the ability of firms to build scale economies through developing access to larger markets and the capacity of firms to learn and implement new production methods and techniques. Both of these possibilities are largely absent in Palestine as the conflict and its related myriad obstacles to movement and access increasingly reduce the market size of Palestinian firms and effectively cut them off from contacts with firms in Israel and the rest of the world. Therefore, one of the main channels through which growth is spurred in North-South regional integration arrangements –technology-transfer—is not present in the Israeli-Palestinian context. Like production, Palestinian productivity growth also seems to have followed closely the avatars of the conflict. As a result, the overall productivity and labor productivity of Palestinian firms rose between 1997 and 2000, declined sharply in 2001 (ensuing the onset of the Intifada), and recovered by 2004 (World Bank, 2007e: 14-15, 73).

The Palestinian economy is also greatly dependent on the Israeli economy for its trade flows. This relationship of dependence is almost wholly one-sided. In 2003, Palestine's imports from and exports to Israel accounted for 73 and 92 percent of the total respectively (World Bank, 2006a: 49). On the other hand, Israel's trade with Palestine only accounted for about 1 percent of Israel's total imports and 6.3 percent of its exports (Arnon & Bamya, 2007: 193). Palestinian exports are also dependent on Israel for access. Since there are no ports or airports in Palestine, exports can only go out through Israel, Jordan or Egypt and Israel currently controls all checkpoints and trade access routes. Also, because Palestinian cars and trucks are not allowed access into Israel, Palestinian firms depend on Israeli firms to transport their export goods into Israel and, for those with other final destinations, onward to third countries. As a result, Palestinian trade flows totally depend on the state of the conflict with Israel and the degree of closure and other restrictions imposed by the GoI at any given point in time. For example, Palestinian exports, after increasing by 4 percent in 1999, declined by 7, 35, 13 and 4 percent respectively in the years 2000, 2001, 2002 and 2003. Similarly, Palestinian imports increased by 19 percent in 1999 but declined by 14, 18 and 2 percent in 2000, 2001 and 2002 and started growing by 5 percent again in 2003 (International Monetary Fund, 2006: 8).

Since the beginning of the occupation in 1967,

labor flows from Palestine to Israel have been one of the main sources of growth in the Palestinian economy. They were also the main engine of income convergence during the first years of the occupation (Kleiman, 1999 as cited in Dessus, 2004: 4). Labor flows, however, have also been highly variable depending on the security situation and the decisions of the GoI and they declined sharply after the beginning of the second Intifada. The percentage of all employed Palestinians working in Israel fell from an average of 16 percent in 1994-99 to 7 percent in 2003-2005 (World Bank, 2006a: 2). This decline led to substantial losses to the Palestinian economy. For instance, the World Bank calculates that, based on the level determined by the share of "Israeli" employment in total WBG employment in 1999-2000, the number of Palestinian workers in Israel in 2005 could have been 165,000 and their earnings USD 922 million. Instead, because of permit restrictions, employment was only 63,000 and earnings USD 351 million. According to the same study, the estimated loss over 2001-05 because of lower employment amounted to USD 2.4 billion and because of closures to USD 928 million, with the total losses amounting to 3.3 billion USD.[22] By 2007, a man in the West Bank only had a 77 percent chance of being employed compared to 1999 (World Bank, 2009b: 32).

Because the Palestinian economy is so closely linked to the Israeli economy, growth and government revenues fluctuate with the cycles of the conflict. For instance, during the growth years of 1995 to 1999, government revenues in US dollars almost doubled, going from US 510 million (15.8 percent of GDP) to US $ 942 million (22.6 percent of GDP) (World Bank, 2007d: 6). On the other hand, the Intifada led to a steep decline in government revenues. By December 2000 – three months into the Intifada--, revenues had declined by 50 percent relative to the pre-Intifada level.[23] Moreover, the Palestinian Authority is also dependent on Israel to collect on its behalf and transfer to it "clearance revenues," which amount to roughly 60 percent of overall PA revenues.

Despite its contravening the Oslo Accords, Israel has repeatedly used the withholding of these revenues as a political tool to place pressure on or to "punish" the Palestinian Authority. For instance, in 2001 (during the second intifada), the GoI suspended the regular transfer of clearance revenue until December 2002. Similarly, in the second quarter of 2006, the GoI suspended revenue transfers to the PA due to the Hamas electoral victory (and donors suspended budget support). Overall, in 2006, resources to fund recurrent budget expenditures fell by more than one third compared to the previous year. After the advent of the Salam Fayyad Government, the GoI restarted the transfer of clearance revenue (including the retained funds from February 2006 to June 2007) and donor funding resumed.

The energy sector is another area in which the Palestinian economy utterly depends on Israel.

[22] The ensuing losses to individual Palestinian workers are very high since wages earned in Israel are roughly two thirds higher than those earned in WBG (assuming there is a job available) (World Bank, 2006a: 20-21).

[23] Although conflict reduces economic growth and government revenue in general, most of the decline in Palestine seems to be due to the close connection of the Palestinian economy to the Israeli economy. In particular, the World Bank estimates that: "The steep decline reflected tightened restrictions on the movement of goods in and out of the West Bank and Gaza, and cutbacks in Palestinian consumer spending, both of which reduced imports." (World Bank, 2007d: 6).

In particular, the PA depends on Israel for eighty percent of its electricity supply as well as for all petroleum imports (Arnon & Bamya, 2007: 168). Electricity imports from Israel into the West Bank and Gaza are supplied through the Israeli public power supply monopoly –the Israel Electricity Company (IEC). The IEC provides all the electricity supply used in the West Bank --except for the recent connection of the Jericho area to Jordan.[24] In Gaza, roughly 68 percent of electricity supply is provided directly by IEC while the 25 percent produced by the Gaza Power Plant also depends on Israel because the plant runs on gasoil imported from IEC. The remaining 7 percent of Gaza electricity supply is imported from Egypt. Because such a high percentage of Palestinian electricity supply comes from an Israeli public monopoly and gets to Palestine physically through Israel, the Israeli government can disrupt the electricity supply to the West Bank and Gaza at any time.

This dependency has had dire consequences on the financial management of the electricity sector, on actual electricity supply –especially in Gaza—and on overall strategic energy planning. Regarding financial management, the Israeli Ministry of Finance systematically deducts from the tax revenues it collects on behalf of the PA the amount owed to IEC by Palestinian electricity distribution companies and municipalities which are unable to/do not pay the IEC fully for its electricity supply. The total amount deducted for this concept from PA revenues amounted to more than 350 million USD since 2000. This payment collection system means that Palestinian electricity distribution companies and municipalities have weak incentives to collect payments from clients since any leftover amount will by default be passed on by the IEC to the PA. This perverse incentive system jointly with the ongoing economic crisis has led to an increasing culture of non-payment[25], weakening the sector's financial management, placing a great burden on PA finances and straining the relationship between electricity distribution companies, municipalities and the PA.[26]

This system also weakens institutional legitimacy and emphasizes the dependence of the PA on Israel. The PA has acknowledged this situation and taken action to redress the part that is within its power –attempting to improve collection rates from consumers and municipalities. To this effect, it is working on introducing a system of (water and electricity) "payment certificates" that will be necessary to engage in any transactions with or receive payments from the PA (International Monetary Fund, 2008: 7). The PA has also started monitoring municipalities' bank accounts to ensure that payments made

[24] This is a positive development whose replication is advised in the recommendations section of this paper. "The PA has agreed with Jordan to connect the Palestinian power grid to that of Jordan at Jericho through a 33kV line via King Abdallah Bridge. JDECO (Jerusalem District Electricity Company) submitted a new request recently to upgrade the line to 132 kilovolt, which is compatible with the voltage supplied by the Jordanian electricity company. This connection would not link the power grids of Israel and Jordan. JDECO will execute the work on the Palestinian side. The Jericho area will be disconnected from the Israeli power grid, and JDECO will manage a separate electricity supply system for the customers connected to the electricity supply from Jordan. The Israeli Ministries of National Infrastructure and Defence (Civil Administration) have approved this connection." (World Bank, 2007c: 14).

[25] This problem is particularly acute in Gaza due to the Israeli-imposed blockade. Currently, the collection rate of the Gaza electricity distribution company GEDCO is only around 25-30 percent. *Status of GEDCO*, 2008: p. 2.

[26] The IMF estimates that "net lending" from the PA to the municipalities and electricity distribution companies "rose from NIS 1.5 billion (7.4 percent of GDP) in 2006 to NIS 2.2 billion (10.6 percent of GDP) in 2007, as utility collection rates declined, and some municipalities used households' utility payments to pay for other municipal services." (International Monetary Fund, 2008: 8).

by consumers are indeed transferred to suppliers. On their side, some electricity distribution companies such as GEDCO are planning to introduce pre-paid meters to increase their collection rates.

Perhaps the most obvious example of the potential consequences of Palestinian dependence on energy supply from Israel is the current energy crisis in Gaza. Since the 2006 Hamas electoral victory, Israel has imposed a blockade on the Strip. As has been documented by aid relief organizations and donor agencies, this blockade has had a disastrous impact on the economy of the Gaza Strip and hence on the living conditions of the population. In the energy sector, the blockade has led to a sharp reduction in electricity supply. Israel has the means to implement this reduction both because the electricity supply to the Strip –except for 7 percent which comes from Egypt[27]-- and the fuel for the Gaza Power Plant come from Israel and because Israel controls entry and exit into Gaza. In September 2008, the Gaza Electricity Distribution Company (GEDCO) calculated the energy deficit to be at 15 percent and it forecasted it to rise to 25 percent in the winter-time.[28] This electricity supply deficit has led to intermittent power cuts with a heavy impact on industry, sewerage treatment plants and hospitals.

Moreover, the Gaza Power Plant warehouse is experiencing a shortage of basic electrical materials needed for system maintenance such as transformers, cables and fuses. Many of these materials have been purchased and donated and have been waiting in Israel and the West Bank for transport into the Strip for over six months. The GoI, however, has denied all applications submitted by the Palestinian Energy Authority for security permission to transport them into Gaza. The absence of spare parts has led to the inability of GEDCO to carry out even basic maintenance work on its network – including in such sensitive areas as water wells, sewage stations and hospitals. Lacking maintenance constitutes a high risk of injury and death accidents to the population and is likely to affect electricity supply in the future.[29] It also contributes to heavy network losses, which are currently estimated at around 30 percent. Sewage leakages have already been a problem for some time and are polluting the waters in Northern Gaza, endangering the lives of the Bedouin population there.[30] Overall, the Gaza energy crisis underscores the dire consequences of the total dependence of Palestine on Israel for electricity supply as well as the urgency to diversify electricity supplies toward own generation and purchases from Jordan and Egypt.

Moreover, the current system of electricity supply through the IEC does not properly suit Palestinian needs. As has been noted by the Aix Group, there are problems of quantity and price of electricity supply as well as voltage. In order for municipalities to increase the amount of electricity they purchase from the IEC, they need to pay it large fees and the IEC does not even respond to this increase in demand unless it has extra supply in its transmission lines. In addition, priority in service is given to the Israeli customer, leaving the end of feeder lines in

[27] *Status of GEDCO*, 2008: Table 1. "Sources of Energy and Deficit."

[28] *Status of GEDCO*, 2008: Table 1. "Sources of Energy and Deficit."

[29] World Bank sector mission notes. November 2008.

[30] Letter dated November 5th, 2008 from GEDCO to the World Bank.

Palestine with low voltage which often results in electricity cutoffs during grid maintenance operations (Arnon & Bamya, 2007: 170).

Finally, all petroleum imports into Palestine are managed by a Palestinian monopoly (the Palestinian Petroleum Commission), which in turn buys fuel from a single Israeli supplier.[31] This two-sided monopoly increases the energy dependence of Palestine on Israel and prevents the PA and private Palestinian companies from exploring alternative sources of energy supply. Options for increasing energy autonomy will be discussed in the recommendations section at the end of this paper.

De-development

Sara Roy characterized the economic trajectory of the Palestinian economy since its occupation by Israel in 1967 as "de-development." She defines this process as one dominated by expropriation, integration and de-institutionalization and substantiates it in developments occurring up to the year 1999.[32] This sub-section will attempt to elucidate whether this process of de-development has continued after the year 2000. To do so, it will track six economic transmission mechanisms which link the *de facto* economic regime described above with its actual economic consequences. These economic transmission mechanisms are: wages, land and electricity prices, transport costs, isolation from the outside world and fragmentation of the internal economic space.

Wages--The (relative) integration of the Palestinian economy into the Israeli economy which took place after 1967 bid up Palestinian wages (and overall prices) to levels well above those of countries at comparable stages of development. For instance, the average wage of a Palestinian production worker is about twice that of a Jordanian worker and almost three times an Egyptian's (World Bank, 2007e: iii). However, due to the special circumstances of conflict and occupation (such as low levels of public and private investment and reduced scope for enterprise learning and technology transfers), Palestinian productivity levels did not go up by enough to compensate for wage increases. Dessus (2004) finds that, between 1968 and 2000, rising productivity in Palestine only marginally contributed to GDP growth, which was mainly fueled by factor accumulation. For the 2000-2004 period productivity increased, but not by enough to keep up with rising costs and international competition (World Bank, 2007e: 14-15). In fact, the average wage productivity in Palestinian industry is only 57 percent of Egypt's and 85 percent of Israel's. In specific –particularly labor-intensive—sectors, competitiveness gaps are even starker. For instance, Palestinian wage productivity in the food processing industry is only 66 percent of Egypt's and 41 percent of Turkey's while, in the wearing apparel sector, Jordan's wage productivity is triple and Egypt's and Turkey's nearly double that of Palestine. As a result, in many areas, Palestinian workers are not competitive with the rest of the world. (World Bank, 2007e: 16).

Land and Electricity Prices--Over the past forty years, there has been a continuing process of confiscation of Palestinian land by the GoI. As a result, the availability of remaining land in

[31] "The Israeli company *Dor Alon* was the sole company chosen by the Palestinians to supply oil products for West Bank and Gaza from 1994 until the end of 2006. Starting from January 2007, the largest fuel marketing company in Israel – Paz Oil - was chosen by the PA to supply the product requirements of the West Bank." (World Bank, 2007c: 12).

[32] See, for instance, Roy (1999).

Palestine is low and its price is very high. Land suitable for industrial development in Ramallah costs from $100 to over $200 per square meter, levels which are comparable to those of prime real-estate in major European cities (World Bank, 2007e: 47). Similarly, the average cost of serviced land in Palestine is roughly three times the cost of land in Egypt and five times the cost in Jordan (World Bank, 2006a: 69). As a result, the World Bank's 2007 Investment Climate Assessment finds that Palestinian businessmen view the availability of serviced land as a major constraint to developing new businesses and expanding existing ones (World Bank, 2007e: 47). The current restricted framework through which energy supply decisions are being made has also led to a supply shortage and soaring electricity prices. In the year 2000, the average price of electricity in Palestine was twice as high as in Lebanon, three times higher than in Israel and Jordan and five times the price in the USA (Arnon & Bamya, 2007: 169).

Transport Costs--Transport costs are a further contributor to de-development. After uncertainty, transportation is cited by Palestinian businessmen as the most important constraint to the expansion of the private sector (World Bank, 2007e: 38). Israel requires that Palestinian trucks use the "back-to-back" system according to which all goods need to be unloaded from and re-loaded again onto trucks at checkpoints. Moreover, routes are now much longer due to the blocking of some roads to Palestinians and the multiplication of checkpoints. As a result, the World Bank estimates that a truck that was able to make three rotations per day before the Intifada, now makes only two. All of these obstacles have significantly raised unit transportation costs. By restricting access to major West Bank cities such as Nablus, Ramallah, Jerusalem, Bethlehem or Jenin, closures have dramatically raised transportation costs within the West Bank. On the basis of interviews with drivers of two major Ramallah-based companies, the World Bank estimates that transport costs alone have gone up by more than 100 percent along major trading routes compared to pre-Intifada times. Similarly, a one week closure in Gaza leads to an estimated four-fold increase in transportation costs for a furniture producer as importers and exporters need to pay extra fees for shipments stuck at the terminal. These extra costs amount to 77 percent of the value added in the Gaza Strip. Prolonged closures are particularly damaging. During prolonged closures, importers and exporters from Gaza experienced an almost tenfold increase in the cost of transport from the port of Ashdod in Israel to Gaza compared to the cost before the Intifada (World Bank, 2006a: 29-30).

Another major factor increasing the cost of transport is unpredictability. The degree of uncertainty on the time needed to clear customs, for example, is very high. The 2007 World Bank Investment Climate Assessment survey reveals that, on average, it takes companies in the West Bank around 22 days to clear imports. However, the longest time averages nearly 43 days (World Bank, 2007e: iv). This variability and uncertainty in time lags greatly increases transportation costs. In the case of maritime transport, a standard deviation of 20 percent of transport time increases transportation costs by nearly 45 percent (World Bank, 2006a: 21).

Isolation from the Outside World--Because of the multiplication of barriers to movement and access, the Palestinian economy is becoming

increasingly closed and inward-looking. Trade between Palestine and the rest of the world, between Palestine and Israel, between the West Bank and Gaza, and within the West Bank have all declined. Between 1999 and 2006, Palestinian exports declined from 19 to 12 percent of GDP while imports declined from 84 to 79 percent of GDP (International Monetary Fund, 2006: 8). Similarly, between 1999 and 2003, Palestinian exports to Israel declined from 359 to 256 million USD while Palestinian imports from Israel fell from 1853 to 1307 million USD (World Bank, 2006a: 41).

Fragmentation of the Internal Economic Space--Even before the closure of Gaza in 2006, movement of people and goods between the West Bank and Gaza was severely hampered and the corridor between the two areas was not operational. The situation worsened at the beginning of the Intifada and the World Bank's Investment Climate Assessment finds that, since 2000, the percentage of WBG enterprises selling into the other territory has fallen by half (World Bank, 2007e: iv).

Moreover, because of the combined impact of impediments to trade and economic activity within the West Bank, the size of markets inside the West Bank itself also appears to be shrinking. One could say that there is a *de facto* "fragmentation of the socio-economic space in the West Bank into a northern, a central and a southern economic zone, bounded on three sides by the separation barrier and to the west by the Jordan Valley, a significant agricultural area that is increasingly difficult for Palestinians to access" (World Bank, 2007e: 25). As a result, the percentage of Palestinian firms making a significant share of their sales outside their home city declined from nearly 60 percent in 2000 to around 40 percent in 2005 (World Bank, 2007e: v). Because of this internal fragmentation of the economic space, which is reflected in large price differentials across areas, there is no longer a unified market within the West Bank.[33] This dramatic reduction in market size severely reduces economic opportunity and affects the ability of Palestinian firms to take advantage of scale economies.

7. The Economic Consequences of Dependence

The economic transmission mechanisms described above--wage growth outstripping productivity growth, over-inflated land prices, high transportation costs and uncertainty in delivery times and an increasingly autarkic and internally fragmented economy-- combine to produce a host of negative economic effects which will be presented below. These effects are: low investment, de-industrialization and overall weakening of the productive structure and deficiencies in firm capacity.

Low Investment--Private, public and total investment have declined almost consistently between 1999 and 2006. Over this time period, total investment as a percentage of GDP was halved, going from 38 to 19 percent. Private investment fell from 31 to 15 percent and public investment from 7 to 4 percent of GDP (International Monetary Fund, 2006:8). Moreover, in 2006, only 50 percent of firms in the West Bank and 25 percent of those in Gaza were investing

[33] As a result, the differences between the highest and lowest retail prices of agricultural commodities, for instance, are high –for tomatoes, eggplant, squash, cucumbers and bell peppers it ranged between 400 percent and 215 percent. (World Bank, 2006a: 31).

and only 35 percent of West Bank firms and 15 percent of Gaza firms were investing in conducting formal personnel training (World Bank, 2007e: 18). Similarly, only 18 percent of firms had a loan (World Bank, 2007e: 39). The World Bank's 2007 Investment Climate Assessment found that "the fact that very few businesses have loans reflects not the lack of available funds or a weak financial system, but rather the lack of investment opportunities for Palestinian enterprises." It also pointed out that there is no need to invest because existing capacity utilization is very low –only 50 percent. (World Bank, 2007e: 40, iii).

De-industrialization--Sara Roy (1999) pointed out the weakening of the Palestinian productive structure induced by the context and policies of the occupation and called the trend de-development. The trend of a declining share of industry in GDP which she identified for the 1995 to 2000 period seems to have peaked at the height of the "integration" between the Palestinian and the Israeli economies. In fact, between 1995 and 2000, the share of agriculture and manufacturing in GDP declined from 13 to 9 and from 18 to 13 percent respectively. The sectors that took up the slack from agriculture and manufacturing were services and, in particular, real estate and "other services."

On the other hand, following the relative "de-coupling" between the two economies since the onset of the second Intifada in 2000, the sectoral distribution of the Palestinian economy seems to have stabilized. Between 2000 and 2005, the shares of agriculture and manufacturing in GDP increased slightly, going from 9 to 10 and from 13 to 14 percent respectively. As a result of this slight recovery as well as an increase in construction as a percent of GDP, the (over-inflated) share of services in GDP over the same period declined from 48 to 45 percent (World Bank, 2006a: 4 Table 2). However, the closure of Gaza since 2006 has led to a dramatic decline in its industrial production. Since producers can access neither the inputs for production nor the crossings to send out what they produce, the number of industrial working establishments in the Strip has declined by 95 percent, going from 3900 in 2005 to 195 in December 2007. (World Bank, 2007a).

Although with the relative "de-coupling" from the Israeli economy since 2000 the decline in industry (and agriculture) as a share of GDP has been halted, the accompanying trend toward a more autarkic economy has led to a simplification of the productive structure. In the manufacturing sector, for instance, most exports are low value added goods that require little processing and the overall composition of exports reflects a very low and unsophisticated manufacturing base. It also indicates the lack of participation in intra-industry or intra-product trade. For instance, the fall in the share of processed food and textiles in exports and the rising share of stone, marble and quarrying from 2000 to 2005 suggest that exports are becoming more resource-based and embody decreasing degrees of processing (World Bank, 2007e: 17). The World Bank's latest Country Economic Memorandum for the West Bank and Gaza finds that:

> "The trend of progressive deindustrialization of WBG continued in 2003 to 2005 as the economy moved toward goods at lower levels of the technology ladder and imports of food products largely crowded out imports of investment goods. The level of processing embodied in exports as

> captured by the aggregate share of food products together with industrial raw materials recently declined significantly. Similarly, a shift in import demand toward lower processed goods and the fall in investment goods which have accompanied the overall decline in total imports suggest a further erosion of the industrial base" (World Bank, 2006a: iii).

In agriculture, Roy (1999) pointed out a decline in the share of high value added products for export and a turn toward basic foodstuffs for domestic consumption (potatoes, onions, tomatoes). Since 2000, agricultural exports have not increased as declines in the production of some products compensated for increases in others. (World Bank, 2006b: 27 – 47). Overall, a recent World Bank study finds the agricultural sector to be particularly resilient to closures and other movement and access restrictions. This is consistent, however, with a versatile sector which can turn from exports to catering to the domestic market depending on movement and access restrictions. In addition, the study pre-dates the closure of Gaza, which must have led to a sharp decline in agricultural exports from the Strip.

Moreover, the increasing isolation of the Palestinian economy from the rest of the world (including Israel) has led to a stagnation in firm size and enterprise learning. In fact, in 2006, the average firm size in Palestine was about 4 workers, the same as it was in 1927, and only 21 industrial establishments had more than 100 workers (World Bank, 2009b: 1, 19) This small firm size combined with limited access to enterprise learning help explain the fact that only a small share of industrial firms have international quality standards (World Bank, 2007e: iii), which greatly limits their market and export potential.

The above-described de-development process has had a greatly deleterious effect on the welfare of the Palestinian population. This impact can be seen in terms of income per capita and poverty levels as well as in employment and unemployment trends. Real income per capita in 2005 remained about 30 percent below its pre-Intifada level and it was expected to be about 27 percent below its 2000 level in 2011 (World Bank, 2009b: 11). According to the 2007 Household Survey, poverty was at 30 percent in Gaza and 19 percent in the West Bank. The overall employment level, which had fallen by 23 percent between 1999 and 2002, only recovered its pre-Intifada level by 2005. Similarly, the unemployment rate rose from 12 to 35 percent between 1999 and 2002. Due to population growth, however, even by 2006, unemployment had not recovered its pre-Intifada level and it stood at 24 percent (35 percent in Gaza and 17 percent in the West Bank) (International Monetary Fund and World Bank, 2006; World Bank, 2009b). By 2008, unemployment had continued to rise and it stood at 40 percent in Gaza and 19 percent in the West Bank (World Bank, 2009b: 10).

Institutional de-legitimization

This section will argue that the current institutional framework for economic relations between Palestine and Israel fosters –but does not create-- neo-patrimonial rent-seeking behavior and slows down the development of the legitimacy and independence of Palestinian institutions, with adverse implications for a fu-

ture Palestinian state.[34] It will also argue that it is within the power of the PA to improve governance and, to a certain extent, take measures to enhance economic autonomy even within the difficult context of the occupation and the unsupportive framework of the Paris Protocol. The first sub-section will analyze the governance situation in the 1990s. In particular, it will set out the patterns of neo-patrimonial rent-seeking behavior supported by the Paris Protocol, the emergence of those patterns even in contexts independent from the Paris Protocol and the resulting perception of PA corruption in the eyes of the Palestinian public. It will finish by briefly examining the likely impact of the dependence of Palestinian institutions and the Palestinian economy on Israel on the popular credibility of the PA. The second sub-section will turn to describing the political economy that underlined the governance situation of the 1990s and how this system was increasingly resented by the Palestinian population and was shaken by the second Intifada starting in 2002 and the election of the Hamas government in 2006. The third and final sub-section will describe how the new government of Salam Fayyad is working to improve governance while still operating without the required autonomy in a fragile political economy environment which is very different from that prevailing in the 1990s.

[34] Our argument will be that the Paris agreements and the constellation of political economy forces existing within and between Israel and Palestine created incentives for neo-patrimonial rent-seeking behavior. However, this result is not deterministic and can be altered even in the current circumstances. This is supported by the fact that, when the PA has decided to tackle corruption and improve governance in a number of areas –as it increasingly did since 2002 and even more so since 2007--, it has been successful in doing so. It is also corroborated by the fact that many cases of neo-patrimonial behavior –such as the rent-seeking or *wasta* involved in PA participation in many Palestinian private enterprises—did not in any way involve the Government of Israel or Israeli companies.

PA Governance in the 1990s

The Paris Protocol supported rent-seeking behavior through two main avenues. The first is the financial management system and, in particular, the tax collection system it devised. The second is the network of public and private monopolies it legitimized. Until the 2002 reforms, tax revenues from excises on petroleum, tobacco and alcohol, as well as profits from public enterprises were deposited directly into private accounts outside the purview of the Ministry of Finance. Moreover, the 1995 Investment Promotion Code provided the executive with wide and unspecified discretionary power to grant exceptional tax exemptions to large projects.[35] The dangers to good governance posed by such policies were pointed out early on by international donor agencies.[36] These arrangements, however, were approved and condoned by Israel (who deposited funds directly into private rather than PA accounts) and the diplomatic community.[37] This has now been openly acknowledged, including by the World Bank: “At the beginning of the Oslo process… several risky compromises were accepted by the diplomatic community. The first of these was the creation of a Palestinian financial system

[35] These policies were part of the Law of Encouragement of Investment passed in 1995 and modified in 1998. “Critics argued that the law was not effective because it ignored small-scale businesses, which represented the majority of Palestinian enterprises. It was claimed that the Law was biased toward large firms and thus promoted monopolies for politically influential groups in the Palestinian economy.” (Khan, Giacaman & Amundsen, 2004: 176).

[36] See, for instance, Chua, D. (1998).

[37] The bet of the international community in the 1990s was that they needed to support President Arafat at any cost. The cost, however, ended up being the disenchantment of the Palestinian population and growing support for Hamas culminating in its 2006 electoral victory. The diplomatic community was also wary of holding the PA accountable since it was unwilling to hold Israel accountable –for its part in implementing the Oslo agreements as well as for continuing settlement expansion.

featuring certain opaque elements that could operate beneath any "radar screen" of public accountability, and would offer President Arafat what was referred to by some diplomats as "walkabout money" with which to secure political loyalties." (Roberts, 2002: 19). Whether this money was siphoned off or simply used for public PA or PLO purposes beyond public scrutiny, the fact remains that the system did not comply with any basic standards of transparency and accountability.

Regarding the role of public monopolies, much remains to be explored at the analytical level and tackled at the policy level. The facts are that the PA granted monopolistic concessions to private investors in large infrastructure projects, such as telecommunications and electricity, which were accused of being awarded in a non-transparent manner, were poorly regulated and often resulted in high profits for providers, high costs for customers and entry barriers to other potential Palestinian entrepreneurs. In the area of telecommunications, a single company, PALTEL, was granted a 20-year license to operate, maintain and manage the telecommunications sector in Palestine. PALTEL has been subject to heavy criticism, including of abuse of monopoly power and clientelism. World Bank studies substantiate these claims and have called for an opening up of the sector to competition. A 2008 report describes the sector as being characterized by "the presence of a private regulated monopoly, unauthorized competition (from Israel), and overall weak governance and regulation" and calls for the urgent liberalization and improvement in regulation of the sector (World Bank, 2008).

The PA also monopolized imports and distribution of cement and petroleum. The monopolies in the import of petroleum and cement were established in cooperation with Israeli firms. In the case of the cement sector, it seems that large business interests on both sides coalesced to form the Palestinian import monopoly and its relationship to the Israeli monopoly *Nesher* Company. Indeed, "the PNA cement monopoly has been criticized not only because it eliminated competition and raised costs for the vital construction sector, but also because it created a powerful coalition against the development of a Palestinian cement industry" (Khan et al., 2004: 185). All of the above-described monopolies were institutionalized by the Paris Protocol.

As mentioned above, however, there were cases in which rent-seeking was unconnected to the Paris Protocol or to Israel. For example, the PA went into business partnerships with private firms in sectors which do not warrant government intervention, such as hotels, casinos, cigarettes and flour milling. In these areas, moreover, there was no relationship to Israeli firms nor were the interventions reflected in the Paris Protocol. As it is now acknowledged, "each of these strategies involved discriminatory support for large firms." (Khan et al., 2004: 176). This is also the perception of Palestinian businessmen. A 2005 Survey conducted by the Center for Private Sector Development of the Palestinian Businessmen Association found that "Palestinian entrepreneurs still perceive a degree of corruption in the PA and insufficient transparency of its activities. The major issues of concern by businessmen encompass the PA's direct involvement in commercial activities (for example, fuel, cement, cigarettes) and the lack of progress with promised gradual withdrawal." (World Bank, 2006: 65) A World Bank survey also found that, in 11 percent of cases, respondents "claimed that a government agen-

cy or official had asked for part ownership of their firm as a condition to allow them to operate."(Khan et al., 2004: 182). Similarly, a 1997 Palestinian Legislative Council report denounced that a large number of firms either totally or partially owned by the PA did not have their revenues collected through the government budget nor were they audited by the Palestinian Public Monitoring and Audit Department. [38] As a result of all these opaque fiscal and regulatory practices, the PA was perceived by the Palestinian population as increasingly corrupt.[39] By 2004, polls found that 84 percent of Palestinians perceived there to be corruption and 94 percent believed that one could obtain a government position only through connections (Brynen, 2002: 137).

The PA was not only perceived as corrupt, but also as not autonomous and not credible. The fact that the Oslo process created the first Palestinian government in history has been hailed by many as a success in and of itself. For instance, Kimmerling and Migdal (2003) view it thus: "The Oslo process created the first ever Palestinian government…Sometimes that governance was surprisingly effective; most times, it was frustratingly inefficient, even corrupt. Still, it consisted of Palestinians ruling Palestinians" (pp. 346-347).

Because this first government was a government without a state and a government that was utterly dependent –and designed to be dependent—on Israel, its credibility was questioned from the outset.[40] Surveys show that Palestinians consider independence as the highest national priority (34 percent), well ahead of national unity (26.5 percent) and economic prosperity (16.5 percent) (Brynen, 2002: 133). There is also a tendency by sectors of Palestinian intellectuals to view close economic integration with Israel as a form of neo-colonization.[41] Therefore, the uneven "economic integration" and dependence which was institutionalized by the Oslo process as described in the previous sections could easily be seen to corroborate these fears. Moreover, international experience shows that the gap between the PA's *de jure* and *de facto* institutional frameworks is likely to further erode its credibility, weakening prospects for healthy institution-building well into the future.[42] Last but not least, the perceived dependence and "pliability" of the PA to Israel –

[38] These firms included the Petroleum Public Commission, Al-Bahar Company, the Tobacco Commission, Palestinian Commercial Services Company, the Radio and Television Commission and the Palestinian National Company for Economic Development. (Khan et al., 2004: 180).

[39] See the Jerusalem Media and Communications Center, the Development Studies Program at Birzeit University and the Palestinian Center for Policy and Survey Research for examples. Keating 20.

[40] For a description of the development of the PA as "client state" resulting from an "asymmetric containment strategy" fostered by Israel, see Khan et al. (2004).

[41] "…elements of the Palestinian leadership and social elite, like others in neighboring Arab countries, feared such an approach (economic integration) and viewed it as a sort of economic colonization, which would replace direct Israeli military rule in the region with indirect technological and economic control." (Kimmerling & Migdal, 2003: 387).

[42] Gaps between *de jure* and *de facto* institutional structures are common in developing countries, in particular in colonial and post-colonial environments –such as those of Africa and Latin America. In these continents, the first "modern" legal framework their populations ever knew was that of the colonial power. The second was that set up after independence by elites which often imported a *de jure* framework from the colonial power, but proceeded to operate through *de facto* policy processes which greatly differed from their formal legal frameworks. This disconnect between formal (*de jure*) and informal (*de facto*) institutions and policies gravely eroded the credibility and legitimacy of the state in Africa and Latin America. In contrast, state legitimacy and credibility is much higher in regions which have had the "historical luxury" of developing their institutions unencumbered by colonialism, such as most of Asia. In such countries, the correspondence between *de jure* and *de facto* institutions is much closer because formal institutions reflect the outcome of an endogenous process of political development.

de jure as institutionalized in the Oslo and Paris accords and *de facto* in its policies and those of the Israeli government—not only weakened the PA, but also strengthened the standing of Hamas, which increasingly presented itself as the only truly autonomous option from Israel.[43]

The Political Economy of the 1990s and its crisis

This political economy scenario characterized by poor governance, dependence, and eroding credibility was the result of the coalescence of a series of forces prevailing in Palestine and Israel in the 1990s. One could argue that the result of this confluence of forces was over-determined in that each one factor alone was sufficient to explain the ultimate outcome and, hence, that it is hard to ascertain which one of them was the determining cause. In one analysis, the historical tradition of neo-patrimonialism in Palestine (since the time of the Ottoman Empire carried through by the British, the Jordanians and the Israelis) and of the PLO in exile could be seen as simply resulting in its transposition to the PA. In a second analysis, it could be argued that the confluence of a strong occupying state (Israel) with a weak occupied non-state naturally led to the wish of the former to create a client country in the latter (Palestine).[44] These objective conditions would explain the desire and ability of Israel to create a weak and dependent economic and political elite in Palestine supported by the unnecessary and ill-regulated monopolies that are reflected in the Paris Protocol and by the Israeli forbearance and even support for the web of financial irregularities that emerged in the 1990s.

It can also be argued that what emerged was truly the result of the combination of all of these factors.[45] In this view, a few well-organized actors with good channels of communication between them ---the PLO elites, the wealthy Palestinian diaspora businessmen, the Government of Israel and Israeli big business—cooperated to create the above-described arrangements. These arrangements did not serve well the interests of the Palestinian –and arguably the Israeli—populations, but did create benefits for those participating --the Palestinian diaspora and Israeli firms through their business profits, the PLO elite through concentration of power and economic benefits, the Israeli government by creating a dependent "client" non-state in Palestine.

As the 1990s proceeded, however, the Palestinian population became increasingly frustrated. The economy stagnated, there was no progress in the peace process and settlement expansion continued unabated. Moreover, restrictions to movement and access to Israel as

[43] Recent polls, however, show that popular support for Hamas since it actually took power in Gaza has declined dramatically as the population experienced the worsening living conditions resulting from the Israeli blockade of the strip, Hamas repression and declining security due to Hamas-Fatah in-fighting. 83 percent of Gazans believe living conditions have deteriorated since Hamas took power (Near East Consulting, 2007). The same polls also show a concomitant decline of support for the peace process.

[44] As Shimon Peres (1993) argued in *The New Middle East*, "A separate Palestinian state would be received with unease, either overtly or covertly, among Jordanians, and would face fierce opposition from Israelis." (p. 175) Therefore, he proposes a confederation with Jordan with a demilitarized West Bank and Gaza "except for the Israeli security areas." (p.173) The fact that this was the political vision proposed by Peres in 1993 would support the view that the creation of economic dependence through Oslo was deliberate and part of a broader plan of creating a dependent Palestinian non-state. Whether this entity would be under Israeli or Jordanian tutelage was of secondary importance.

[45] For a description of these various interpretations, see Brynen (1995a).

well as between and within the West Bank and Gaza multiplied and were highly unpredictable making the daily life of the population as well as any business activity increasingly difficult. Many of the provisions of the Oslo accord were not implemented and the population started to doubt if they ever would be. It also became increasingly clear that the PA would no longer be able to ignore the new emerging centers of power in Palestinian society –the educated and organized poor in villages and, especially, in refugee camps and their grass-roots organizations, the new intellectual elites from the universities and their NGOs, and the emerging Islamic movement. Finally, any expectations for “good governance” that the Palestinian population may have entertained from its leaders were badly disappointed. It was in this context that the second intifada erupted in the year 2000. As described by Kimmerling and Migdal (2003):

> “The Al-Aqsa intifada directed discontent not only at the Israeli occupation but also toward the inefficiency, corruption, and authoritarian rule of the PA and its inability to bring about the expected economic development, rise in the standard of living, and true liberation from Israeli occupation. The uprising also brought growing dissatisfaction with Arafat’s leadership into the open.” (p. 393).

The Intifada was a turning point. In the future, neither the PA nor the diplomatic community would be able to ignore the Palestinian population the way it had been ignored during the years of the Oslo process. Moreover, a new class of Palestinian intellectuals and professionals as well as grass-roots activists which had emerged at Palestinian universities and become active during the first intifada also challenged PLO dominance in the political arena while the specter of Hamas lurked in the background ready to bank on any and all real and perceived PA failures. At the same time and at the international level, the donor community had undergone a process through which “good governance” and, in particular, good financial management had been put to the forefront. With this confluence of new forces, the “gentlemen’s agreement” of the 1990s between PLO elites, the diplomatic community and the government of Israel was no longer viable. Most prominently, it would no longer be possible to sweep PA financial mismanagement under the rug for political expediency. Finally, many governments in the Arab world were coming under increasing pressure by Islamic movements which used as fuel the ongoing Israeli-Palestinian conflict. As a result, these governments stopped viewing the continuation of the conflict –which had been used for decades as a diversion of public attention from their internal failures-- as being in their interest. On the contrary, they realized that an effective, secular and moderate Palestinian leadership that was able to bring about an end to the Israeli occupation would be a great contribution to maintaining their own internal stability.

This change in the constellation of political economy forces at the beginning of the new century led to the beginning of the implementation of reforms in the PA. Most prominently, some of the worst abuses in public finance management were eliminated. Between 2000 and 2004, the PA implemented a series of important public finance management reforms. These reforms included the establishment of a Central Treasury Account through which all revenues are collected and all payments are made (and the concomitant elimination of side accounts leading to the diversion of funds). The PA also started formulating an annual budget approved by the

Palestinian Legislative Council and which forms the basis for expenditures throughout the year. It established tight controls on the expenditures of government ministries, transferred payroll responsibilities to the Ministry of Finance, made payments of public sector salaries exclusively through bank accounts, and improved the operation and oversight of Palestinian public investments. These reforms, according to the World Bank, had the result of "taking (the PA) from being a relative laggard in many respects (of public finance management) to setting an example for the MENA (Middle East and North Africa) region." (World Bank, 2007d: vi).

These reforms, however, were viewed by the public as "too little too late" and, after the PA held elections under pressure from the United States in 2005, the Palestinian population elected a Hamas government. After having forced elections on Palestinians (and Israelis) and refusing to accept their results, the United States –and the rest of the western international community—isolated the newly elected Government and stopped supporting it financially. In order to continue supporting the Palestinian population, they channeled their funds through newly created accounts outside the purview of the Ministry of Finance and directly under the President of the PA, Mahmoud Abbas, as well as to non-governmental organizations.

Governance and Economic Autonomy in the Salam Fayyad Government

The stand-off between the PA and the donor community came to an end in the West Bank with the establishment of a new government led by former Finance Minister Salam Fayyad. The combination of Mahmoud Abbas as President and Salam Fayyad as Prime Minister –one a recognized reformer and the other a well-respected technocrat-- signaled the intention of the PA to turn a new page in leadership and policies. The Palestinian Reform and Development Plan (PRDP) they presented in December 2007 reflects this new consensus within the PA leadership. The document clearly states in its preamble that its goal is "stabilization and rebuilding of trust" (Palestinian National Authority, 2008) by enforcing security (within Palestine and in Israel), improving governance and reducing corruption, increasing prosperity and regaining legitimacy.

The latest reports of the IMF and the World Bank report that the Salaam Fayyad government is making progress in institution-building, improved public finance management and fiscal consolidation (International Monetary Fund, 2010; World Bank, 2009). They praise the PA for its fiscal management through its control on the public wage bill and the reduction in utility subsidies as well as its improvements in cash management and control on expenditure commitments (International Monetary Fund, 2008). The Fund notes that the 2009 deficit was in line with the budget targets and that further adjustment was planned in the 2010 budget. The IMF also noted that private sector confidence had increased in the West Bank due to the Palestinian Authority (PA)'s track record in institution-building as well as its reforms in the security, public finance, and governance areas.
Both institutions called on the donor community to support the government's adjustment effort, in particular given the enormous needs of the reconstruction effort in Gaza.

The World Bank also praised the government's efforts to increase development expenditures

and to link policy-making, planning and budgeting, steps which are critical to sound governance and accountability. The Government has also taken measures to deliver on the thorny and long-delayed liberalization of the telecommunications market. To this effect, the agreement to grant licenses to a new company –*Wattanyye*—to operate alongside PALTEL finally came into effect after over a year of delays in the approval and release of the licenses by the Israeli government. These reforms, entailing the reversal of many of the malpractices supported by the Paris Agreement, show that a PA with the necessary political is able to improve governance even in the current unsupportive circumstances. Opinion polls seem to appreciate the progress made by the PA and show a positive and improving appraisal of the Fayyad government regarding both economic management and security.[46]

The implementation of the PRDP can address one of the key shortcomings of previous governments by improving governance. In addition to good governance, however, two key economic outcomes will likely be needed to enhance the credibility of the current PA government and build the basis for increased economic autonomy. These two outcomes are an improvement in economic performance and, hence, in the living standards of the Palestinian population, and a clear focus on building strategic economic autonomy. An improvement in economic performance, as the experience of the past two decades and basic economic logic show, is highly unlikely to pan out unless there is a significant easing of current restrictions to access and movement of people and goods.[47] Movement is the lifeblood of any economy and, in the current circumstances, the Palestinian economy is likely to continue to turn inward into increasingly stagnating and self-contained local economies within checkpoints. The PA is making great efforts to improve security. However, for an easing of restrictions to take place, a decision in this regard is needed by the Government of Israel and, for the moment, no such decision has been forthcoming.[48]

Our paper also suggests that, in addition to implementing the priorities of the PRDP –with all of which we concur—the PA should make it a priority to develop strategic economic autonomy from Israel. Without institutional and policy autonomy, the prospects for the development of the future institutions of an independent Palestinian state will be severely impaired and it will be difficult for the PA to deliver the socio-economic outcomes the Palestinian population expects. This paper's section on policy recommendations will point out some areas where these choices are particularly important for the PA, especially in the trade, tariff and tax collection, and energy sectors. It will also present summary recommendations for the donor community, the Arab world and the Government of Israel.

[46] Results of this poll show a steady increase in the positive evaluation of the Fayyad government. The majority (58 percent) of respondents evaluate the performance of the Fayyad government in improving the economy positively (a 4-point increase since August 2008). Similarly, 60 percent of respondents positively evaluate the performance of the Fayyad government in improving the security situation (Arab World for Research and Development, 2008).

[47] This is a point which has repeatedly been made by all development agencies as well as by the PA itself. For a description of existing obstacles, see World Bank (2007b).

[48] An easing of restrictions to movement and access within the West Bank would probably need the removal of settlements –as most checkpoints are there to protect settlers—and the GoI has shown no political will to move in that direction. On the contrary, settlement expansion continues apace and with it the multiplication of restrictions to access and movement for Palestinians.

Conclusions

The *de jure* economic regime and policies governing Palestine-Israel relations is one of *sui generis* economic integration featuring a customs union with labor flows. This is an economic regime appropriate for a liberal peace-time framework among sovereign and well-established states willingly seeking the benefits of economic integration. The context of Palestine-Israel relations, however, is completely different. It is a mercantilist context of war and occupation between two fundamentally unequal partners. One of them (Israel) is a well-established state with a developed economy and a strong military and it is occupying the other (Palestine), which is a weak nation with no formal state, fledgling institutions and no army.

The result of imposing a liberal peace-time framework on a mercantilist reality of war and occupation has been a lopsided *de jure* regime. This regime consists of a customs union whose policies are determined unilaterally by Israel and extended to Palestine and labor flows envisaged as a general principle with the ability of each party to limit them at will. The *de facto* regime is even more problematic and appears wholly unbound by the legal restrictions envisaged in the *de jure* framework. This framework is characterized by pervasive and highly unpredictable restrictions to movement and access of people and goods, continued confiscation of natural resources (especially land and water) and a regime of military and administrative decisions affecting all aspects of economic relations. This regime is most accurately characterized by its uncertainty and its unilateral determination by Israel through its own economic, political and security considerations.

The economic consequences of the combination of the above-described *de jure* and *de facto* economic regimes on the Palestinian economy are dependence, de-development and institutional de-legitimization. The dependence of the Palestinian economy on the Israeli economy can be found at many levels including production levels and productivity growth, trade, labor flows, fiscal revenues and electricity supply. They also extend to other aspects not examined in this paper such as currency, banking system, private sector business ties, the health sector and the environment. This dependence greatly reduces the degrees of freedom of the Palestinian Authority and keeps the Palestinian economy as an impoverished "appendix" of the Israeli economy. This dependence has also meant that the Palestinian economy is completely at the mercy of the Israeli economy and its fluctuations, the cycles of the conflict, and the policy decisions of the GoI. This economic leverage has consistently been used by the GoI as a political tool in its conflict with Palestine.

It has also led to de-development through a number of economic transmission mechanisms such as wage growth outstripping productivity growth, over-inflated land prices, high transport costs and uncertainty in delivery times and an increasingly closed and internally fragmented economy. The economic effects of these developments have been reflected in low and declining investment levels, de-industrialization, an overall weakening of the productive structure and deficiencies in firm capacity. The overall impact on the welfare of the Palestinian population has been dramatic. Real incomes per capita in 2006 were 30 percent below their pre-intifada levels, and poverty and unemployment stood at 46 and 24 percent respectively.

Finally, the gap between the *de jure* and the *de facto* economic regimes, the lack of sovereignty and the dependence of PA institutions on external actors and exogenous factors, the support by the Paris Protocols and the GoI of poor governance in economic arrangements in the PA, and overall weak development results have contributed to the emergence of a deficit in the legitimacy of the fledgling institutions of the Palestinian Authority. Reversing these trends and making progress toward strengthening the economic autonomy and the effectiveness and credibility of Palestinian institutions will require a substantial change in the strategic direction of the economic regimes implemented so far. In particular, it will likely require a systematic but progressive and pragmatic re-engineering of economic relations away from Israel and towards the rest of the world.[49] For this strategy to pan out, it needs to be led by the PA and supported by the donor community and the Government of Israel.

Only with a strategy of systematically increasing economic and institutional independence will Palestine be able to reduce points of friction with Israel, strengthen its institutions and economy and be able to gain the credibility and legitimacy it needs in front of its population. Ultimately, the peace process will also benefit from a less imbalanced relationship between the two parties, greater autonomy among them, fewer points of friction in their relationship and, hence, fewer opportunities for collective punishment which only worsen the chances for reconciliation. It is only through mutually-agreed steps undertaken autonomously by two independent states in a context of peace that real cooperation can ultimately emerge in the medium to long run. This scenario, however, is unfortunately still a long way off and acting as if it were here today will only put off its advent increasingly further into the future.

[49] This chapter is written from the vantage point of Palestine. It is likely, however, that a strategy of progressive separation from the Palestinian economy is also advisable for Israel –chiefly for security reasons. A policy of increasing separation also seems to be what Israeli policy-makers are actively pursuing and stating as their goal. Hence, the Palestinian economy may not have much choice but adjust to this ongoing *de facto* "de-coupling." As long as the occupation of the West Bank and Gaza continues, however, Israel is legally responsible for the welfare of its population and hence cannot fully 'de-couple" from its occupied territories.

Recommendations

Although the ultimate solution to the Palestinian economic problem is the end of occupation, we still recommend the following as needed policies to mitigate the effect of the de facto mercantilist condition. In order for the recommendations to have an impact, if implemented, Israeli governments should take all measures necessary to allow for the reduction of obstacles to movement and access by Palestinians within and between the West Bank and Gaza as well as facilitate imports into and exports out of Palestine. The implementation of the 2005 Agreement on Movement and Access would be a good starting point. It should also avoid all measures of collective punishment as it is currently implementing in Gaza. These measures are not only contrary to basic ethics and international law, but they also worsen Israel's own security prospects, its standing in the international community and the chances of the peace process as a whole. On the contrary, Israel should support the work of the PA and avoid all actions which undermine its legitimacy in front of the Palestinian population.

For the PA—we recommend that, in every institution-building and policy choice made by the PA, the question of whether it furthers or hinders economic and institutional autonomy from Israel should be posed. We also encourage the PA to proceed with the implementation of its PRDP and its established priorities, including the improvement of governance and security, as its ability to deliver on its objectives will critically affect its legitimacy in the eyes of the Palestinian population. Our recommendations are focused on the area of building economic autonomy. This issue is particularly relevant in the following areas:

Consider Establishment of a Free Trade Area. As has been pointed out by several studies beforehand, the possibility of turning the current customs union with Israel into a free trade area should be considered.[50] This would enhance the economic policy autonomy of the PA by returning to it the capacity to make trade policy and set external tariffs. We believe that, as has also been pointed out by these studies, the trade regime chosen should be an appropriate one for a small open economy. It should also explore closer association with neighboring countries and, in particular, Jordan and Egypt, as well as the maintenance of the FTA with the EU and the US.

Establish Economic Borders and Collect own Tariff and Trade Taxes. We recommend that the PA start collecting its own tariff and tax revenues on imports. This would end the current dependence of the PA on receiving "clearance revenues" from Israel. Under a new arrangement, the PA would collect its own tariff revenues and VAT and excise taxes on imports. This collection could be carried out by the Customs Department of the Ministry of Finance of the PA or, if it were to be considered more politically or technically expedient, by a contracted international firm. The establishment of "economic borders" through points of collection between Israel and Palestine should in no way be viewed as impinging on the future borders of the Palestinian State.[51]

*Increase Energy Autonomy from Israel***.** The PA's letter of energy sector policy of 1997 expresses concern over the current over-dependence on Israel for electricity supply and establishes the need to take into account "strategic national interests" in determining sector policy. The importance of greater energy autonomy is highlighted by the current energy crisis in Gaza as well as by the energy shortage in Israel.[52] Some critical decisions are currently pending in the energy sector which should be guided by the principle of building energy autonomy (especially from Israel):

- **Own energy supply should urgently be enhanced**. To this effect, the Gaza Power Plant's (GPP) conversion from gasoil to gas should be undertaken soonest. This conversion, as has been pointed out by the World Bank's 2007 energy sector review, would allow for a significant expansion in electricity production as well as a dramatic reduction

[50] See, for instance, World Bank (2006a) and Arnon & Bamya (2007: 188-212).

[51] The establishment of economic borders and commencement of own collections has also been recommended by the Aix Group and by a number of World Bank reports.

[52] "Israel…is facing a shortage of production that will last at least up to the target year of 2020. Therefore, one can expect that Israel will be reluctant to increase exports to Palestine" (Arnon & Bamya, 2007: 174).

in electricity costs (to roughly 20 percent of their current cost).[53]

- **The Gaza Marine Field gas project should be developed in accordance with the principles of enhancing energy security**. In particular, the option of exporting all the gas to Ashkelon in Israel for transformation into electricity and buying back a portion into Palestine does not seem wise given the current energy crisis in Gaza and potential future repeats of an economic blockade by Israel. On the contrary, policies which would enhance energy security and diminish dependence on Israel should be considered, including: a) exploitation of Gaza Marine Field gas for use by the GPP in Gaza and potential export to Egypt and Israel; b) transit considerations – if possible and in order to improve physical security, a dedicated system of delivery should be avoided as it may be more vulnerable to selective shutdown; on the contrary, the possibility of mixing Gaza Marine gas with gas from the Yam Thetis field, or with gas exported from Egypt in order to diminish the risk of selective shutdown should be explored; moreover, if gas from Gaza Marine Field were landed directly in Gaza, rather than transiting through Israel, this would increase supply security to Gaza; c) market power –diversity of buyers should be considered and monopsony situations, in particular from Israel, should be avoided.
- **Enhancing energy supply from Egypt and Jordan.** The possibility of importing gas from Egypt (via El Arish) to increase electricity production at GPP until the Gaza Marine Field gas becomes available in 2011 should be explored as should the expansion of electricity supply from Jordan to the West Bank (by extending the current supply arrangements from Jordan to Jericho through JEDCO to other parts of the West Bank) and, hence, diminishing reliance on the Israel Electricity Company (IEC).

Build independent infrastructure. The PA should forcefully pursue and seek international support for the urgent need of building of its own port and airport/s. If necessary, it could ask for support from third parties to operate security systems at such locations so that the security requirements of both the PA and Israel could be fulfilled. At the same time, it should make clear to donors that projects for joint infrastructure with Israel, such as the recent proposal to build a joint airport in Netanya are not feasible or desirable in the short to medium-run given the current occupation and conflict situation. The likelihood of their being implemented is very small and, even if they were, the access to such infrastructure by Palestinians would continue to depend wholly on Israel, aggravating Palestinian dependence and extending it to the area of critical infrastructure.

For donors-- the donor community should encourage Palestinian economic autonomy, support PRDP implementation, hold the PA accountable, and pressure Israel to reduce obstacles to movement and access in Palestine lest all its efforts and those of the PA be in vain. In particular, the donor community should weigh each area of support to the PA with criteria of

[53] See World Bank (2007c: 37, Box 2).

economic and institutional autonomy from Israel in mind and aim to encourage Palestinians to build on own resources, develop economic ties with neighbors (especially Jordan and Egypt) and increase relations with the rest of the world rather than aggravating dependence on Israel. Donor recommendations of joint infrastructure and joint industrial zones, as mentioned above, are not feasible in the short-to-medium term and only aggravate Palestinian dependence on Israel. On the contrary, the donor community should support joint ventures between Palestinian firms and companies from their own countries. In particular, donors should support any activities that promise diversification in Palestinian economic relations and prospects for learning-by-doing and increasing market access for Palestinian entrepreneurs. Regarding infrastructure, donors should support the building of Palestine's own port and airports and contribute in whichever way they can to ensure their financing and security arrangements.

For the Arab world—the Arab League should urgently implement its unanimous decision to allow tariff-free access to Palestinian products into its markets, explore opportunities for joint business ventures with Palestinian firms. Moreover, oil-rich countries should consider the possibility of providing the Palestinian population with subsidized oil which could substitute for the current Israeli petroleum monopoly provision to Palestine. Egypt and Jordan should consider all areas in which they can find win-win situations for economic cooperation with Palestine. For instance, the increased supply of electricity exports to the West Bank (by Jordan) and Gaza (by Egypt) should seriously be examined. In particular, the Egyptian government could helpfully reconsider the proposal by private Egyptian businessmen to build a gas-powered electricity plant in Sinai to increase electricity exports to Gaza.

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