



PALESTINIAN - ISRAELI ECONOMIC RELATIONS: TRADE AND ECONOMIC REGIME

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RESEARCH PAPER

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Acknowledgments

In 2007 PIBF issued the research paper 'Future Economic Relations between the Palestinian and Israeli Economies – A Private Sector Perspective: Impact of the Possible Trade Scenarios.'

In March 2014, prompted by the resumption of the Palestinian-Israeli Permanent Status Negotiations the Palestinian Authority saw relevance in having an updated perspective of the private sector based on the 2007 report to provide valuable information and analysis and if the negotiations would advance and also cover the future economic relations between the parties.

Towards this end the Palestinian International Business Forum (PIBF), the Office of the Quartet Representative (OQR) and the International Council of Swedish Industry (NIR) teamed to produce this Report.

Since work on the Report began, however, the situation in the region has changed in many respects. The need for a new economic and trade regime between Palestine and Israel is now more evident than ever.

The Swedish Government, through the Swedish International Development Coordination Agency (SIDA), was kind to provide the necessary funding for conducting the research for this Report.

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In the process of finalizing the report special hearings were held with Palestinian and Israeli private sector representatives and business people.

The PIBF and NIR endorse the general perspective of the report. The specific contents of the report and its findings are the product and responsibility of the research team.

Report Highlights

- Palestinian – Israeli economic relations are at an impasse. The West Bank is on the brink of economic collapse and Gaza is already in crisis.
- Economic viability and fiscal sustainability have been lost; a paradigm shift is necessary.
- A clear and fundamental change in the nature of Palestinian – Israeli economic relations is called for.
- The trade regime has to be changed and economic restrictions removed. A new regime could give the Palestinian economy double-digit growth for a decade.
- The Paris Protocol should be replaced by a Free Trade Agreement (FTA) with Israel.
- A package of transitional measures taken collectively will create a critical mass for change. A virtuous circle of private sector confidence, new investment, and growth momentum will follow.
- Once the initial ‘booster’ effect of removing restrictions has passed, exports will become the single most important long-term growth engine for Palestine.
- Agreement on an FTA and new economic and trade relations can be achieved without necessarily reaching a final status agreement, but a ‘good faith’ political process is necessary.
- Both Israel and Palestine will gain tremendously from shifting to a new FTA economic and trade regime. A successful transition to an FTA may also facilitate the political track.

Palestinian – Israeli Economic Relations: Trade and Economic Regime

Palestinian – Israeli economic relations are at an impasse. The West Bank is now experiencing declining income per capita, rising unemployment, and higher poverty, while Gaza continues to endure recurrent humanitarian and economic crises. The unsustainability of the *status quo* is painfully clear.

Economic viability and fiscal sustainability under the current economic regime has been lost; a paradigm shift has to occur on the Israeli side to trigger a change in perceptions on the Palestinian side and transform the future of the Palestinian economy.

The present economic and trade regime (based on the Paris Protocol of 1994), combined with the restrictions associated with Israeli administrative and security measures, has had a dramatic negative effect on Palestinian economic growth. But the Palestinian economy has also demonstrated remarkable growth potential when these restrictions have been relaxed.

Using advanced macro-economic modelling, this report identifies the optimum long-term growth strategy for Palestine and proposes the negotiation of a new trade and economic regime with Israel, to break the impasse and realise Palestine's true growth potential. The methodology employed in this analysis was first developed as part of a comprehensive study of the Palestine International Business Forum (PIBF) and the International Council of Swedish Industry (NIR), published in 2007. This report then uses this methodology to analyse three optional economic and trade regimes that can replace the unsustainability of the *status quo*.

Quantitative analysis shows the optimal way to achieve sustainable economic growth requires replacing the present economic and trade regime with an advanced Free Trade Agreement (FTA). This report also proposes a comprehensive package of detailed changes and measures which, taken collectively, will create a critical mass for change; boosting private sector confidence, attracting new investment, and creating the needed economic momentum to transform the economy.

Under such a strategy Palestinian real GDP is estimated to increase from \$12 billion to \$44 billion in around ten years, experiencing double-digit growth rates for a decade (as has been the experience of other post-conflict countries, such as Bosnia). Continuous fast development of Palestinian exports is identified as the single most important long-term growth engine of the Palestinian economy, generating continued economic growth long after the initial 'booster' effect of removing restrictions has passed. Analysis shows that the share of exports (goods and services) in Palestinian GDP can rise from 16% to as much as 42% after 15 years. Under the proposed FTA regime, fast GDP and export growth would accelerate growth in employment and reduce unemployment. This analysis forecasts the unemployment rate to drop from its present rate of ~30% to only ~7 – 8% after ten years.

An agreement on a new economic and trade regime can be achieved without concurrently reaching a final status agreement. Growth can ensue so long as there is an underlying assumption that a good faith political process will resume, in due time, with the aim of reaching an agreed resolution to the conflict. Furthermore, FTA negotiations can take place under the umbrella of the Euro-Mediterranean economic and financial partnership process.

It should be emphasised that only a clear and fundamental change in the nature of Palestinian –Israeli economic relations will make it possible to cut through the constraints, restrictions and bureaucracy which hold back Palestinian economic development and impede progress on the political track. Incremental change will fall short of changing perceptions. A critical mass of measures is needed.

Using quantitative analysis this report shows that Israel will gain considerably from shifting to the proposed FTA with Palestine. This shift can be a major growth-engine of Israel for the coming ten year period. The benefits associated with a new economic relationship have the potential to raise Israeli GDP per capita to a level close to the top fifteen richest countries in the world, and generate cumulative export gain of 50% of Israel's total present exports. The contribution to employment is projected to be 75,000 new jobs per annum – an addition of almost 75% to the annual number of new jobs created in Israel over the last decade (2003 – 2013).

WHAT'S IN THE REPORT

(See the Introduction for full report contents and methodology)

This report provides quantitative, evidence-based analysis of the Palestinian – Israeli trade and economic regime, in both its current unsustainable form, under alternative trade and economic regimes, and under optimum trade conditions, and examines how to transition from the current regime to the optimum scenario. This report is divided into 5 broad sections:

1. The Status Quo: Current Palestinian Economic Performance and Prospects
2. A New Economic Paradigm: Recasting Palestinian Economic and Trade Relations
3. The Transition Period Towards a New Trade Regime
4. Sectorial Analyses: How a New Paradigm May Affect Key Palestinian Economic Sectors
5. Benefits for Israel: How the Changes Will Improve the Israeli Economy

This executive summary provides an overview of key findings and conclusions from these five sections; please see individual chapter headings in the full report for complete details.

THE STATUS QUO: CURRENT PALESTINIAN ECONOMIC PERFORMANCE AND PROSPECTS

(See Part One for full details)

Today's economic *status quo* can be interpreted as the direct consequence of two overlapping systems of governance: the Paris Protocol (in effect since 1994, yet originally designed to last only five years; it has now been in place for over twenty), and the elaborate matrix of Israeli administrative and security restrictions. This report's analysis shows how the limitations of the Paris Protocol, combined with the restrictions of the Israeli administrative and security measures, have raised Palestinian transaction costs, denied economies of scale, lowered total factor productivity, and undermined Palestinian competitiveness at home and abroad.

This report estimates that the *status quo* economic regime has resulted in lost Palestinian GDP of up to \$15 billion USD annually. For more than a decade the Paris Protocol has been accused of hampering Palestinian economic growth, increasing the trade deficit with Israel, causing negative trade diversions, and deepening Palestinian dependence on the Israeli market. The Protocol also resulted in significant tax leakages and losses to the Palestinian treasury. Moreover, the Protocol severely affects the Palestinian price level, as it imposes the cost structure of Israel onto the Palestinian economy – in spite of the huge differences between the two economies.

While Palestinian economic growth prospects are in many ways defined by the regime of restrictions, they are



also greatly affected by developments on the political track. This report's analysis identifies how during periods when the Palestinian political horizon has been positive, Palestinian economic growth has surged upwards (for example during the Oslo process 1997 - 1999, and following the Annapolis initiative in 2008). When prospects for a resolution of the conflict have receded, Palestinian economic performance has also declined. A positive political horizon is essential for Palestinian household and investor decision making and confidence.

The lifeline of a small economy such as Palestine is trade and its ability to adapt quickly to globalisation and technological change. This report identifies how the economic restrictions, coupled with the lack of political horizon for investors, have cut off this lifeline at four levels:

- By distorting the production structure towards retail trade, construction and government;
- By suppressing exports and skewing trade relations to a dependence on trade with Israel;
- By repressing economic growth generating a large output gap;
- By undermining fiscal sustainability and generating a dependence on external budget support.

Furthermore, this report identifies how the weakening growth performance in the West Bank, coupled with the collapse of Gaza's economy, has shifted the Palestinian production structure towards sectors with low tax compliance, undermining the growth of public revenues and widening budget deficits.

Finally, this report identifies that under the current trade and economic regime the only engine of economic growth in recent years has been the recurrent fiscal deficit. The reduction of this fiscal deficit – in response to declining external budget support and without the emergence of an alternative source of growth such as private and public investment – has reduced economic growth to stagnation levels, with declining per capita income in 2013 and 2014. Had the donor community compensated the withdrawal of fiscal stimulus, by financing an increase in development expenditure and public investment in infrastructure, economic growth would have rebounded. However this did not occur, with the consequence that both economic and fiscal sustainability have been lost.

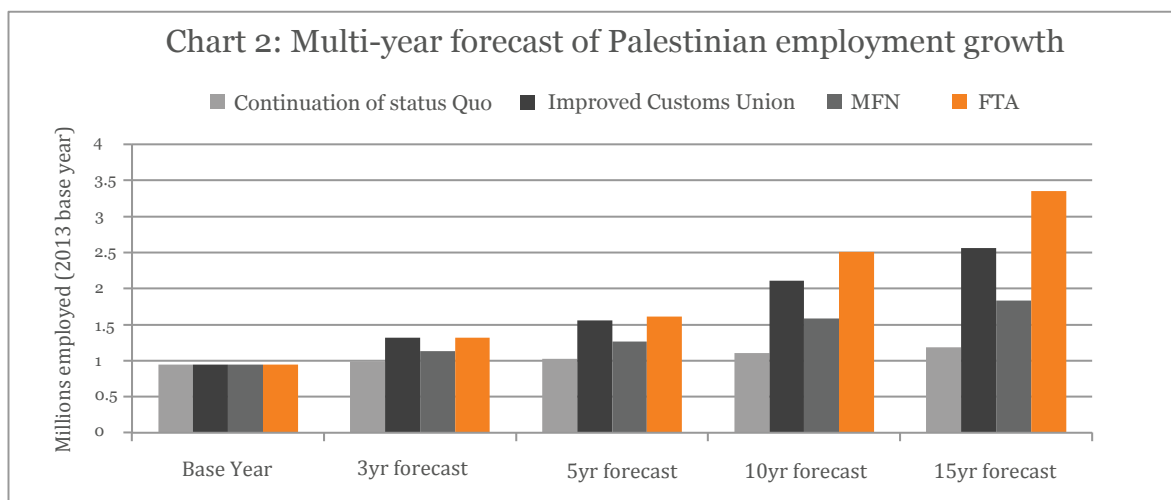
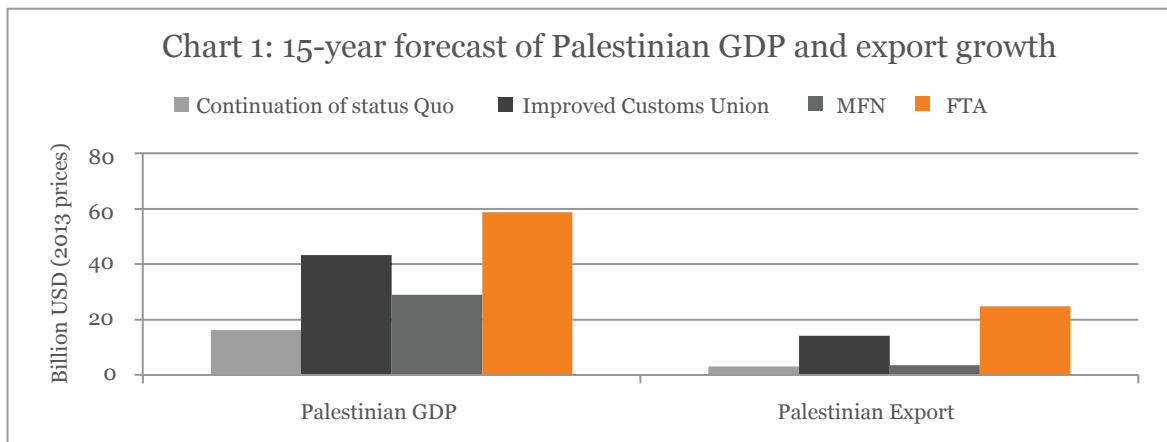
This report concludes that under the present restrictive trade and economic regime there is no prospect of a return to Palestinian economic viability and fiscal sustainability.

A paradigm shift is required to change the economic environment in Palestine. A change primarily in trade and economic regime must take place, supported by a new Israeli policy to undertake real actions and measures which advance the Palestinian economy, and a Palestinian government to coordinate the sequence and implementation of these measures. A critical mass of measures taken collectively will send a strong signal to the Palestinian business community and international organizations that there is a serious intention on the Israeli side to move forward and generate a turnaround in Palestinian economic growth prospects.

A NEW ECONOMIC PARADIGM: RECASTING PALESTINIAN ECONOMIC AND TRADE RELATIONS (See Part Two for full details)

To recast the Palestinian economy away from the current economic and trade regime, and unlock its true growth potential, this report quantitatively analyses and assesses three alternative models for Palestinian-Israeli economic relations: an Improved Customs Union, a Most Favoured Nation (MFN) agreement, and an advanced Free Trade Agreement (FTA). These three alternate economic and trade regimes are compared as per their contribution to the main Palestinian macro-economic parameters: GDP growth, exports, investment and employment.

Using quantitative analysis, this report establishes that the optimal regime for Palestine is an advanced FTA with Israel. The high-level results of this analysis are illustrated in Charts 1 and 2 below:



Under an FTA scenario Palestinian real GDP is estimated to increase from \$12 billion to \$44 billion in just ten years, as a result of very strong double-digit growth rates over the first decade of the new economic and trade regime (as has been the experience of other post-conflict countries, such as Bosnia).¹ This report forecasts that the growth potential of Palestinian real GDP would be 18% per annum for the first three years, followed by lower double-digit growth for the next seven years, before settling to a long-term growth trend of 6%. This will result in a GDP of nearly \$60 billion after 15 years.

An FTA would allow most Palestinian businesses to benefit from tariff-free access to Israeli markets, whilst allowing Palestine to maintain an independent external trade policy towards third parties. This is of particular importance for Palestine to become a full member of GAFTA and other bilateral and multilateral trade agreements. An FTA with Israel would also allow for additional components of Palestinian – Israeli cooperation (for example movement and access arrangements, tax standardisation etc.) to facilitate greater business cooperation and investment.

Most importantly, an FTA regime would be the most promising regime for the purposes of eliminating or relaxing the restrictions on the Palestinian economy.

[1] The West Bank and Gaza registered double-digit GDP real growth for a period of fifteen years after the 1967 war (from 1968 to 1982); the West Bank registered average real GDP growth of close to 15% in 1997- 1999; and again double-digit growth in the post-Second-Intifada period (2003 – 2005), and after Annapolis (2008 - 2011).

The removal of restrictions will, in the first five years, allow for existing unused Palestinian production capacity and rising consumption levels to drive the initial high double-digit GDP growth rates. However in the long-term this report identifies that the primary growth engine of the Palestinian economy is the export-driven expansion of the main Palestinian productive sectors: manufacturing industry, agriculture, and tourism. These sectors have all experienced minimal growth or stagnation under the *status quo*. Under a new FTA regime exports, as a share of Palestinian GDP, will increase to 42% after 15 years. Arab markets will be the most important export destination for Palestine, closely followed by Israel, with a combined share of 80% of total Palestinian exports; the US, Europe, and other global markets will account for the remaining 20% of exports.

Finally, fast GDP and export growth, under a new FTA regime, would accelerate growth in employment. This report forecasts unemployment rates to drop from its present rate of ~30% to ~17% after five years and to ~7 – 8% after ten years, where it will stabilise.

The clear comparative advantage for Palestine of the FTA economic and trade regime is consistent with the findings of the 2007 PIBF –NIR Study. This consistency, in spite of the substantial changes in circumstances, re-affirms the conclusion that an advanced FTA is the best economic and trade regime for Palestine.

The scale of the challenge posed by the complexity of the web of restrictions, and the mammoth bureaucratic apparatus that has developed to maintain it, must not be underestimated. Only a clear and fundamental change in the nature of Israeli – Palestinian economic relations, as in the proposed shifting to the new FTA regime, will make it possible to cut through this web of restrictions and eliminate it.

An agreement on the envisioned new economic and trade regime can be achieved without concurrently reaching a final status agreement. The underlying political assumption is that a good faith political process will resume with the aim of reaching an agreed resolution to the conflict. Furthermore, FTA negotiations can take place under the umbrella of the Euro – Mediterranean economic and financial partnership process.

TRANSITION PERIOD TOWARDS A NEW TRADE REGIME (See Part Three for full details)

This report proposes the immediate reactivation of a reformed Joint Economic Committee (JEC) (to include the participation of a neutral third party and an effective arbitration system) to use as a mechanism for negotiators to review the state of implementation of the Protocol, agree jointly on amendments to resolve some of the acute problems identified in this report, and to manage the interim process of transition.

This report identifies that the transition from the current regime will require a planning framework, a set of organising principles, and a series of enabling measures in order to succeed.

This report proposes a range of specific and politically feasible measures within an actionable framework to enable this transition. These measures include, inter alia, required amendments to the Paris Protocol to allow for a smooth transition to the FTA regime, resuming free trade with Gaza, allowing for Palestinian development of Area C, the reduction of restrictions on the import of materials and equipment, reform of the revenue clearance system, the deployment of Palestinian customs and border officials to crossings, and the establishment of Palestinian import/export facilities.

If these measures are taken collectively, as a critical mass, they will trigger major new investment, economic growth, and significantly improve prospects for the political track. However, if these measures are taken incrementally, or are not fully implemented, very little will change.

SECTORIAL ANALYSES: HOW A NEW PARADIGM MAY AFFECT KEY PALESTINIAN ECONOMIC SECTORS (See Part Four for full details)

This report identifies that three sectors of the Palestinian economy – Agriculture, Manufacturing, and Tourism – are the most important in terms of their potential contribution to Palestinian GDP, export, and employment growth. This report identifies quantitatively that all three sectors have the greatest growth prospects under an advanced FTA economic model, and identify the steps and measures needed to allow these sectors to reach their full growth potential.

Agriculture

This report identifies that the economic *status quo* has damaged agricultural sector growth more severely than any other sector of the Palestinian economy. The report finds that the shortage of water resources necessary for irrigation has been the primary contributing factor to Palestinian agricultural decline, having prevented both the expansion and quality of Palestinian farming (e.g. through forcing Palestinian farmers to grow low-value crops that require less water). Productivity and value of production are further impacted by restrictions on fertiliser use, restrictions on access to land, and poor links to processing and markets.

The report identifies that transformational growth in the agriculture sector, under a new economic and trade regime, can be powered by a combination of measures including expanding irrigation, expanding the area of land under cultivation (including land in Area C), improving the productivity of irrigated land, and shifting production to a higher-value crop mix. Of these, the report identifies that the most critical enabler of agricultural development (once the transition to the new economic and trade regime is underway) is the availability of water for irrigation.

This report therefore recommends the prioritisation of reallocation of water from the Mountain Aquifer, and development of major water desalination and wastewater treatment infrastructure, as necessary steps to boost sector growth.

Manufacturing

The Palestinian manufacturing industry has the greatest potential for rapid growth of all economic sectors, following transition to a new economic regime. This sector will be able to employ existing unused capacity almost immediately, and respond to new opportunities in both domestic consumption and export markets.

Growth in manufacturing will be driven primarily by the development of new export-orientated industries targeting both Arab and Israeli markets, facilitated by major new investment in Palestinian industry by Multi-National Companies (MNCs), as well as by import substitution and significant domestic market growth. The manufacturing sector will benefit greatly from the primary long-term strengths of the Palestinian economy: unique bilateral agreements with large markets; strategic geographical location in proximity to both Israel and GCC markets; and high education and training levels across the Palestinian workforce.

This report identifies that for this sector to achieve high growth, priority needs to be given to lifting restrictions on the import of capital equipment and inputs, lifting restrictions on Palestinian business travel, and increasing Palestinian access to export markets. These steps will have a major impact on raising total factor productivity and restoring Palestinian export competitiveness.

Tourism

Palestine has exceptional tourist potential, given its high concentration of unique tourist attractions, geographic location (ideal for joint-tourism packages with Israel, Jordan, and Egypt), and existing number of nearly 20 million tourist entries annually.

This report identifies that a new economic regime will allow Palestine to realise this potential, primarily through prioritising four growth-engines: converting ‘same-day’ tourists into overnight visitors; cooperating with Israel to create a joint ‘Holy Land’ tourism product; removing restrictions and increasing investment in tourism infrastructure; and facilitating travel (by providing entry visas) for millions of new visitors, including those from Arab and Muslim countries.

These developments will enable the number of overnight tourists to triple in the first three years following transition, from the existing figure of 0.5 million overnight stays to approximately 1.5 million overnight stays. This report forecasts that this figure will continue to rise, reaching around 6 million overnight stays for incoming tourists after fifteen years.

BENEFITS FOR ISRAEL: HOW THE CHANGES WILL IMPROVE THE ISRAELI ECONOMY **(See Part Five for full details)**

The *status quo* has a major negative cost on Israel: both an explicit cost, in terms of high security, defence, and administrative costs; and in terms of untapped economic benefits (e.g. from lost trade with Arab countries, lost tourism revenues, and lost export opportunities *vis-à-vis* international markets).

- Transition to a new economic and trade relationship with Palestine will result in the gradual and progressive reduction of explicit costs to Israel and the removal of constraints on Israel’s true export potential. The envisaged FTA relationship and accompanying improvement in the political atmosphere will benefit Israel economically in major and fundamental ways, including:
 - Israel will benefit from enhanced exports to the Palestinian markets;
 - Israel will benefit from the opening of major (and proximate) Arab markets, including with time GCC markets, to Israeli goods and services;
 - Israel will benefit from increased tourism and growth, especially through the development of a joint-tourism offer with Palestine;
 - Israel will benefit from increased Foreign Direct Investment (FDI).

This report forecasts that Israel will experience a GDP gain of at least 2 percentage points per annum, over a ten year period, under the new economic and trade model. This represents a very significant new growth-engine for Israel, raising Israeli GDP per capita to around \$50,000 in ten years²; this level of GDP per capita will bring Israel close to the top fifteen richest countries in the world. Furthermore, this report forecasts Israel’s cumulative export gain to be around \$45 – 50 billion per annum in ten years; a 50% increase on the present Israeli export level.³ Finally, this report forecasts that the derived total contribution to Israeli employment will be equivalent to around 750,000 new jobs (75,000 new jobs p.a.). This represents an addition of almost 75% to the annual number of new Israeli jobs created over the last decade (2003 – 2013).

This forecast follows a scenario which assumes that, concurrently with the agreement on the new FTA regime, Israel will be able to export products directly to Arab markets. Under another scenario, which assumes that only indirect Israeli exports will be allowed to enter Arab markets, the benefits to Israel are expected to be one quarter to one third lower.

Taken together, this report identifies quantitatively that transition to a new Palestinian-Israeli FTA economic and trade regime, supported by a new Israeli policy to undertake real actions and measures which can advance the Palestinian economy, can be a major economic win-win for both parties.

[2] 2013 prices

[3] Goods and services at constant 2013 prices

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Introduction: Aims and methodology of the report

Palestinian – Israeli economic relations are at an impasse. The West Bank is now in declining per capita income territory with rising unemployment and poverty, while Gaza continues to endure recurrent humanitarian and economic crises. The unsustainability of the status quo is painfully clear.

Economic viability and fiscal sustainability under the current economic regime has been lost; a paradigm shift has to occur on the Israeli side to trigger a change in perceptions on the Palestinian side and transform the future of the Palestinian economy. Only a fundamental change in the nature of Palestinian – Israeli economic relations will make it possible to lift the restrictions that impede Palestinian economic growth and change the course of Palestinian economic development.

The main purpose of this report is to analyse the economic effect of transition from the current trade and economic regime between Palestine and Israel, and *vis-à-vis* other markets, to a new trade and economic regime that is better suited to the purpose of eliminating or relaxing the present restrictions. At the same time, this report presents detailed and concrete proposals for a transition period towards a new trade and economic regime, which can be set in motion simultaneously with a resumption of talks between the parties. This report also presents and quantifies the substantial benefits for Israel in shifting from the status quo to the recommended new trade and economic regime.

Methodology

The methodology employed in this report was first developed as part of a comprehensive study of the Palestine International Business Forum (PIBF) and the International Council of Swedish Industry (NIR), published in 2007. Since 2007 the methodology of the PIBF-NIR study has been improved in a series of works. This report updates the 2007 report, using the most up-to-date information and the improved methodology.

This report employs a methodology of two-level analysis: macro-economic analysis and sectorial analysis, which focuses on the main productive and exporting sectors of the Palestinian economy.⁴

The report examines the economic growth potential of the Palestinian economy under optimal conditions, which will enable: (a) removal of administrative, security and other restrictions; (b) harnessing the unused Palestinian production capacity, and the other inherent strengths of the Palestinian Economy; and (c) application of a new trade and economic regime that will best support rapid export-oriented long-term sustainable economic growth. This report's analysis relates to the primary macro-economic parameters of GDP growth, exports, investment, and employment.

This report then assesses optional new trade regimes according to their potential contribution to these main macro-economic parameters.

The report's findings and conclusions have been discussed in meetings with Palestinian and Israeli private sector leaders. Their comments and observations are incorporated into the report.

Political assumptions and preconditions

An agreement on a new economic and trade regime can be achieved without concurrently reaching a final status agreement. Growth can ensue so long as there is an underlying assumption that a good faith political process will resume, in due time, with the aim of reaching an agreed resolution to the conflict. Furthermore, FTA negotiations can take place under the umbrella of the Euro-Mediterranean economic and financial partnership process.

[4] This study focuses on agriculture, manufacturing industry, and tourism. These three sectors are, by far, the most important in terms of their potential contribution to sustainable long-term growth of GDP, exports and employment. Infrastructure sectors are of critical importance as enablers. Other important sectors such as ICT or construction are secondary, in terms of their potential contribution, in comparison to agriculture, manufacturing industry, and tourism.

With regards to transition period arrangements, this report assumes that the Israeli government realises that it is in Israel's interest to revive the Palestinian economy, and that this approach is translated into political readiness to undertake real measures on the ground. The detailed set of transition measures this report proposes can be applied without adversely affecting Israel's security interests.

It is imperative that these proposed enablers are taken collectively, as a package, in order to achieve the critical mass needed to trigger positive private sector perceptions towards new investment and economic growth.

Structure of the report

The first part of this report examines the current economic performance and prospects for the Palestinian economy under the status quo. In this section, this report also examines the anticipated economic implications of continuous deterioration under the status quo.

The second part of the report presents analysis and assessment of the long-term development prospects of the Palestinian economy under a new economic paradigm. Then, the report analyses several possible trade and economic regimes vis-à-vis Israel and in relation to Arab and international markets, in the Palestinian macro-economic context.

The third part of the report relates to the transition period towards a new trade and economic regime. The report presents various measures that can be enacted, either simultaneously as part of a resumption of talks towards a resolution of the conflict, or independently of final status negotiations should the political track be proceeding more slowly. It is noted that if the required easing and enabling measures are taken incrementally, with time gaps in between, little will change. If however they are taken collectively, as a critical mass, positive perceptions will be triggered towards major new investment and growth.

The fourth part of the report provides sectorial analyses, examining the potential for economic growth of three key sectors of the Palestinian economy under each of the different trade and economic regimes. In this part the report also highlights certain large projects that would have significant macro-economic impact and value.

The fifth and final part examines the benefits for Israel in shifting from the status quo to the recommended new trade and economic regime.

Part 1: Current Palestinian Economic Performance and Prospects

Introduction

Since 1994 Palestinian – Israeli economic relations have been governed by the Paris Protocol, signed between the Palestinian Liberation Organisation (PLO) and the Government of Israel (GOI) on 9 April 1994. In 1995 the Protocol was incorporated as Annex 5 of the Israeli – Palestinian Interim Agreement on the West Bank and the Gaza Strip (Interim Agreement). As part of the Interim Agreement the Protocol was intended, and in fact designed, to serve for a short interim period of five years, to enable the (then fledging) Palestinian Authority to establish independent institutions and acquire the needed experience to manage its own economic affairs, independently of Israel.

By the end of the interim period both the Interim Agreement and the Protocol should have been replaced by a “Permanent Status” peace agreement. However, the failure of negotiations between the PLO and the GOI led to the *de facto* extension of the Protocol far beyond the interim period it was intended and designed to serve for.

For more than a decade the Protocol has been the object of debate and criticism. It is accused of hampering Palestinian economic growth, increasing the trade deficit with Israel, causing negative trade diversions, and deepening Palestinian dependence on the Israeli market. The Protocol also resulted in significant tax leakages and losses to the Palestinian treasury.⁵

Moreover, the Protocol severely affects the Palestinian cost structure and price level, as it imposes Israel’s cost structure onto the Palestinian economy – in spite of the huge differences between the two economies. While Israel is in a position to mitigate some of these high costs by using natural gas as a source of energy and benefiting from economies of scale and technology transfers, Palestine cannot benefit from any of these advantages due to the restrictions imposed on it. Palestine is among the poorest Arab countries, with GDP per capita of around \$2,500, while Israel is a rich country and member of the OECD, with GDP per capita of around \$37,000 – fifteen times higher than in Palestine.

In terms of incomes, the average salary of an Israeli employee is 4.5 times higher than the average salary in the West Bank, and more than six times higher than in Gaza (at 9,050 NIS, 2,050 NIS, and 1,450 NIS respectively).

If unemployed and underemployed persons are taken into account, and considering the much higher unemployment and underemployment rates in Palestine, and the much lower rate of participation in the Palestinian labour force, the gap widens to more than 7:1 in favour of the average work-age Israeli, in comparison to their Palestinian counterpart.

In spite of these huge differences in income Palestinian households face a price level which is similar or close to that of Israeli households, in most product categories.

The effect of this imposed linkage is especially severe in two of the most important product categories: imported food products, and energy products (fuel, electricity, etc.). In these two product groups the price level in Israel is especially high because of high taxation and other structural causes.

The share of these two categories in Palestinian household expenditure is much higher than in Israel, which intensifies the negative effect of this linkage on Palestinian society. Moreover, the high cost of energy also affects the prices of all other products, as it raises production costs across all sectors of the economy.

In conclusion, the imposed linkage to the Israeli cost structure severely affects the welfare of Palestinian house-

[5] For more information on this subject please see OQR Report “Back to the Future: Integrating the Political and Economic Tracks”, Report for the Ad hoc Liaison Committee AHLC, March 2013.

holds, and is among the principal structural causes of high Palestinian poverty rates.

- In addition to the Protocol's inherent limitations, Israel has and continues to restrict Palestinian economic development through an elaborate matrix of restrictions, which intensified after the outbreak of the Second Intifada in September 2000. This matrix (elaborated in Annex 1 of this report) includes:⁶
- Restrictions on the movement of people, labour and goods, as well as on access to domestic and foreign markets;
- Permitting and licensing requirements on all new developments, including housing projects, in East Jerusalem and in Area C;
- Restrictions on the import of capital equipment and raw materials by Palestinians;
- Fragmentation of Palestinian territory by delinking Gaza and East Jerusalem from the West Bank, and keeping the Jordan Valley under tight residency restrictions;
- Limitations on exploiting Palestine's natural resources, including natural gas deposits located offshore from Gaza, water sources in the West Bank, and Dead Sea minerals.

These restrictions have raised Palestinian transactions costs, denied economies of scale and technology transfer, lowered total factor productivity, and undermined Palestinian competitiveness at home and abroad. Despite improvements in the security situation in the West Bank since 2004 and the changing realities in the Gaza Strip since 2007, Israel continued to apply these restrictions, and in some cases has even intensified their severity. When combined with the lack of a political horizon, which is essential for household and investor decision-making processes, and the unpredictability of political developments which may affect access and movement, these restrictions have had a devastating effect on the Palestinian economy.

Overview of Palestinian economic performance

The political track is intimately woven with the economic track. Progress (or lack thereof) in the peace process provides the backdrop to Palestinian households and business community for their decision making, with respect to consumption, investment, and choice of residence.

Since 1967 there was a brief period, between 1995 and September 2000, when perceptions of the business community and households became strongly positive: in the expectation of a final status agreement at the end of the interim period of the Oslo agreements. The Palestinian business community at home and abroad raised the level of investment to an annual average of 37% of GDP (Table 1.1). There was substantial subcontracting by Israeli companies and large investment in manufacturing, as indicated by capital formation in machinery and equipment (non-building) which increased from 8.5% of GDP in 1996 to 12% of GDP in 1999. Exports increased from 14% of GDP in 1994 to 18% in 1998 – 1999, and remained on an upwards trajectory. Workers' remittances reached 15% of GDP in 1998 – 1999, and private transfers from abroad accounted for a further 8% of GDP, fueling Palestinian income and purchasing power (Table 1.1).

These endogenous growth factors, particularly the increase in investment, resulted in a double digit rate of economic growth averaging 12% in 1997 – 1999. This performance contributed to higher Palestinian Authority tax revenues, resulting in a fiscal balance. The recurrent fiscal deficit was only 1.5% of GDP in 1997, but improved to a small surplus in 1998 (0.7% of GDP), and was balanced in 1999.⁷ Both economic viability and fiscal sustainability were attained.

[6] For more details see Annex 1

[7] There have been extra budgetary expenditures which are not recorded in the data above. These are estimated at less than 2% of GDP.

The failure to reach a Permanent Status agreement by 2000, as predicated in the Interim Agreement of 1995, was followed by a second Palestinian uprising (aka the Second Intifada). This ushered an era of significant political strife and instability, which resulted in large economic and financial losses and a draconian web of economic restrictions imposed by Israel on Palestinian activities. Between 2001 and 2003 Palestinian output declined, albeit recovering to an extent between 2004 – 2007, whilst per capita income remained stagnant for the whole 2001 – 2007 period (Chart 1.1).

Table 1.1: Palestine: Major economic indicators as percentage of GDP, unless otherwise indicated

	1997-99	2007	2008	2009	2010	2011	2012	2013
Real growth	12.4	6.6	6.1	8.7	8.1	12.4	6.3	1.9
West Bank	14.3	12.7	11.8	9.0	7.1	10.7	6.0	0.5
Gaza	8.7	-2.4	-5.1	16.0	30.1	17.7	7.0	6.0
Cost of living (average)	6.2	1.9	9.9	2.7	3.8	3.2	2.8	1.7
Exports (goods & services)	18.0	19.3	17.4	15.6	15.3	17.2	16.6	16.5
Gross Investment	37.6	24.6	22.1	24.6	22.1	21.7	21.6	22.0
o/w plant , equipment	12.8	5.4	5.9	6.3	6.0	6.3	5.3	5.4
External transfers to private sector	8.8	23.9	21.6	10.8	10.8	5.4	10.3	9.8
Worker's remittances	15.5	10.9	11.2	11.4	12.1	12.0	10.0	10.2
ODA	15.2	31.2	37.0	38.7	28.3	21.4	18.0	15.9
Budget Deficit	0.0	24.5	20.1	22.3	13.9	12.2	12.9	13.0 ¹
External budget support US\$ million	4	1,012	1,763	1,348	1,147	814	925 ^{**}	992 ^{**}
% of GDP		18.4	26.4	18.5	10.5	7.8	7.6	7.5
Unemployment (%)	12	22	27	25	24	21	23	24
GDP at current prices US\$ million	3942	5506	6673	7268	8913	10,465	11,279	12,575

Source: PCBS National Accounts; Economic and Social Monitor 2014, Balance of Payments; ODA database. ^{**} Adjusted for \$150 million of US budget support delayed in 2012 and disbursed in 2013.

Israel withdrew unilaterally from Gaza in August 2005. However effective governance in Gaza could not be established amidst the on-going strife between Hamas and Fatah. A contributing factor to this deterioration was the siege imposed on Gaza in the aftermath of Hamas' parliamentary election victory in January 2006, and the failure to implement the November 2005 Agreement on Movement and Access (AMA). In June 2007 a de facto government was established by Hamas, and Gaza was cut off from the West Bank and major donors, ushering in an era of instability and economic decline under a draconian Israeli siege.

During the subsequent period (2007 – 2009) positive political perceptions were revived in the aftermath of the Annapolis Peace Conference. The Paris pledging conference in December 2007, alongside the formation of a credible Palestinian government in July 2007, generated optimism and an exceptional level of support from donor countries. In 2008 the PA received \$1.76 billion in budget support, not only to cover the 2008 budget deficit but also to finance PA salary arrears to its employees (incurred in 2006 – 2007 during the PA's financial crisis). This was a huge fiscal stimulus to the economy, equivalent to 26% of GDP,⁸ with a clear focus on reviving the economy and preparing for Palestinian economic and political sovereignty.

These positive perceptions were reinforced by the formation of a Palestinian government under Dr Fayyad, with its focus on improving governance, institution building, and rural development. Robust reforms were implemented in the Ministry of Finance including: greater control over expenditures, the implementation of sound public financial management (PFM) practices through upgrading the accounting system, establishing an external audit mechanism, and institutionalising monthly reporting of fiscal accounts with standards of transparency which exceeded those of neighbouring countries, including Israel. By April 2011 the Ad Hoc Liaison Committee (AHLC) meeting in Brussels stated that “according to the reports from the World Bank, the IMF, and the UN, the PA is above the threshold of a functioning state in the key sectors they studied”.⁹

The reestablishment of security in the West Bank, following the disbanding of the armed militias (which had gained control of several cities), the strengthening of the judiciary, and the resultant restoration of law and order, increased business confidence and contributed to an increase in investment, particularly in residential housing.

Performance of the Palestinian economy 2007 – 2014

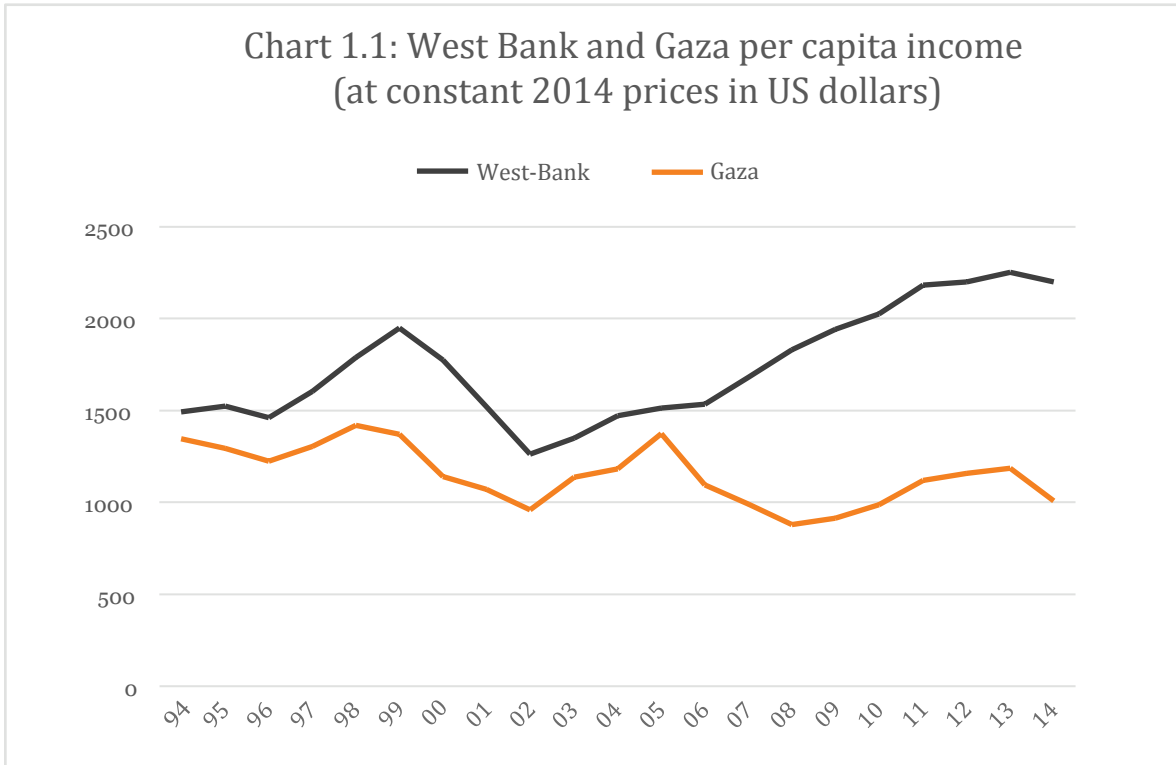
It is interesting to note that these positive developments in security, institution building, and strong donor financial support, which under normal circumstances would have resulted in an upsurge of private investment and growth, were undermined by a turnaround in the Israeli political orientation. In 2009 a new Israeli coalition government was established, and it became clear that it lacked sustained interest in attaining an agreement with the Palestinians on an end to the conflict based on a two state solution.

Gross investment, which had reached 38% of GDP in 1997-99, actually declined to 18% by 2007. It then rebounded to 25% in 2009 in the wake of the Annapolis initiative, but declined again to 22% as the peace process ran out of steam. In any case, gross investment was mostly focused on residential housing. Having been burned in 2000 by the failure to reach a final status agreement, the business community was reluctant to assume that risk again. Investment in plant and equipment, which was 13% of GDP in 1997-99, fell by more than half to 5-6% of GDP throughout the 2007-13 period. This was barely sufficient for capital depreciation, implying that net investment in plant and machinery may have actually been negative.

[8] In comparison, the US Treasury stimulus of \$760 billion at the height of the 2009 recession was 6% of GDP

[9] Meeting of the AHLC, Brussels, 13 April 2011, Chair's summary

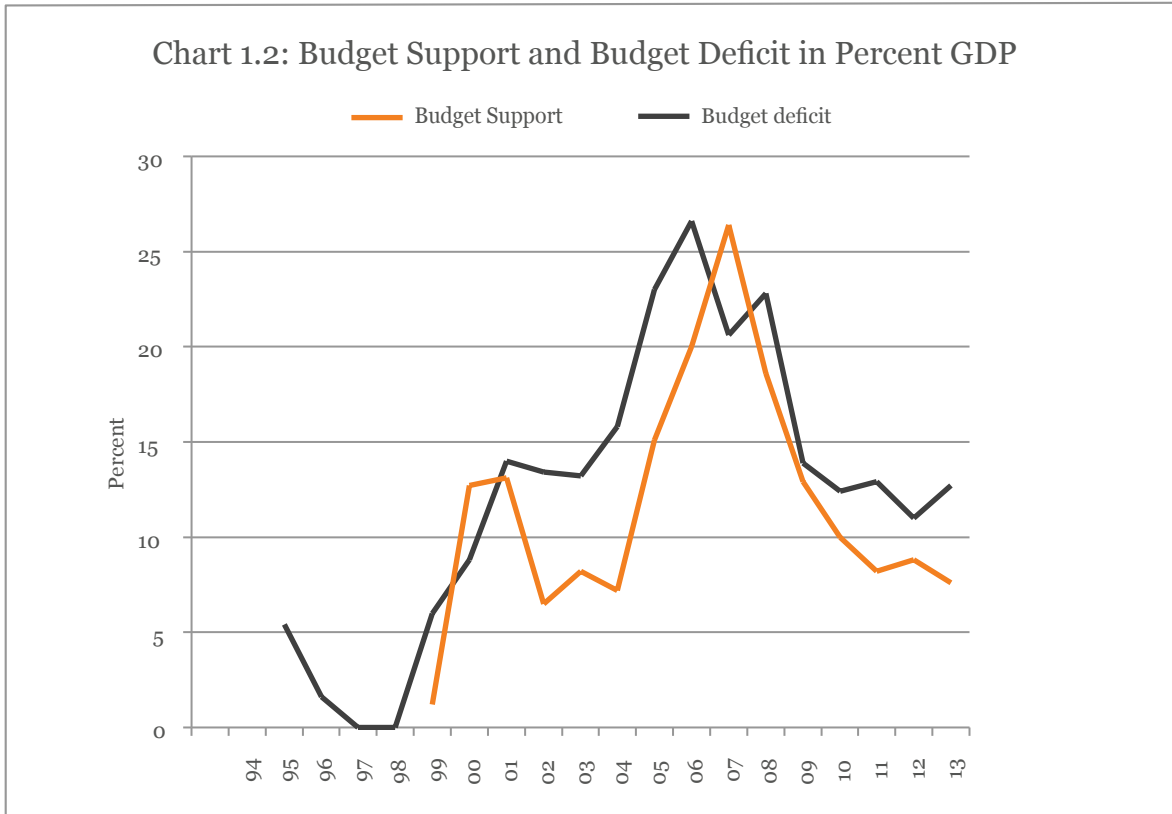
Real economic growth for Palestine was in the 6% range in 2007 and 2008, rising to 12% in 2011, falling sharply to 2% in 2013, and then to *minus* 2.5% in 2014 – the first decline in GDP since 2006. However these aggregate figures do not reveal the full picture. One must distinguish between the West Bank and Gaza which have different growth trajectories. The West Bank followed a “normal” trajectory, without strife, while Gaza was buffeted by three Israeli assaults (2008/09; 2012; 2014) and the Israeli siege. Chart 1.1 shows the per capita income trajectory for the two regions for the last twenty years.



Source: PCBS National Accounts

The West Bank benefitted fully from the fiscal stimulus of large donor aid in 2007-09. Real growth reached 12% in 2007-08, but then as external budget support declined, forcing a reduction in fiscal deficits, growth in the West Bank declined as well. External budget support went down steadily from 22% of GDP on average in 2007-08, to about 8% of GDP in the 2011-14 period. In 2014 only \$1 billion was received in budget support, or one third of the GDP share obtained in 2007-08. Budget deficits, which were around 22% of GDP in 2007-09, were reduced by almost half to 13% in 2013. This was a huge withdrawal of fiscal stimulus from the economy, equivalent to 15 percentage points of GDP, without any compensating increase in other sources of growth such as public or private investment, exports, workers’ remittances, or external transfers to the private sector.¹⁰

[10] For an analysis of the impact of fiscal policy on Palestinian economic growth see Karim Nashashibi: “Palestinian public finance under Crisis Management: Restoring Fiscal Sustainability” UNDP position paper January 2015



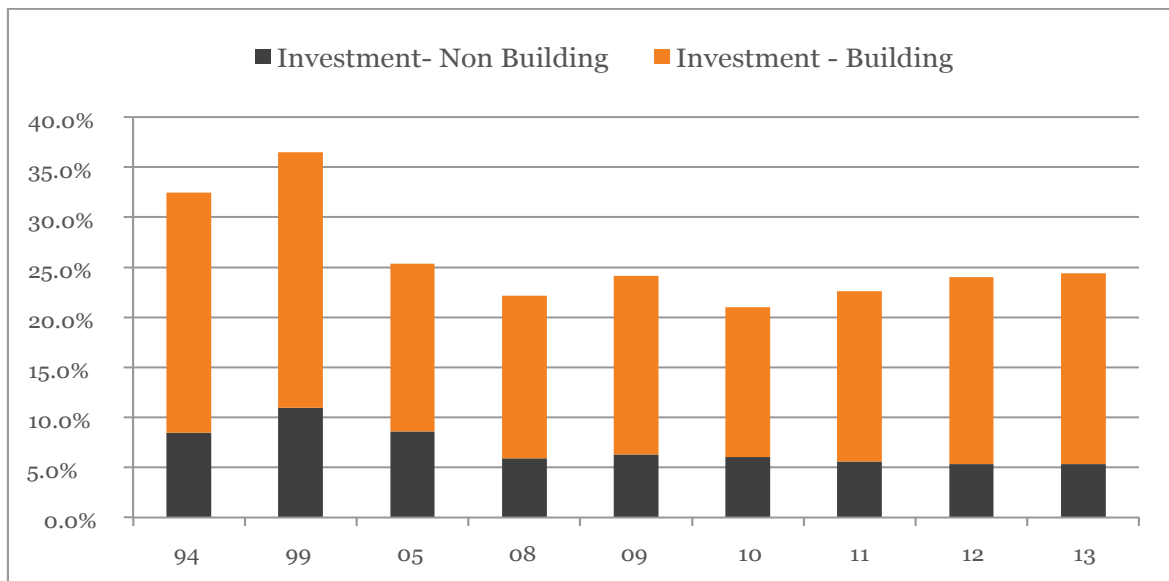
Source: MoF monthly reports; Karim Nashashibi “Palestinian Public Finance under Crisis Management: Restoring Fiscal Sustainability” UNDP, January 2015.

Development expenditures in PA budgets also declined sharply from 5.6% of GDP in 2007 to 1.6% of GDP in 2013. However, some development spending took place outside the Budget, directly by donors, and there are indications that this type of spending also declined.

As mentioned above, the rate of investment declined substantially since 2009; exports went down from 19% of GDP in 2007 to 16.5% in 2013. Worker remittances increased from 11% of GDP in 2007 to 12% in 2010-11, and down to 10% by 2012-13. External transfers to households and the private sector (including UN agencies and NGOs) which reached 24% of GDP in 2007, declined sharply to about 10% of GDP – half their level in 2007. This data suggests that the spike in West Bank growth in 2007-08 was an artificial bubble, entirely sustained by the temporary increase in external assistance. The fiscal deficit was the major engine of growth, with some lagged effects through housing and construction until 2011, which maintained the West Bank’s growth rate in the 9-11% range. When PA employees were finally being paid their salary arrears from 2006 in 2007, in addition to their ongoing salaries, many of them took mortgage loans and bought housing. Construction, as a share of GDP increased from 6% in 2007 to 11% in 2011 and remained at that level until 2013. However, with the continued reduction in the budget deficit, and no significant pick up in any of the other sources of potential growth, the rate of growth in the West Bank declined sharply to 6% in 2012, 0.5% in 2013, and 0.2% in 2014. As a result, per capita income in the West Bank has been declining since 2012, for the first time since 2006. Economic viability has been lost.¹

[1] Almost all investments in buildings in Palestine are in residential buildings; which is in fact consumption of housing services

Chart 1.3: Buildings and Non-Building Investment as Percentage of GDP, 1994 – 2003 (computed from 2004 prices)



Source: PCBS, National Accounts 1994 – 2012, amended series (September 2014); PCBS, National Accounts, 2013

In addition, the economic infrastructure of Palestine is characterised by an extreme degree of under-development. This situation is the result of almost five decades of very limited investment in infrastructure; first, under Israeli direct rule (1967 – 1993), and then under the Palestinian Authority. As early as 1993 the World Bank emphasised that under-developed infrastructure would produce (in combination with other basic weaknesses) an economy with low capital formation, low capital-labour ratios, and low labour productivity, which crippled Palestinian productive capacity and rendered it extremely vulnerable to external economic and political shocks.¹¹

Gaza under siege

The tightening of the Israeli siege, which began in June 2007 and worsened following the Israeli incursion in 2008 – 2009, devastated Gaza’s economy and caused negative growth in 2007 – 2008. Permitted imports into Gaza from Israel were restricted to only 26 items, crippling the manufacturing sector due to lack of inputs. A virtual ban on the movement of people in and out of Gaza, particularly students and business people, separated Gaza’s society and economy from the West Bank.

The Israeli ban on Gaza’s exports to both Israel and the West Bank was especially devastating as Gaza’s economic lifeline is exports, to a much greater extent than the West Bank. During the first half of 2005 there were 1054 monthly truckloads of exports to Israel and the West Bank, whereas during the 2009-10 agricultural season (October-September) only 224 truckloads were allowed (mostly cash crops destined to Europe). Exports of furniture, garments, processed foods, and agricultural produce to the West Bank and Israel were virtually eliminated.¹²

Restrictions on imports from Israel, particularly construction materials, encouraged the build-up of a large tunnel network to Egypt which supplied Gaza with fuel, construction materials, and consumer goods. Over 100,000

[11] The World Bank study of 1993 estimated the ratio of WB&G public sector development expenditure to the GDP, in the Israeli-rule period, at less than one-third of the worldwide average for developing countries, and less than a quarter of that in Jordan (data for the early 1990s). World Bank, ‘Developing the Occupied Territories: An Investment in Peace’ (Washington, D.C., World Bank, 1993), Vol. 2: The Economy, pp. 34–35.

[12] Furniture exports averaged 168 truckloads per month; agricultural produce 500; processed foods 155; and garments 172. See Paltrade: “Gaza crossings annual monitoring report” November 2010 and “Gaza Activities Report”, September 2008

litres each of Egyptian subsidised diesel fuel and gasoline were entering Gaza on a daily basis. At its peak in 2010 there were over 1,200 tunnels – these provided the government with substantial tax revenues, and were mostly controlled by Hamas.¹³ While the tunnel economy did not provide an alternative outlet for Gaza's exports through Egypt, partly because of Egypt's protective policies, the resumption of imports revived the economy and, in particular, the construction sector.

As a result of the tunnel trade with Egypt, Gaza's catch-up growth rebounded to 8% in 2009 and then double-digit growth in 2010-11. This was followed by yet another decline from 2012 onwards, following the Israel-Gaza conflict in November 2012, the destruction of most of the tunnels by Egypt in 2013 and the tightening of the siege by Israel. Whereas the average annual growth in the West Bank during 2007-13 was 8%, Gaza's average annual growth during the same period was 5%. In 2014 the economic and humanitarian situation continued to deteriorate, even prior to the conflict with Israel in summer 2014: between October 2013 and May 2014 the Hamas government had been unable to pay its employees regularly; and unemployment rose from 28% during the first half of 2013 to 45% during the second quarter of 2014. Hemmed in between Egypt's border closure and Israel's ongoing siege, and unable to pay its 45,000 workers due to financial restrictions on salary transfers, the de facto government in Gaza opted to challenge Israel through launching rockets. The subsequent Israeli offensive (8 July – 26 August 2014) caused over 2,000 casualties, destroyed 5% of the housing stock, much of the electricity and water infrastructure, and displaced over 100,000 people.

Both the siege, along with three Israeli incursions in five years, have robbed Gaza of its energy and entrepreneurial resources. Per capita income is lower than it was 20 years ago, having fallen from \$1,347 in 1994 (2004 base year) to an estimated \$1,100 in 2014 (at constant prices). Unemployment has reached 38%, with the result that Gaza has become dependent on external charity payments, where over 70% of the population receives humanitarian aid.¹⁴ With its population unable to move freely between Gaza and the West Bank, or to trade freely, it can only survive through external financial assistance.

Following the most recent conflict with Israel it became clear to the Gaza population, and to the donor community as a whole, that the *status quo* under the existing siege was unsustainable. This was recognised by the donor community at the Cairo Conference in October 2014, with reconstruction pledges of \$5.4 billion, which exceeded expectations. However, without a lifting of the siege and a resumption of movement of people and goods across the Egyptian border, this cycle of destruction will continue, preventing any meaningful recovery and reconstruction of Gaza's capital stock and institutions. So far the Government of National Consensus (GNC) has been unable to take over governance in Gaza, particularly with regards to establishing a security presence on the Egyptian border, with the result that Rafah's closure continues. Nor has it been able to facilitate reconstruction, which has yet to take off, with the exception of small projects and individual reconstruction and repair of housing.

Economic consequences of restrictions

The lifeline of a small economy such as the Palestinian economy is both trade and its ability to adapt quickly to globalisation and technological change. The economic restrictions described above, coupled with the erosion of economic space and the lack of any political horizon for investors, has cut off this lifeline at four levels:

- By distorting the production structure towards retail trade, construction and government;
- By suppressing exports and skewing trade relations to a dependence on trade with Israel;
- By repressing economic growth generating a large output gap;
- By undermining fiscal sustainability and generating a dependence on external budget support.

[13] NIS 10 were levied on each ton of aggregate; NIS 20 on cement; and NIS 50 on construction steel. Paltrade op.cit

[14] See Oxfam: Gaza weekly update 15-21 April 2012

The restrictions on movement of people and goods have raised transaction costs, thereby eroding competitiveness. The lack of predictability, inherent in the capricious implementation of these restrictions, has disrupted supply chains and relations with clients both domestically and abroad. These two factors have removed a broad array of activities dependent on trade from profitable production.

The fragmentation of markets and economic space has prevented both trade linkages, a better allocation of resources, and complementarities between the West Bank and Gaza economies from being exploited. The inability to develop Area C and undertake long term investments in large plants and equipment, and to develop agriculture at a profitable level, has denied the Palestinian business community the benefits of economies of scale.

Consequently, the incentive structure of the business community has been distorted towards quick turnover activities, retail trade, services, and residential housing. The structure of the economy has been skewed out of kilter, away from productive sectors with high value added such as agriculture and manufacturing, to retail trade, government, and residential construction. The productive base has been repressed and so have services, such as education and health. By 2013 the Palestinian economy had been hollowed out. Table 1.2 illustrates the major shifts it has experienced:

Table 1.2: Shift in the Palestinian production and trade structure 1995 – 2009 (shares of GDP at constant prices)

	Manuf.	Agric.	Const.	Trade	Service	Inform & Com	Finance	Gov't	Exports	imports
1995	17.9	11.2	5.3	12.9	26.8	0.1	1.9	9.5	15.8	69.9
2000	10.9	8.2	6.7	11.7	27.0	4.1	3.9	8.5	20.3	69.8
2005	12.5	4.9	6.2	10.2	23.7	2.3	3.4	16.9	14.7	72.9
2009	12.4	6.1	6.8	9.8	20.2	6.7	4.7	14.5	17.9	67.2
2013	12.8	4.1	10.7	17.2	19.2	5.9	3.6	12.1	17.9	54.5

Source: PCBS National account series at constant prices, 2004 base year

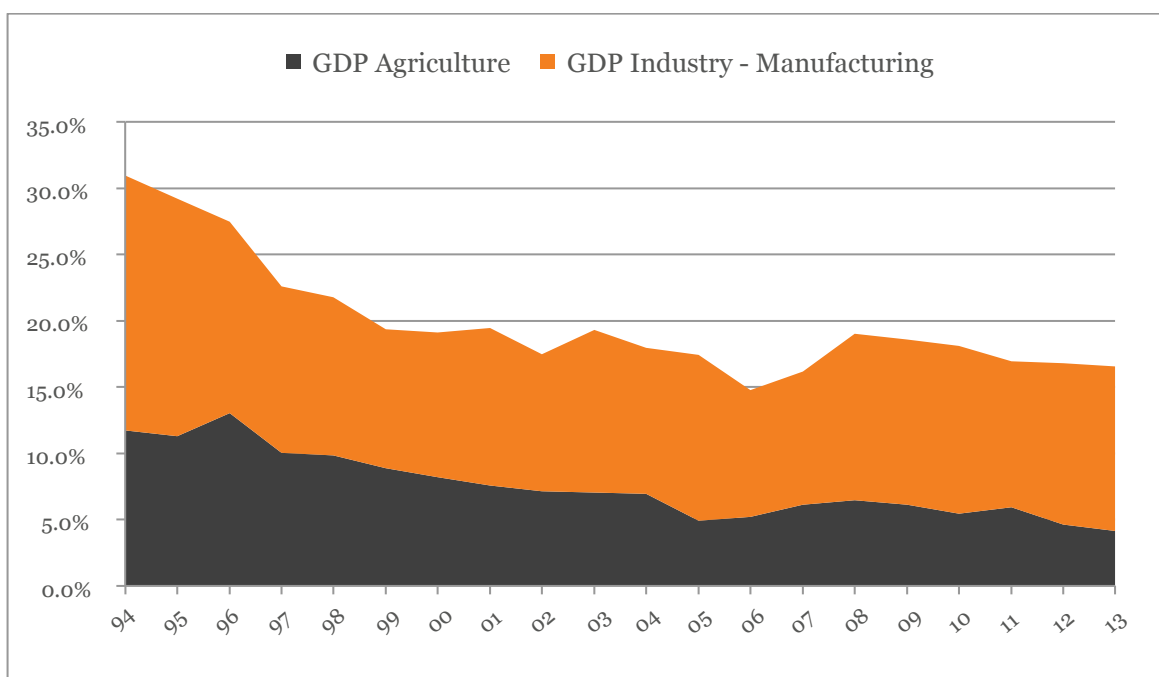
In a middle income country, manufacturing typically ranges in the mid-twenties as a share of GDP (in Jordan it accounts for 21%). In Palestine, it has been scaled back by the control regime to less than half its potential size, declining from 18% of GDP in 1995 to 13% in 2013. This sharp drop is partly due to the shrinking of the textile, garment and footwear industries, which lost most of their competitiveness due to the higher transaction costs associated with restrictions on movement and access.¹⁵ Manufacturing in Gaza, which used to have thriving furniture, garment, and building materials industries, has since 2006 and the beginning of the Israeli siege has been virtually shut down.

With economic development the share of agriculture in GDP typically declines as more dynamic sectors grow faster. However, in Palestine much of the decline has been due to trade restrictions on Palestinian agricultural exports to Israel. In the West Bank the separation wall has eliminated border trade, which was previously thriving in the northern West Bank. Long transportation delays (particularly harmful for perishable agricultural products) have contributed to lowering exports. In addition, the downgrading of infrastructure, particularly rural roads, the lack of adequate irrigation and transportation facilities, and the virtual absence of testing labs and extension services, have all contributed to lowering yields, labour productivity, and limited exports. As a result agriculture in Palestine suffered a very sharp drop over a short period of time, from 11% of GDP in 1995 to only 4.1% in 2013.

With the slowing down of the economy in the West Bank after 2009, retail and wholesale trade –which typically serves as the last resort for seeking job opportunities, and disguises unemployment – increased from 10% of GDP in 2005 to 17% of GDP in 2013; a remarkable increase.

[15] Israel's trade liberalisation, including a reduction in the Customs Union external tariff, under WTO rules, also contributed to loss of competitiveness

Chart 1.4: Share of Agriculture and Manufacturing Industry in the Palestinian GDP 1994 – 2013 (percentage of total GDP, computed from the GDP in constant 2004 prices)



Source: PCBS National Accounts Statistics 1994 – 2012 (amended series published September 2014), 2013

Economic consequences of the trade regime

The trade regime established under the Paris Protocol created a customs and monetary union between Israel and Palestine with one major advantage: in theory goods, people and capital could move freely between the two. However, it also had several serious disadvantages: trade diversion which may have exceeded trade creation,¹⁶ Israeli control over indirect tax revenue, and loss of Palestinian economic sovereignty over trade and exchange rate policy.

Economic restrictions imposed by Israel, particularly after 2000, on the movement of goods, people and capital nullified the major advantages of the Protocol while exacerbating its disadvantages. Checkpoints, border posts, and the separation wall denied to a large extent Palestinian producers' access to Israeli and foreign markets and workers' access to jobs, whereas Israeli products had free access to a captive Palestinian markets. Even movement of capital was being inhibited by Israeli banks refusal to convert Palestinian banks NIS cash balances.¹⁷

But for a short list of exceptions, the Protocol obliges the PA to implement the Israeli Import Policy, including the Israeli Tariff, Standards and Import Procedures. However, the Israeli Import Policy, which is designed to protect Israeli products, restricted Palestinians from importing cheaper inputs and products from abroad in favour of Israeli products. As a consequence, Palestinians are also not allowed to import cheaper petroleum products from Arab countries that don't meet the applicable Israeli standard, keeping Palestinian energy costs high and limiting the competitiveness of Palestinian industries.

Another economic consequence of the trade regime is the disproportionate concentration of Palestinian trade *vis-à-vis* the Israeli market. Except for well-established Palestinian exports, such as stone and marble, the difficulty of accessing foreign markets has favoured the Israeli market for both exports and imports. The proximity of the Israeli market, its size (\$290 billion GDP), and long established Palestinian relations with Israeli traders

[16] As analysed by Jacob Viner's seminal work: *The Customs Union Issue* 1950

[17] Beyond a cap unilaterally decided by the bank of Israel. For an overview of the performance of the trade regime under Oslo see: The Aix Group "Twenty years after Oslo and the Paris Protocol", June 2013

and producers, have made it much easier to access than attempting to export to other foreign markets.

Moreover, Israel doesn't recognise any Palestinian trade agreement with other countries, including the Interim Association Agreement with the European Union and the Greater Arab Free Trade Agreement (GAFTA). Israel argues that these agreements violate the Protocol. It also argued against the Palestinian application to the World Trade Organisation (WTO) claiming that the West Bank and the Gaza Strip do not qualify as a Separate Customs Territory, since the Palestinian side is obliged by the Protocol to apply the Israeli import policy. According to this Israeli position, the Protocol bans the Palestinians from diversifying their trading partners.

As a direct result, the Palestinian economy continues to be captive to Israel. In 2013 72% of Palestinian imported goods came from Israel (\$3.6 billion) while 89% of Palestinian exports of goods (\$775 million) were destined to Israel.¹⁸

Another consequence of the trade regime has been the loss of economic sovereignty. By adopting the Israeli currency (NIS), Palestinian policy makers surrendered monetary and exchange rate policy to the Israeli Central Bank. The adoption of the NIS was the right decision during the Interim Agreement period and until the PA would be in a position to attain fiscal sustainability. However, when the Israeli currency appreciates, it reduces export competitiveness for both Israeli and Palestinian exporters. Palestinian monetary authorities cannot do anything about it, for lack of their own currency. The NIS appreciated (in real effective terms) by 20% between June 2004 and June 2014.¹⁹ Had Palestine managed its own currency, it could have depreciated this currency to maintain its competitiveness with the rest of the world.

The loss of economic sovereignty under the trade regime governed by the Paris Protocol was translated into Israeli control over 70% of Palestinian tax revenue, under the "clearance" process. This control had two major consequences. Firstly, that at any time Israel could freeze the transfer of "clearance revenue" to the Palestinian Treasury, which the Israeli authorities have done on several occasions for political reasons (the most recent freeze occurred in December 2014, when the PA elected to apply for membership in the International Criminal Court). Withholding 70% of Palestinian tax revenue has had dire consequences on Palestinian public finance, including the inability to fully pay salaries to its 165,000 employees, the accumulation of payment arrears to the private sector, and rising indebtedness to the Palestinian banking system beyond prudential safeguards. The second consequence has been that of revenue leakage, in favour of the Israeli Treasury and estimated by the Palestinian Ministry of Finance (MoF) at \$280 million per year.²⁰ The revenue leakage issue has been repeatedly raised by MoF with the Israeli side in various joint committees, but because Israel has disempowered the Joint Economic Committee, these claims have not been addressed.²¹

Fiscal consequences of restrictions

The weakening growth performance in the West Bank, the collapse of Gaza's economy, and shifts in the production structure towards sectors with low tax compliance (see below), have undermined the growth of public revenues and widened budget deficits.

With Gaza's economy on life-support since 2006, its contribution to PA revenues has declined sharply. Gaza's residents were exempted from income tax payments after the imposition of the Israeli siege in 2006, and the switch to petroleum products imported from Egypt (following the Hamas takeover and tightening of the Israeli siege) virtually eliminated tax receipts and excise duties on these products previously paid when they were imported from Israel. Gaza's share of "clearance revenue" collected by Israel declined from 29% in 2005 to 8% in 2013. In 2014 there was some recovery of PA revenues from Gaza, particularly from fuel imports, raising Gaza's share to about 18% of PA clearance revenue. However, the devastating war in July/August reduced consumption

[18] PCBS; Performance of the Palestinian Economy 2013

[19] IMF Consultation Report with Israel, 2014

[20] Also see UNCTAD report October 2014, which estimates this leakage at \$ 300 million annually

[21] See Chapter 3 for details on the leakage

in Gaza sharply and substantially slowed this increase in imports.

In contrast to Gaza’s declining contribution to PA revenues, the PA continued to spend about 34% of its recurrent budget in Gaza (\$1.5 billion in 2013) on wages and salaries (for teachers, health workers and security personnel who had become unemployed) and for transfer payments. In brief, with virtually no revenues accruing from Gaza to the PA Treasury, and very large PA spending on Gaza, Gaza’s contribution to the fiscal balance has been highly negative.

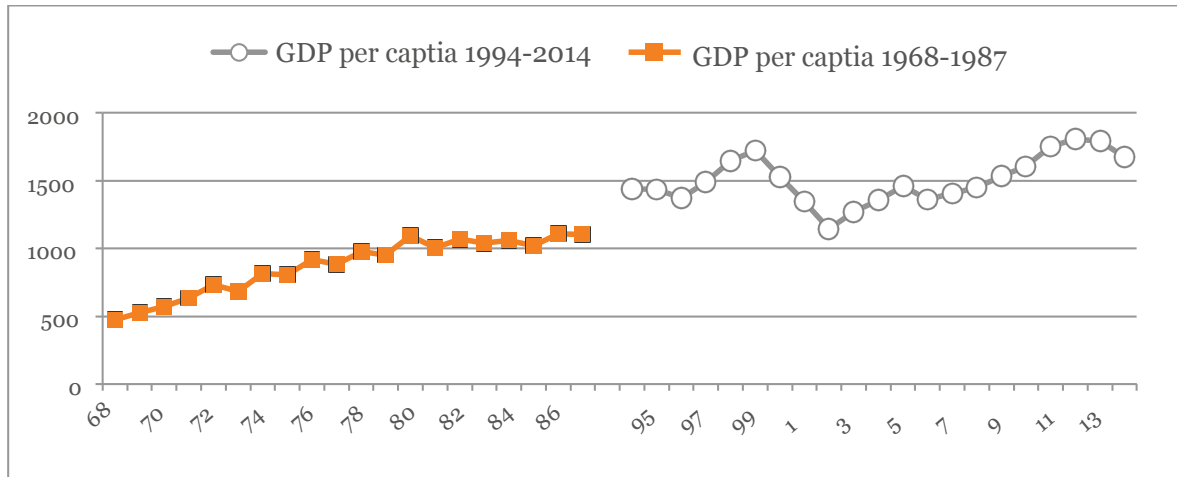
It has been difficult to reduce the PA budget deficit below 13% of GDP in the 2012 to 2014 period, because of low economic growth which limits the increase in public revenue. Because external budget support has remained at only 8% of GDP, a large unfinanced gap has emerged. As the PA has reached a limit in borrowing from the banking system (\$1.2 billion), most of this unfinanced gap was translated into payment arrears to the private sector, estimated at \$600 million by end 2013. This approach has caused stress and uncertainty in the private sector and has had a destabilising effect on the banking system, as suppliers seek credit from the banks against PA receivables, with a substantial risk of default. Fiscal sustainability has been lost.

Long-term effects: Three lost decades of Palestinian economic development

Palestinian national accounts data shows that the Palestinian economy has experienced three lost decades of economic development.

In 2014, fifteen years after the outbreak of the Second Intifada, Palestinian GDP per capita was estimated to be 3% below its pre-Intifada level (in real terms), and only 16 percent higher than when the Palestinian National Authority was created two decades ago. Palestinian Gross National Income (GNI, which takes into account the remittances of Palestinian workers in Israel and abroad) is still below the pre-Intifada GNI level. Moreover, these two decades came after a decade of economic stagnation, which started in the first half of the 1980s and deepened in the period of the First Intifada (from December 1987 to the early 1990s).

Chart 1.5: Palestinian GDP and GNI Per Capita 1968 – 1987, and 1994 – 2014 (constant 1986 and constant 2004 US dollar prices)

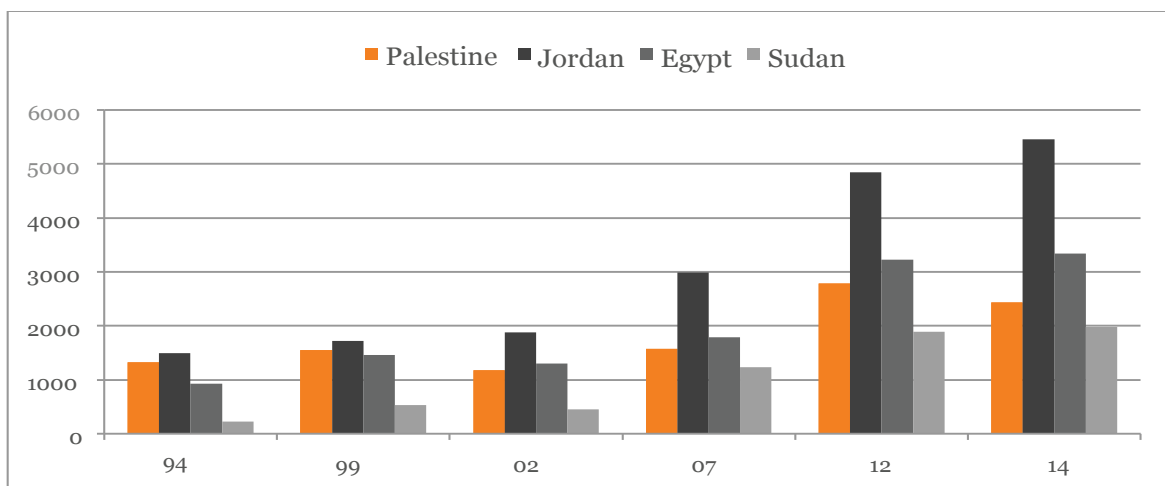


Sources: 1968 – 1987 data: ICBS. Data is unavailable for the last years of Israeli direct rule, since the outbreak of the First Intifada (1986 prices). 1994 – 2014 data: PCBS, National Accounts 1994 – 2012, amended series (2004 prices), (September 2014); 2013 – 2014 GDP figures are based on IMF preliminary estimates (as of September 2014).

The impact of these three lost decades, in terms of lost growth and economic development, is revealed when comparing the situation of the Palestinian economy with that of other developing Arab economies, which have advanced considerably during this period (particularly over the 2000s).

Chart 1.6 below compares the development of Palestinian GDP per capita over the last two decades against that of Jordan, Egypt, and Sudan. In 1994 Palestinian GDP per capita was only slightly lower than that of Jordan, one third higher than Egypt's, and five times higher than that of Sudan. By 2014 Palestinian GDP per capita is less than half that of Jordan, almost 30 percent below Egypt's, and only slightly higher than the GDP per capita of Sudan.

Chart 1.6: Palestinian GDP Per Capita in Regional Comparison 1994 – 2014 (current prices in US dollars)



Sources: Palestinian data - PCBS, National Accounts 1994 – 2012, amended series (September 2014); 2013 – 2014 GDP figures are based on IMF preliminary estimates (as of September 2014). Jordanian data – Central Bank of Jordan and IMF; 2013 – 2014 GDP figures are IMF preliminary estimates (as of October 2014).

Lessons drawn from Palestinian economic performance under restrictions

Four lessons can be drawn from the brief history and analysis of the Palestinian economic development under the control regime:

- When there is a credible political horizon towards a solution to the Palestinian Israeli conflict, as was the case in 1995-2000, the Palestinian private sector responds immediately by investing heavily into the Palestinian economy.
- The inability to access international markets at low transportation costs has concentrated Palestinian imports and exports on the Israeli market. This has created a high trade dependence on Israel and a high trade deficit, reinforcing Israel's hegemony on the Palestinian economy.
- With the only engine of growth – the recurrent fiscal deficit – being reduced since 2011 (and without the emergence of alternative sources of growth, such as new private investment), economic growth was reduced to stagnation levels with declining per capita income in both 2013 and 2014.
- Both economic and fiscal sustainability have been lost. Had the donor community compensated the withdrawal of fiscal stimulus, by financing an increase in development expenditure and public investment in infrastructure, economic growth would have rebounded. Economic viability would have been restored.

Looking forward, it is clear that the entire economic environment in the West Bank and Gaza needs to be fundamentally changed, to provide the private sector with a favourable political horizon and a new set of incentives to invest. Such a change in environment does not necessarily require an agreement between the two sides on Final Status issues. However, it would need a change in Israeli policy, from merely stating that Israel is supportive of

Palestinian economic development, to taking real actions that demonstrate Israel's commitment to reviving the Palestinian economy. Having an economically viable neighbour – as opposed to continuing to manage a conflict which will be further aggravated by a steady decline towards poverty and violence – is a win-win situation for both Israel and Palestine. In turn, the Palestinian government would need to engage the Israeli side in coordinating the sequence of economic facilitation measures taken by Israel, and ensuring security, separately to but in parallel with the political actions it takes to achieve a final status agreement.

In Summary:

A paradigm shift has to occur on the Israeli side to trigger a change in perceptions on the Palestinian side. Incremental changes, by taking individual measures with time gaps in between, will not change the negative perceptions and investment environment. A critical mass of measures taken collectively will send a strong signal to the business and international communities that there is a serious intention to move forward towards a resolution of the conflict.

Part 2: Recasting the Palestinian Economic and Trade Regime – A Macro-Economic Analysis

Introduction

Part 1 above surveyed the deterioration of Palestinian economic performance over the last three decades, and especially since 2000, under the toll of the matrix of Israeli restrictions and the unsuitable economic and trade regime. Part 2 will now examine the growth potential of the Palestinian economy under alternative economic and trade regimes.

This part opens with a comprehensive analysis of the economic growth potential of the Palestinian economy under optimal economic and trade conditions, including the following:

- (a) Removal of the complex web of administrative, security and other restrictions, under which the Palestinian economy has been functioning over the last two decades.
- (b) Harnessing the unused Palestinian production capacity, and the other strengths of the Palestinian Economy.
- (c) Support export-oriented long-term sustainable economic growth.

The report analyses and assesses Palestinian growth potential under this optimal scenario in relation to the main macro-economic parameters: GDP growth, exports, investment and employment.

The report then examines several optional trade regimes, according to their potential contribution to these main macro-economic parameters.

Insights from the sectorial analysis (Part 4) help us in refining and detailing the results and conclusions of the macro-economic analysis. The report also looks at the contribution of various supplementary arrangements and additional cooperation agreements.

Part 2.1: Palestinian economic potential under a new economic and trade regime

This report's analysis shows high growth prospects for Palestine, reflecting the exceptionally depressed level of the Palestinian economy under the status quo, and the enormity of unutilised production capabilities.

Palestinian GDP growth potential: Historical evidence and econometric analysis

Historical Evidence

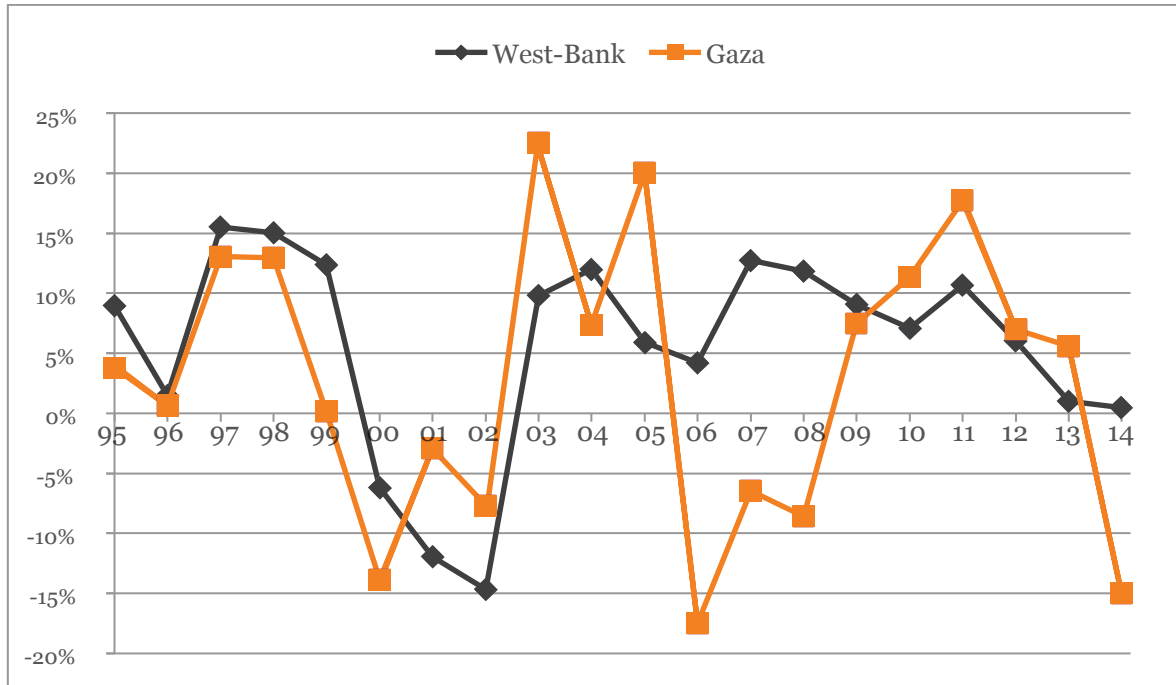
As shown in Part 1, economic growth data over the last two decades reflects the enormous impact of administrative, security, and other restrictions on the rate of GDP growth; and the remarkable Palestinian growth potential in periods of relatively relaxed restrictions.

The West Bank registered high real growth of about 15% per annum, on average, in the relatively relaxed period of 1997 – 1999. Then, after the steep fall in the early years of the Intifada (2000 – 2002), an upward correction of 10 – 12% growth came in 2003 – 2004. The data for 2006 – 2009 shows the high growth in the West Bank under the Fayyad governments. All in all, the partial relaxation of restrictions in the West Bank, in the relatively calmer period of 2003 – 2012, enabled this region to achieve an impressive real growth rate of 9%, on average, for a period of ten years.

In Gaza, the extreme political upheavals were reflected in an extremely volatile economic growth record. In this region too, the short periods of relatively relaxed restrictions were characterised by double-digit growth rates: 10% on average in 1997 – 1999, and 17% on average in 2003 – 2005.

In 2010 – 2012, the very partial relaxation of restrictions following the Mavi Marmara Affair (June 2010)²² was reflected in average GDP growth of 12% (or 10%, on average, for 2010 – 2013).²³

Chart 2.1: GDP Real Growth in the West Bank and in Gaza: 1995 – 2014 (annual percentage change)



Sources: Palestinian data – PCBS, National Accounts 1994 – 2012, amended series (September 2014); 2013 figures – PCBS, National Accounts (December 2014); 2014 GDP figures are based on IMF preliminary estimates (as of September 2014)

Econometric Analysis: The primary role of security and other restrictions

The dramatic negative effect of the present restrictions, as detailed in Annex 1, is confirmed by the econometric (regression) analysis presented in Annex 2.1.

The regression model computes the effect of security and other restrictions on West Bank growth, along with two complementary effects which were found to be of strong statistical validity and significance: average growth rates for the previous two years, and another factor representing “global growth” – the real growth rate of Lower and Middle Income Countries between 1996 and 2012.

The regression analysis shows that under a relaxed level of restrictions (similar to that of 1994-1999), used Palestinian production capacity can be harnessed to generate fast and sustainable medium-term GDP growth (about five years) of above 15% per annum in the West Bank. The results of the model for Gaza are statistically weaker, because of the highly fluctuating nature of the Gaza’s 1996-2012 economic data. Even so, the statistical analysis indicates that even higher medium-term growth in Gaza is possible, under a relaxed level of restrictions.

After the first period of about five years, growth rates are predicted to gradually decrease.

[22] In June 2010 a flotilla of ships (the ‘Gaza Freedom Flotilla’), including the ship *MV Mavi Marmara*, were intercepted by Israeli security forces as they attempted to enter Gaza by sea, ostensibly to deliver humanitarian aid. A security incident occurred in which nine members of the flotilla were killed by the Israeli security forces during the boarding process, causing an international political outcry. The political fall-out of this incident resulted in partial relaxation of Israel restrictions on Gaza.

[23] Furthermore, in the relatively restriction-free period of the 1970s and the early 1980s, the Palestinian Territories (West Bank and Gaza, then under Israeli direct rule) registered average annual real GDP growth of close to 15% over a period of 12 years (ICBS).

New long-term growth engines: Export-driven growth of the main productive sectors

One should note that the incidences of fast growth described in Part One, are only partial reflections of Palestinian growth potential. These incidences of double-digit growth were achieved through growth of import-driven consumption and non-tradable sectors (construction, public services etc.). The growth of the main productive and export-oriented sectors (manufacturing industry, agriculture, tourism, etc.) has been minimal. These trends are mirrored in the fast and continuous decline of the share of these productive sectors in the Palestinian GDP.

A new economic and trade regime will enable renewed continuous fast growth of these sectors, primarily as export-driven growth. Renewed fast growth of the manufacturing industry and agriculture, as well as tourism, will serve as the most important engines of sustainable long-term economic growth.

Basic long-term strengths of the Palestinian economy

The basic characteristics of the Palestinian economy indicate promising potential for sustainable long-term economic growth under a new growth-supportive economic regime. Palestine's development potential stems from a combination of the following strengths and advantages:

- The Palestinian economy is very small, being only around 3% the size of the Israeli economy and one quarter the size of the Jordanian economy.
- Palestine has an ample sized and highly-educated workforce. Once economic recovery begins the Palestinian economy will be able to benefit from this advantage.
- Palestine has close ties with the large and advanced Israeli economy. Palestine would have free access to Arab markets in addition to other large trading partners, and would also benefit from exceptionally strong international economic support.

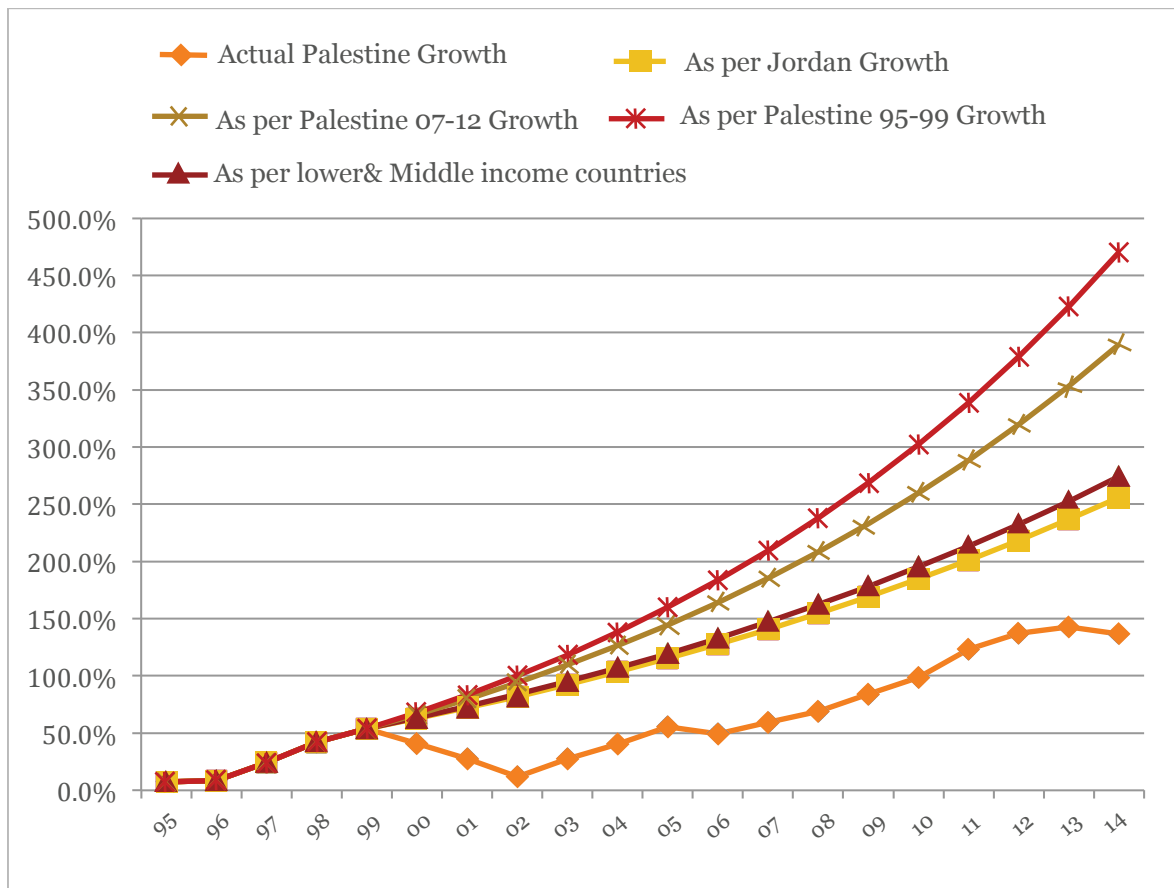
Lost GDP since 2000 as a quantitative indicator to long-term GDP growth potential

Given the strengths of the Palestinian economy, the econometric analysis, the exceptionally high growth that was achieved in the relatively restriction-free period of the 1970s, and the double-digit growth rates seen in periods of relatively relaxed restrictions since 1994 (Chart 2.1), the following "as if" indicative analysis assumes that:

- a. Under a restriction-free economic regime Palestinian real GDP would have grown at least as fast as that of Jordan, or at the average growth rate of lower and middle income countries, over the last fifteen years (i.e. since 2000). In both cases average annual real GDP growth was about 6%, compared with the average Palestinian actual real growth rate of 3.6% over the same period (2000 – 2014).
- b. The average Palestinian real GDP growth rate during the relatively relaxed period of 1995 – 1999 (prior to the Second Intifada), or under the Salam Fayyad governments (2007 – 2012), indicates that, if the Palestinian economy is freed of restrictions, it has a significantly higher real GDP growth potential than either Jordan or the average of lower and middle income countries. Average annual real GDP growth in the first of these periods (1995 – 1999) was 9.1%, and in the second (2007 – 2012) it was 8%. Palestinian growth figures in the 1970s were even higher. Average Palestinian annual real growth rate over twelve years from 1968 – 1980 was 11%.

The analysis of cumulative lost real GDP growth over the last two decades (1994 – 2014), as per these comparisons, is presented in Chart 2.2:

Chart 2.2: “As If” Analysis of Lost GDP Growth 1994 – 2014 (Cumulative Real Growth Rates)



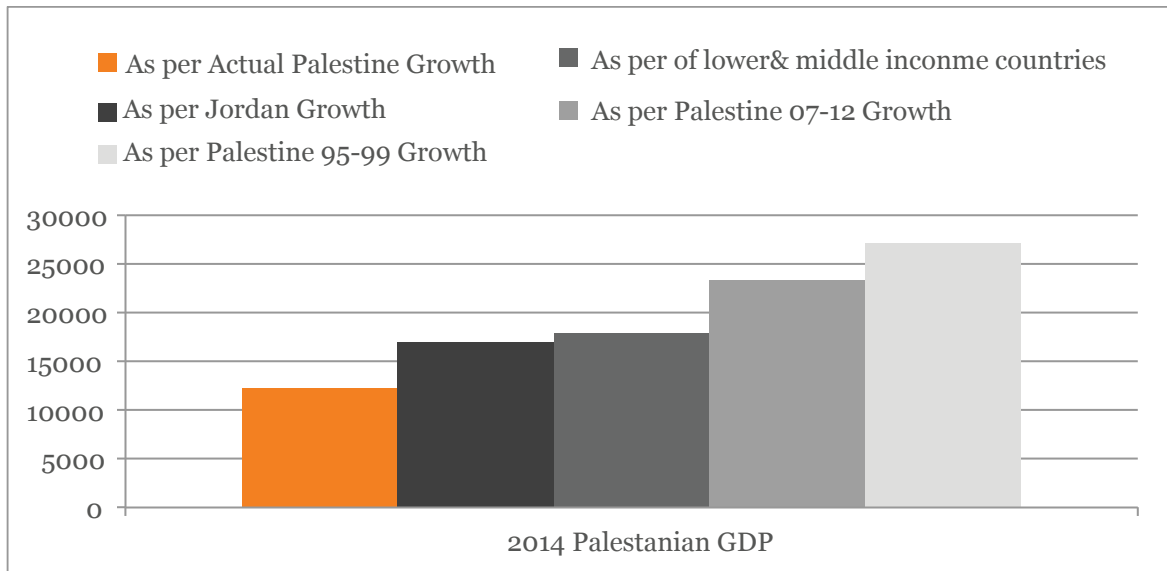
Sources: Palestinian data – PCBS, National Accounts 1994 – 2012, amended series (September 2014); 2013 – PCBS, National Accounts; 2014 – PCBS preliminary estimates (as of January 2015). Jordanian and international data – World Bank, 2014 World Development Indicators, p. 62, 64.

This “as if” analysis shows the following:

- Actual cumulative real growth of the Palestinian GDP, under the economic regime of strict and overwhelming restrictions, was 137% over the last two decades (1994 – 2014).
- If Palestinian economic growth was similar to that of Jordan or to the average of all low and middle income countries, annual real growth would have been almost twice as fast, with cumulative real growth of more than 250% over the same period.
- If allowed to operate under conditions of less intensive restrictions, as in 2007 – 2012, or under a much more restriction-free economic regime, such as in 1995 – 1999, annual real growth would have been almost three times that of actual real growth; with cumulative real growth of Palestinian GDP of around 400 – 450% during this period.

The derived absolute GDP figures, under these assumptions, are presented in Chart 2.3 in comparison to actual Palestinian GDP figures:

Chart 2.3: “As If” Analysis of Palestinian GDP in 2014 – Derived Absolute GDP Figures (current 2014 prices, US dollars)



Sources: Palestinian GDP at current prices – PCBS, National Accounts 1994 – 2012, amended series (September 2014); 2013 National Accounts Statistics; and PCBS preliminary estimates for 2014 (as of January 2015).

This comparison shows the cumulative cost of the present economic regime, in terms of lost GDP, at 2014 prices:

- Lost GDP of \$5 - \$6 billion, as of 2014, when compared with the performance of Jordan or the average of lower and middle income countries. This GDP loss would have added almost 50% to Palestinian GDP in 2014, and would have raised Palestinian GDP per capita from below \$3,000 to about \$4,000.
- If compared to Palestinian growth potential under a relatively less constrained economic regime (as in 1995 – 1999 and 2007 – 2012) the projected GDP loss is as high as \$11 - \$15 billion, as of 2014. This projected GDP would have more than doubled Palestinian GDP per capita, raising it to \$5,000 - \$6,000, a level comparable to that of Jordan.

Palestinian GDP growth forecast under optimal conditions

The analysis above shows that under a relaxed level of restrictions, unused Palestinian production capacity can be harnessed to generate fast and sustainable medium-term (~5 year) GDP growth of above 15% per annum in the West Bank, and even higher medium-term growth in Gaza.

Continuous fast growth in exports, and an increase in investment to pre-Second Intifada levels (as a percentage of GDP), are predicted to then sustain longer-term economic growth. This growth-engine becomes more significant as the initial fast-growth period following the relaxation of restrictions weakens, though it itself will gradually decrease over time. In addition, longer-term real growth will be supported by two other growth-engines: (a) healthy demands of an expanding domestic market; and (b) further expansion of production capacities, as a result of the combined effect of entrance into the work force of large number of young and educated workers every year (in addition to the continuous stream of increased investments).

Considering all these factors, the real growth potential of Palestinian real GDP, under a new, growth-supportive economic and trade regime, is estimated at 18% per annum for the first 3 years, declining to lower double digit

growth levels for the next seven years, and settling to a long-term growth trend of 6% till 2030.

Table 2.1: Palestinian GDP forecast Under Optimal Conditions (US dollars, 2013 prices, annual real growth rates)²⁴

Year	Palestinian GDP (million US dollars)	Palestinian GDP (annual growth rates)	GDP per Capita (US dollars)	GDP per Capita (annual growth rates)
2013	12,476		2,992	
2014	12,164	-2.5%	2,830	-5.4%
2015	12,103	-0.5%	2,734	-3.4%
2016	14,282	18.0%	3,132	14.6%
2017	16,853	18.0%	3,589	14.6%
2018	19,886	18.0%	4,111	14.6%
2019	22,869	15.0%	4,590	11.7%
2020	26,299	15.0%	5,125	11.7%
2021	29,455	12.0%	5,573	8.7%
2022	32,990	12.0%	6,060	8.7%
2023	36,289	10.0%	6,472	6.8%
2024	39,918	10.0%	6,911	6.8%
2025	43,910	10.0%	7,381	6.8%
2026	46,544	6.0%	7,596	2.9%
2027	49,337	6.0%	7,817	2.9%
2028	52,297	6.0%	8,045	2.9%
2029	55,435	6.0%	8,279	2.9%
2030	58,761	6.0%	8,521	2.9%

Sources: Palestine GDP and GDP per capita figures for 2013 – PCBS National Accounts for 2013 (published December 2014), p. 50, 58. Figures for 2014 – as per PCBS estimated change on 2013 in the economic forecast for 2015 (published Dec 30 2014). Figures for 2015 – annual change from 2014 as per the average of pessimistic and base-line scenario of PCBS economic forecast for 2015.²⁵

Is this GDP growth forecast feasible? A comparison with Jordan

Jordan is the most relevant case for evaluating Palestine’s economic growth potential. Palestine is quite similar to Jordan in terms of its basic resource base. Palestine also enjoys quite similar favourable trade arrangements with major trade partners. The major difference between Palestine and Jordan is that Palestine lacks security, stability, free movement, access to markets, and economic sovereignty.

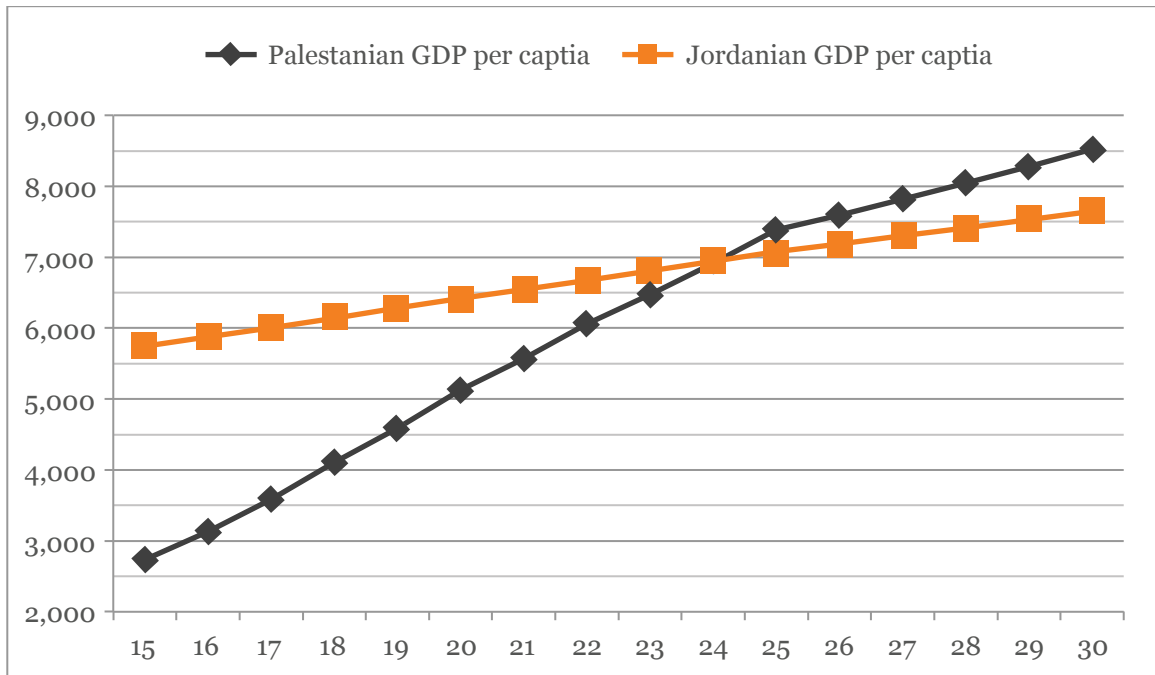
Once these disadvantages are removed under a new economic regime, Palestine will be able to develop its economy on the same export-oriented-growth lines as Jordan has done over the last two decades. Moreover, Palestine’s better access to the Israeli market and Israeli technologies puts it in an advantageous position when compared to Jordan. All in all, an export-oriented growth strategy, which a new economic regime would enable, is expected to work for Palestine at least as well as it has worked for Jordan over the last two decades.

[24] This report’s forecast period starts from 2016, assuming 2015 to be the base year. This is a technical assumption, as we use the most updated available data as the starting point for the forecast. One should refer to 2015 as “Year Zero” of the forecast, and 2016 as “Year One”.

[25] As of January 2015, the political conditions and Israeli actions (such as not transferring Palestinian tax money) appear to generate an economic environment which is a combination of the assumptions of the base-line and pessimistic scenarios.

The feasibility of our seemingly optimistic forecast can be examined by comparison to Jordan. As shown in Chart 2.4, Palestine would need seven years of fast GDP growth until its GDP per capita reaches the present (2015) level of Jordanian GDP per capita; and it would take Palestine two more years of double-digit growth until its GDP per capita equals that of Jordan (by 2024).

Chart 2.4: Is the Palestinian GDP Growth Forecast Feasible? – Comparison of GDP per Capita to Jordan (US dollars, 2013 prices)



Source: Palestinian GDP and GDP per capita. Jordanian GDP and GDP per capita: 2015 – 2019. GDP and GDP per capita figures computed from IMF June 2014 report (p. 42, real growth forecast figures), 2020 – 2030 figures: gradual decline from IMF 2015 – 2019 figures (by 0.5 percentage point and then 1 percentage point).

Palestinian exports: Weak performance over the past two decades

As a very small economy, Palestine can attain sustainable long-term growth only through an export-oriented growth strategy: export of goods, services (e.g. tourism), and “export of workers” to foreign markets that can absorb some of Palestine’s excess labour supply.

The weak performance of Palestinian exports is at the heart of Palestine’s structural economic weaknesses, as reflected in the huge and expanding trade gap. The share of total export of goods and services, as percentage of GDP, is as low as 16%, approximately half that percentage in Israel, and slightly more than one third of that percentage in Jordan (44%).²⁶

[26] PCBS , Balance of Payments; Central Bank of Jordan, Balance of Payments

Chart 2.5: Palestinian Exports and Imports of Goods (\$ million, current prices)

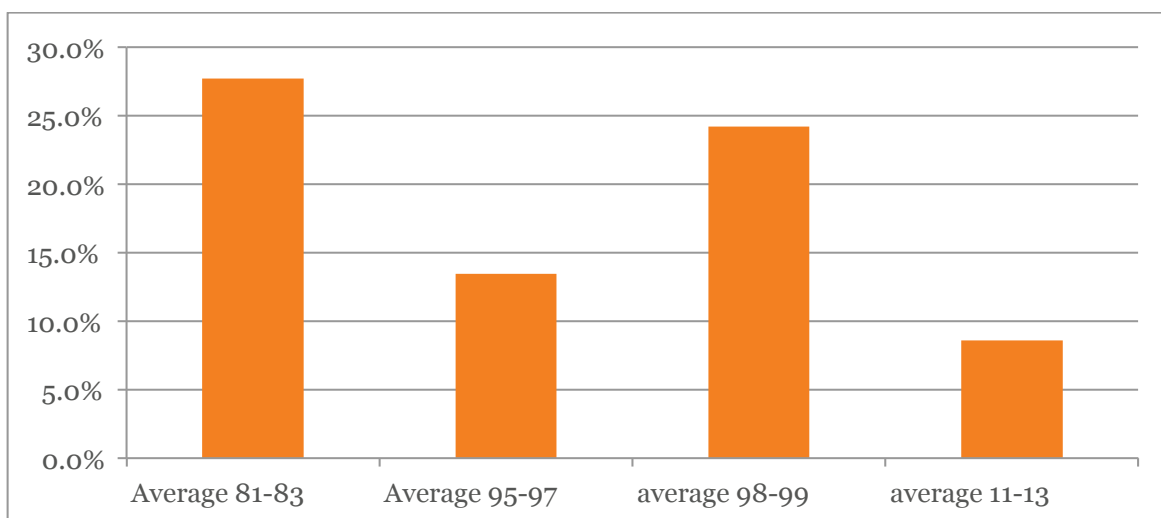


Source: PCBS, Foreign Trade Statistics, 2013, Table 1 (published August 2014); preliminary estimate for 2014 from PCBS, Economic Forecasting 2015 (published 30 December 2014). Note: Balance of Payment export statistics, which are used in our forecast below, presents larger figures as it includes export of services, various adjustments, and also East Jerusalem.

Workers’ remittances (“export of labour”) were a major source of income for the Palestinian economy in the pre-Second-Intifada period. Its magnitude at the eve of the Second Intifada (1998 – 1999) was about 25% of GDP, larger than the total Palestinian export of goods and services. Workers remittances have fallen sharply since the Second Intifada, though they remain significant. Their magnitude has been 8-9% of GDP in recent years; half that of total export of goods and services.

In Jordan, workers’ remittances are about \$5 billion (2014) – equivalent to 14% of GDP. The combined income of Jordan from export of goods and services and workers remittances today is about \$21 billion, slightly less than 60% of GDP; compared with only 25% in Palestine.

Chart 2.6: Palestinian Workers Remittances from Israel as Percentage of GDP



Source: Workers remittances data based on ICBS, except for 2011 – 2013 data which is PCBS balance of payment.

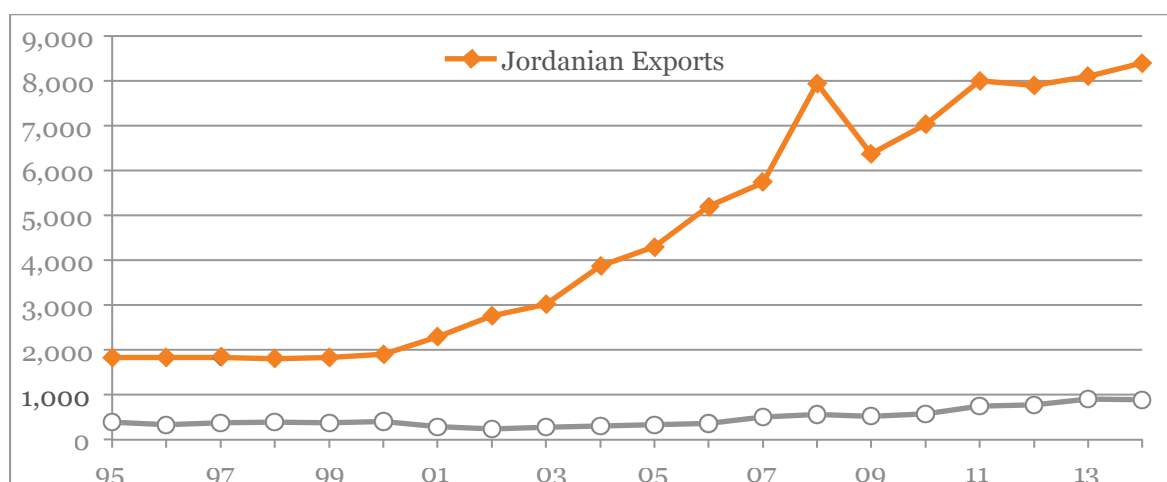
Untapped Palestinian export potential by main markets

Continuous fast development of Palestinian exports is the single most important long-term growth-engine for the Palestinian economy. It is the only means of sustaining economic growth, once the initial boosting effect of relaxation of restrictions weakens.

As described above, Jordan is the most relevant comparative case for evaluating Palestine's export growth potential. Palestine is similar to Jordan in its resource base, and enjoys similar favourable trade arrangements with major trade partners. The difference between the two is that Palestine lacks security, stability, free movement, and access to the markets. The weak performance of Palestinian exports over the last two decades, as a result of this difference, is highlighted by comparison with the fast development of Jordanian exports of goods, shown below in Chart 2.7.

Again as described above, an export-oriented growth strategy, which a new economic regime would enable, is expected to work for Palestine at least as well as it has worked for Jordan over the last two decades.

Chart 2.7: Palestinian Exports of Goods in Comparison to Jordan (million US dollars, current prices)



Source: PCBS Foreign Trade Statistics, IMF estimates for 2014; Jordan – Central Bank

Untapped exports to Israel

The relatively large Israeli economy provides huge economic growth opportunities for Palestine, because: (a) Israel is an immediate, ready market for Palestinian exports and for sub-contracting to Israeli industries; (b) Palestine can greatly increase its export of labour services to Israel, albeit to a much lower extent than in pre-Intifada times; (c) Israel is a ready reservoir of technical know-how, production infrastructure, and marketing channels – consequently, partnerships with Israeli companies would enable Palestinian businesses access to various development projects and export-oriented joint-ventures directed at other markets.

According to our detailed forecast, total exports of goods and services to Israel will grow over the coming fifteen years at approximately the same rate of the GDP, to an amount equivalent to about 15% of GDP.

Untapped exports to Arab markets

Arab markets, and mainly the Arabian Gulf market, have greatly expanded over the last decade. Total imports of the GCC bloc of six Arabian Gulf countries jumped approximately six times over the last 15 years, from an annual average of \$120 billion in 1998 – 2002, to about \$750 billion in 2014.

A very significant component of the potential jump in Palestinian exports under a new optimal economic regime

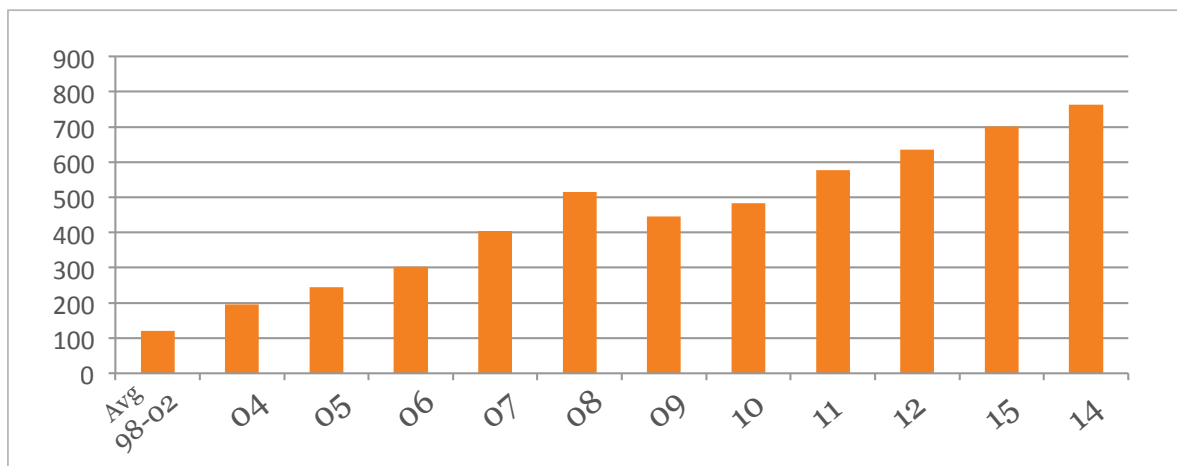
relates to Palestine expanding into Arab markets, especially the lucrative markets of the Arabian Gulf. This can be achieved by benefiting from the combined advantage of Palestine’s membership in GAFTA and its access to advanced Israeli products and technologies. Palestinian exporters would have a unique advantageous position, compared to other Arab exporters, in penetrating and expanding exports to the lucrative markets of the Arabian Gulf. To a large extent, the realisation of this potential hinges on Palestine’s ability to transport its exports seamlessly by land across the Jordan River.

A large share of Jordan’s fast growth of exports since the start of the previous decade has been to Arab markets. These markets, and primarily the GCC markets, account for more than 50% of total Jordanian exports of goods and services, and almost all workers’ remittances.

Once the economic impediments of the status quo are removed under a new economic regime, Palestine will be able to approach these markets along the same lines as Jordan has done over the last two decades.

According to our detailed forecast, total exports of goods and services to Arab markets will grow, over the 15 years of the forecast period, from the currently negligible amount of about 1% of GDP, to an amount equivalent to about 18% of GDP.

Chart 2.8: Total Imports of Goods and Services of the Six GCC Countries (billion US dollars, current prices)



Source: IMF 2014 reports on the six GCC countries

The following is an example of how an export-orientated Palestinian agriculture sector has high export-growth potential to the Arabian Gulf market. This example demonstrates how just one Palestinian economic sector could grow through exports to the Arabian Gulf, and is representative of the potential of a wide-range of Palestinian export-orientated sectors which are currently held back under the present economic and trade regime:

- Export of high-value agricultural products is almost non-existent under the present *status quo* regime. Its huge potential is apparent, however, from various successful small-scale businesses in Gaza and the Jordan Valley, as well as the success of this sector in Egypt and, to a lesser degree, in Jordan.
- Under a new economic regime a wide range of mutually advantageous Israeli – Palestinian export-oriented agricultural and agro-industry business activities would be set in motion, in fields such as high-value vegetable, flower and fruit exports.
- According to our sectorial analysis (Part 4) a new economic regime would enable Palestine to increase its agricultural exports to the Gulf market, over the forecast period of 15 years, to more than \$500 million per year. To a large extent this increase is based on the export of high-value Palestinian agricultural products to these markets, using advanced technologies and inputs.

Untapped exports to the EU, US, and other global markets

The Palestinian Authority has favourable trade agreements with all its major potential global trade partners, such as the EU and the US. These agreements are one of the main strengths of the Palestinian economy. Once the obstacles that have prevented Palestine from benefiting from these favourable trade agreements are removed, Palestinian exports to global markets are expected to increase quickly.

According to our forecast, total exports of goods and services to global markets (non-Israel and non-Arab markets) will grow, over the 15 years of the forecast period, from almost nil in 2014 to an amount of about 8% of GDP.

The tourism sector is a good example of the high growth potential of these markets:

- Tourism has shown a modest recovery in recent years, as a result of the partial relaxation of Israeli restrictions on access and movement in the West Bank. Nevertheless, it has remained small.
- The small contribution of tourism to the Palestinian economy is in striking contrast to the great potential of Palestine as a tourism destination, and in comparison to neighbouring countries such as Jordan or Egypt.
- Under a new economic regime, the high growth potential of the tourism sector will be released, as a result of the following changes: movement restrictions would be replaced by free and orderly movement of tourists in Palestine and between Palestine and Israel; Palestine would become a safe and independent tourist destination; the average length of stay and spending of visitors would increase; travel destinations and points of interest would diversify beyond the strong dependency today on the Christian pilgrim market; the Palestinian tourism infrastructure would be rehabilitated and developed; and cooperation with the Israeli tourism sector would enhance worldwide marketing of a broader “Holy Land” product.
- The removal of Israeli restrictions would enable the Palestinian tourism industry to tap into non-Christian markets (business and conferences, tour packages for Jordan and Egypt, Muslim pilgrimage, visiting friends and relatives, or leisure travel), and to bring in the large private investments required for building a tourism infrastructure that would enable Palestine to become an attractive tourism destination for millions of tourists.

Palestinian export growth forecast under optimal conditions

- Our forecast for overall Palestinian export growth, under optimal conditions, is as follows:
- In the first 3 years, after shifting to a new economic and trade regime, total export growth (goods and services) will be only slightly faster than GDP growth, and its share of GDP will grow from 17% in the base year (2015) to 20% in the third year (2018).
- Then, export-growth will take the lead as the main growth generator, and its growth will become much faster than GDP. Total export share in GDP will increase to 35% by the tenth year (2025), and 42% by the fifteenth year (2030).

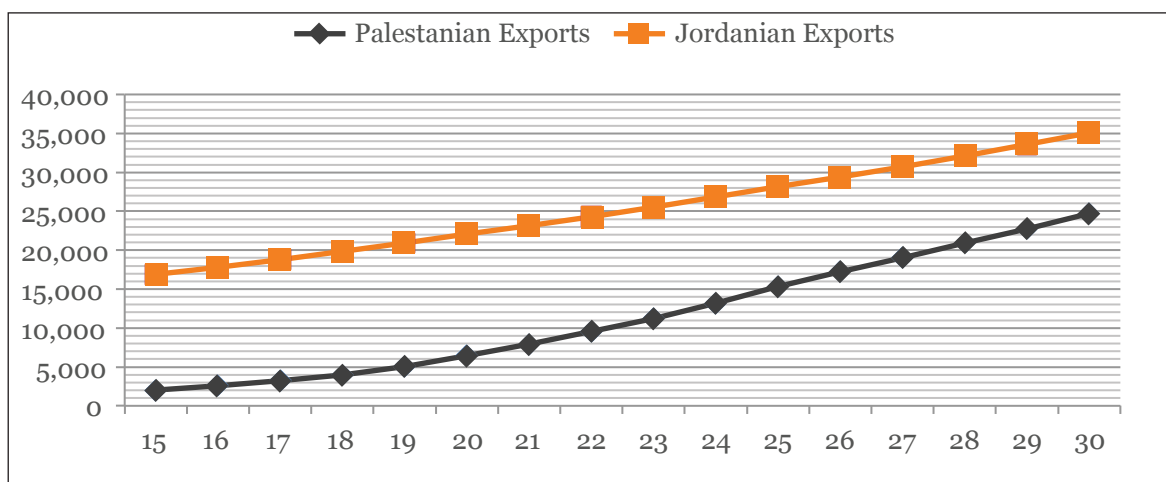
Table 2.2: Palestinian Export forecast (Goods and Services) Under Optimal Conditions (US dollars, 2014 prices, annual real growth rates)

Year	Total Exports (million US dollars)	Annual growth rates	Export as % of GDP
2013	2,072		17%
2014	2,051	-1.0%	17%
2015	2,021	-1.5%	17%
2016	2,571	27.2%	18%
2017	3,202	24.6%	19%
2018	3,977	24.2%	20%
2019	5,031	26.5%	22%
2020	6,443	28.1%	25%
2021	7,953	23.4%	27%
2022	9,567	20.3%	29%
2023	11,250	17.6%	31%
2024	13,173	17.1%	33%
2025	15,368	16.7%	35%
2026	17,221	12.1%	37%
2027	18,995	10.3%	39%
2028	20,919	10.1%	40%
2029	22,728	8.6%	41%
2030	24,680	8.6%	42%

Sources: 2013 figures – PCBS 2013 Balance of Payments Statistics. 2014 – 2015 growth rates – PCBS economic forecast for 2015 (published Dec 30 2014), average of pessimistic and base-line scenarios for 2015.

The feasibility of this seemingly optimistic export-growth forecast can be examined, too, by comparison to Jordan. As shown in Chart 2.9 below, after ten years of very fast export-growth Palestinian total exports will be still below the present (2015) level of Jordanian exports. Even after 15 years of fast growth, in 2030, Palestinian exports will be 35% lower than that of Jordan:

Chart 3.11: Is the Palestinian Export Forecast Feasible? – Comparison to Export Figures of Jordan (US dollars, 2014 prices)



Source: Palestine – Table 3.2. Jordan export growth as per IMF long-term export of goods and travel income forecast – computed from IMF June 2014 report, p. 47 (gradual decline from IMF 2015 – 2019 figures, by 0.5 percentage point and then 1 percentage point).

Potential growth of non-building investment

A main feature of the Palestinian economy, after the Second Intifada, has been continuous stagnation of investment in productive assets. This feature is one of the main facets of the consumption-oriented and external-aid driven economic growth of the post-Second Intifada period. The decline in productive investment has been a main cause of the unsustainability of economic growth under the present economic and trade regime.

Growth of investment under a new growth inductive economic and trade regime

Investment in productive assets – in agriculture, manufacturing industry, tourism, and other export-driven sectors, and in economic infrastructure – is a key long-term growth enabler. A new economic and trade regime is expected to trigger positive private sector perceptions towards investment and growth, and will also enable diversion of external aid from current public consumption to investment in economic infrastructure.

Our forecast is that, under a new economic and trade regime, Palestinian investment in fixed non-residential-building assets will therefore recover to its pre-intifada level of above 10% in 2-3 years. Then, as large public investment programs in infrastructure and large private industrial investment programs mature, the rate of non-building investment will gradually rise to above 15% of GDP. This level of investment is forecast to be maintained for close to a decade, as the gap in economic and industrial infrastructure is gradually closed.

After this decade of exceptionally high investment (coinciding with the decade of double-digit GDP growth), non-building investment will settle to a long-term level of 12 – 15% of GDP. This level of investment, similar to that of Israel and many other growing economies, would support the long-term 6% GDP growth forecast.

The high rate of investment in productive assets will be also mirrored in a structural change of the Palestinian economy. GDP growth will be driven by the productive and exporting sectors of the economy, and the share of these sectors in the GDP will gradually return to mid-1990s levels.

The Palestinian employment challenge: Growing labour market pressures

The Palestinian population is among the youngest in the Arab world: 62% is under the age of 24, of which 41% is under the age of 14.²⁷ As young Palestinians reach maturity in ever larger numbers, they demand appropriate work opportunities. The number of young Palestinians entering the labour force becomes larger and larger each year. From 2001 to 2005, the working age population grew by about 70 – 75,000 annually; this number grew to almost 100,000 annually in the early 2010s, and is expected to increase to about 120,000 annually in the 2020s.²⁸

Another factor that may intensify the pressure on the labour market is labour force participation. The Palestinian labour force participation rate has traditionally been low, reflecting a very low participation rate among women. However, it is increasing, and the rate of increase has accelerated in recent years. In 2000 41.6% of the working age population was employed or actively searching for work. The rate of participation grew to 43.6% in 2012 and 2013, and the most recent labour force survey (April – June 2014) showed a jump to 46%.²⁹

A quantitative analysis of latent Palestinian labour market trends shows that, under conditions of relative stability and economic recovery, the magnitude of Palestinian “hidden unemployment”, in conjunction with the fast growth in numbers of young adults entering the labour market every year, may generate annual growth of 6 – 8% in the labour force over the coming 10 – 15 years.³⁰

[27] PCBS, Demographic and Social Survey of the Palestinian Population (in Arabic), July 2011, p. 14-15

[28] Based on the 2010 size of the 0-4, 5-9, 10-14, and 15-19 age groups; see PCBS, *ibid*, p. 15.

[29] PCBS, Palestinian Labour Force Survey, Annual Report 2013, April 2014, p. 57

[30] Analysis based on PCBS, Palestinian Labour Force Survey, 2010 and 2013.

The Palestinian economy therefore needs to add about 2 million new jobs over the coming 15 years, merely to contain Palestinian unemployment around the present and alarming rate of ~30%.³¹ The number of new jobs needed in order to bring unemployment in 2030 back to below 10% is close to 2.5 million; namely, about 150,000 new jobs per year, on average, compared to an average of about 30,000 new jobs per year which were created over the last 10 years (from 2004 to 2013).³²

Employment growth forecast under optimal conditions

The sectorial mix of GDP growth, as per the forecast above and the sectorial analysis in Part Four, would generate accelerating growth in employment as a percentage of GDP growth (employment to GDP growth ratio). In the first period of about 3 years, the jump of the GDP will still be driven to a large extent by trade and other less labour intensive sectors of the economy. Following this period employment to GDP growth ratio will accelerate, gradually, as the new growth engines of export and investment will take the lead, and growth will be driven by labour-intensive sectors of the economy such as agriculture, labour-intensive industry, tourism, etc.

Our analysis of sectorial GDP and employment growth (Part Four) predicts that in the first three years of the forecast period each percentage point of GDP growth will generate 0.65% growth in employment. Then, the ratio of employment growth to GDP growth will gradually rise, as shown in Table 2.3.

The fast growth in employment under such an optimal new economic and trade regime would enable absorption of all new entrants into the labour market, and a gradual decrease in unemployment, from about 30% in 2015 (measured according to the LOI standards), to about 17% in 2020; and then stabilise at 7 – 8% from 2025 onwards.

Table 2.3: Palestinian Employment Forecast under Optimal Conditions

Year	Labour Force (thousand persons)	Labour Force – Annual Growth Rate (%) ²	Employment – Number of Employed Persons (thousand persons) ³	Employment – Annual Growth Rate (%) ⁴	Unemployment Rate – LOI standards (%) ⁵
2013	1155	3.7%	885	3.1%	23.4%
2014	1,254	8.6%	925.5	4.6%	26.2%
2015	1,329	6.0%	949	2.5%	28.6%
2018	1,674	8.0%	1,322	11.7%	21.0%
2020	1,935	7.5%	1,614	10.5%	16.6%
2025	2,714	7.0%	2,504	9.2%	7.7%
2030	3,632	6.0%	3,351	6.0%	7.7%

Source: PCBS, Labour force survey 2013 (published April 2014), p. 79; Labour force survey Q2 2014 (published October 2014), P. 12. Note labour force aged 15 and above.

Part 2.2: Optional trade regimes and their assessment

Main characteristics, factors, and political assumptions

Considering the special political and economic circumstances of Palestine, the factors influencing the main macro-economic parameters are complex and multi-faceted.

[31] This was the Palestinian unemployment rate, in the second quarter of 2014, according to a relaxed definition of unemployment which includes “despaired persons” who ceased actively searching for work. The unemployment rate under the stricter ILO definition was 26%. This report’s estimate for the unemployment rate in 2015 is 29% according to the ILO standards, and 32 – 33% according to the relaxed definition. Source: PCBS, Palestinian Labour Force Survey Q2 2014 (published October 2014), p. 11 - 12.

[32] PCBS, Palestinian Labour Force Survey, Annual Report 2013, p. 57

In the short and medium term, the most important factors that will affect sustainable economic recovery are:

- Elimination or at least a major relaxation of the complex web of security, administrative and other restrictions that constrain all aspects of Palestinian economic life.
- Leveraging the strengths and advantages of the Palestinian economy, currently greatly underutilised.

In the longer-term the recommended trade regime needs to support the main driving-forces of export-oriented economic growth, and the structural economic changes that will sustain the long-term growth of the four main macro-economic parameters mentioned above.

Short and Medium Term Factors

Elimination or Relaxation of Restrictions: In view of the overwhelming impact and complexity of existing restrictions on Palestinian economic life, the most important factor for the short and medium term is establishing a trade regime which would best serve the purpose of eliminating these restrictions as fast and as completely as possible. Any additional Palestinian-Israel cooperation agreements, accompanying a prospective new trade regime, will therefore be more important as enabling elements during the short and medium term than the nature of the trade regime itself.

Leveraging Underused Growth Potential: As described above, the Palestinian economy has remarkable growth potential given its inherent strengths and advantages, and which has been demonstrated in the past during periods of relative political stability and relaxed security restrictions. As of today, the Palestinian economy has an extremely large surplus of unused production capacity – skilled, high-quality, and unemployed manpower, as well as other production factors.

The combined effect of these two factors is mirrored in the first period of fast growth in the forecast presented above, once the complex web of restrictions is removed or substantially relaxed. Then, as the Palestinian economy will start functioning under “normal” economic conditions, the longer-term effects of a more growth-supportive economic and trade regime will emerge, in terms of contribution to GDP growth, exports, investment, and employment.

Longer Term Factors

In relation to longer-term considerations, a new trade regime needs to support the following main driving-forces of export-oriented economic growth:

- Export facilitation and application of export-promoting policy measures, which will enable Palestinian exporters to take advantage of the preferential trade agreements that Palestine already has with its important potential trading partners.
- Palestinian cooperation with Israel, Jordan, and Egypt, for facilitating export to other markets (mainly Arab and European markets).
- Joint infrastructure projects between Palestine, Jordan, Israel, and Egypt, particularly in electricity generation, electricity grids, electricity transmission lines, gas exploitation, gas and water pipelines, water distribution, and desalination.
- Re-direction of Arab and international aid from financing current expenditures towards growth-generating investments and basic economic infrastructure.
- Growth and exports of tradable services, in addition to tourism (discussed in detail in Part 4).

Gender Equality

While this report has not focused on issues of gender as they relate to trade regimes, it identifies this area as a key component to be taken into consideration in any future models proposed herein. The parties must address gender aspects of poverty and development that are inevitably tied to economic change and the emergence of dynamic international trade regimes in any future economic and trade regime. As experienced under other trade agreements (e.g. NAFTA) the unequal impact of trade regimes on women is particularly felt in such sectors as light manufacturing, textiles and agriculture, as well as in the informal sector. Also, given the existing deep disparities between the Israeli and Palestinian economies, economic inequality is likely to reinforce gender gaps, requiring active intervention of policymakers.

Therefore, the study highlights the need to further explore and develop effective means to mitigate differential gender impacts, taking into account comparative experience. It is recommended that potential resources to explore these issues further be sought from the WTO and NAFTA experience, as well as the work done by UNCTAD, UNIFEM and the World Bank, among others. EU / EC guidelines on gender mainstreaming in general, and provisions in such instruments as the Association Agreements (e.g. provisions on affirmative action) can also serve as useful tools guiding future policy on these issues.

Environmental Protection:

With regard to environmental protection, the study recommends that a future trade and economic regime abide by standards set out in, and best policies and practices to emerge out of myriad trade agreements in existence around the world today that promote “green growth”. As recent studies have shown, economic development and environment protection can go hand in hand. There is a great wealth of analysis and experience in this field, and for that reason the study recommends taking advantage of this experience rather than negotiating *sui generis* environmental clauses. The study would also recommend that the parties look to the broader region and consider the possibility of negotiating multilateral environment agreements (MEAs) and environmental cooperation agreements (ECAs) alongside the trade agreements.³³

Political Assumptions

As stated in the Introduction, the agreement on a new economic and trade regime can be achieved without concurrently reaching a final status agreement. Growth can ensue so long as there is an underlying assumption that a good faith political process will resume, in due time, with the aim of reaching an agreed resolution to the conflict. Furthermore, FTA negotiations can take place under the umbrella of the Euro-Mediterranean economic and financial partnership process.

Three optional trade regimes

The report looks at recasting the Palestinian economy away from the current economic and trade regime, towards a new economic model represented by one of three possible agreements with Israel: an Improved Customs Union, a Most Favoured Nation (MFN) agreement, and an advanced Free Trade Agreement (FTA). These agreements are assessed in conjunction with various enablers and higher levels of Palestinian-Israeli cooperation, including preferential trade arrangements for agriculture and services, arrangements on water and natural gas, transit procedures and joint projects, accumulation of value-added considering Euro Med, and preferential trade agreements with various third parties. These three optional regimes are examined against the present economic and trade regime.³⁴

[33] Please see: Abby Lindsay “FTA Innovations in Environmental Protection and Economic Development”, Retrieved from:<http://lasil-sladi.org/files/live/sites/lasil-sladi/files/shared/Working%20Papers/Working%20Paper%2010%20Lindsay.pdf>

[34] The methodology employed in this analysis was first developed as part of a comprehensive study of the Palestine International Business Forum (PIBF) and the International Council of Swedish Industry (NIR), published in 2007.

Improved Customs Union (ICU)

An Improved Customs Union (ICU) between Israel and Palestine would be the closest to the pre-Intifada situation, restoring the “economic integration” model of the pre-Intifada period. Theoretically, it would mean that national products and services, as well as imported goods, flow freely between the two economies, while maintaining common (or harmonised) external customs tariffs, import taxation, and regulation. It would further mean that Non-Tariff Barriers (such as different product standards, health regulations and related inspections, etc.) are kept to a minimum.

The new ICU regime is expected to include the following improvements, in comparison to the present situation: a significant reduction of restrictions on movement and access, movement of goods, businesspeople and tourists between Israel, Palestine and third-party countries; a relatively stable political and security situation inside Palestine, and between Palestine and Israel; and renewal of official and business cooperation, as agreed in the Paris Protocol. This report also expects a return to a high-level of donor financial support, over the forecast period, with significant part of it directed towards investment in infrastructure.

Given these features, the new ICU regime is expected to enable the Palestinian economy to realise a large part of its growth potential, as described above. However, the following negative effects need to be taken into consideration:

- First and foremost, the ICU regime is an improvement and modification of the present economic and trade regime, and not an entirely new regime replacing the present one. In view of the extreme complexity and strength of the existing system of restrictions, one may suspect that many of the planned improvements will not be implemented, and much of the Palestinian growth potential will not materialise.
- Furthermore, considering the asymmetrical nature of the relations between Israel and Palestine, and taking into account past experience, Israel will retain its dominant position in this new ICU regime. Israeli dominance will most probably be reflected in the erosion of the improved aspects of the new ICU regime over time, and the gradual build-up of new restrictions on the Palestinian economy.
- As to exports, the ICU will be clearly beneficial for bilateral trade with Israel. However, the need for a common (or harmonised) external tariffs and regulations with Israel would make it difficult, if not impossible, for Palestine to conclude or benefit from FTAs with third parties, including with GAFTA. This will considerably limit the growth of exports to Arab and other non-Israeli markets.
- The ICU regime will also keep in place the imposed linkage to the Israeli cost structure, with all its negative effects on the Palestinian cost structure and cost of living, and consequently also on the welfare of Palestinian households and high poverty rates.

Most Favoured Nation (MFN)

An MFN regime means agreed economic separation of Palestine from Israel when a Palestinian state is established. The main objective of an MFN would be to minimise dependence on Israel, and an MFN regime can be the choice of Palestinian state that may elect to separate from Israel, even if it were not the best economic strategy. Having a seaport in Gaza, unimpeded access to Jordan, and also to other markets, are assumed to be the structural underpinnings of an MFN regime and would allow for a major diversification of trade. Moreover, an MFN regime would not have the burden of “rules of origin” transaction costs.

Palestine would join the World Trade Organisation (WTO) and Israel and Palestine would apply a non-discriminatory trade policy (the MFN principle) to each other; namely, Israel and Palestine would treat each other as they treat other non-preferential trading partners. This means that Palestine will have less preferential market access to Israel than most of Israel’s other important trading partners, who have preferential trade agreements with Israel. There would be no mutual recognition of standards and technical regulations; products from one

side would be subject to potential delays and multi-level inspections when entering the other markets, etc. Nevertheless, Palestine may have a very similar external tariff to Israel's and seek cooperation with Israel on issues of common interest, such as water, energy, agricultural exports, and joint regional projects.

Overall, because Israel is expected to remain Palestine's largest export market, and cooperation on major issues such as water and energy will be essential to enhance Palestinian export and growth prospects, an MFN trade regime may not provide as many economic advantages as an FTA.

Even if such political and economic separation occurs without recurrent eruptions of violence, the outcome will be stagnation (and maybe even reduction) in bilateral trade; under this scenario Palestine will not be able to benefit from most of its growth potential.

Free Trade Agreement (FTA)

This regime envisages an Israeli – Palestinian Free Trade Agreement (FTA). It further envisages that this FTA is advanced through additional components and supplementary enablers.

Like an ICU, a Free Trade Agreement (FTA) is an economic integration agreement. Most, if not all, of the goods nationally produced (based on agreed rules of origin) enter the other market exempt of any customs duties or equivalent charges. The main difference between a FTA and a CU is the lack of a common external tariff on third party imports. An FTA does not require the partners to harmonise their external trade policy towards third parties, and partners remain free to negotiate trade agreements, including tariffs, with third parties.

Under an FTA, bilateral economic borders remain intact. The FTA therefore requires separate customs administrations by the parties. The Israeli – Palestinian FTA can be designed to permit diagonal accumulation between Palestinian, Israeli, and third party inputs and value-added aimed at entry the European or US markets duty free.³⁵ A detailed analysis of this aspect is provided in Annex 2.3 on Rules of Origin options.

Most importantly, the FTA allows each party to have completely separate trade policies *vis-à-vis* third parties. For Palestine, the benefits of an FTA would include the freedom to enter into preferential trade agreements which Israel is not party to. Hence, having an FTA with Israel, instead of an ICU, would enable Palestine to become a full member of GAFTA and other trade agreements and multilateral organisations such as the WTO.

Parties to an FTA are free to take further measures towards integration and cooperation, and agree on additional components such as cooperation on health, tax standardisation, competition and bank supervision authorities, harmonisation and recognition of product standards and professional qualifications of service providers, and institutional arrangements such as joint committees, dispute settlement mechanisms, cooperation between standards organisations, etc.³⁶

An FTA can be achieved only in the context of a positive political atmosphere. So, the report assumes that an FTA will also include movement and access arrangements, as well as security procedures, enabling the orderly movement of goods, businesspeople, and tourists between Israel, Palestine and third party countries; and active Israeli and Palestinian governmental policies encouraging new business cooperation and investment.

In addition, the report expects a return to a high level of donor financial support, over the forecast period, with most of it directed towards new infrastructure and other development programs.

[35] See Annex 2.3 detailing Rules of Origin (RoO) procedures and recommendations.

[36] Other important enablers include incentives to investment, competition regulation, sectorial regulation, government procurement, agreement on access of Palestinian labour to the Israeli market, cooperation in tourism, and more.

Macro-economic assessment of the optional trade regimes: Considerations and Analysis

Considering the complexity of the web of restrictions, the mammoth Israeli bureaucratic apparatus that has developed to maintain it, and the strong vested political and economic interests it serves, only a clear and fundamental change in the nature of Israeli – Palestinian economic relations will make it possible to cut through this web of restrictions and eliminate it.

As explained above, an Improved Customs Union (ICU) has certain significant advantages in terms of potential growth in exports to Israel and related growth in GDP and employment. However it has two very important disadvantages:

- It will be much less supportive to the development of trade with non-Israeli markets, primarily Arab markets, which in the long-run are expected to become the largest export market for Palestine, alongside Israel.
- Even more importantly, if this regime is chosen there is high risk that eventually a large part of the present web of constraints will remain in place, given the dominating position of Israel within the ICU. Consequently, a significant part of the expected economic benefits is unlikely to materialise.

A fundamental change of trade regime – namely shifting to an MFN or an FTA regime, based on the guiding principle of “Palestinian economic sovereignty” – will enable both parties to agree on the termination of the present regime of overlapping restrictions (the Paris Protocol and the matrix of economic and civic restraining arrangements); allowing for the negotiation of a new economic system. **The above analysis shows that the most promising move is to replace the present quasi-Customs Union trade regime with an FTA.** An FTA would thus be better than either a Customs Union or an MFN regime, facilitating the most rapid elimination or relaxation of restrictions as is possible, and enabling the Palestinian economic potential to materialise in full and move to a path of fast long-term sustainable growth.³⁷

The supplementary enabling elements of an Israeli – Palestinian FTA should be designed to encourage preferential agreements with third parties, including: Qualifying Industrial Zone (QIZ) style arrangements with the US, the EU and other markets; special arrangements for export-oriented free zones; special economic development zones (in the Jordan Valley or in Gaza); and special-status industrial estates. A new economic regime should also include preferential agreements on key sectors, such as agriculture or tourism, and enabling arrangements on key issues such as the development of water resources, the environment, transportation, trade in services, etc.

Value-added accumulation between Israel, Palestine, and Jordan under the Euro Med mechanism would enhance exports. Palestinian exports to third countries will be advanced by the freedom for Palestine to benefit from preferential trade agreements that Israel is not party to, most importantly the Greater Arab Free Trade Area (GAFTA), and to a lesser degree also the Agadir Group (Egypt, Jordan, Tunis and Morocco), agreements.

Under a new regime movement and access arrangements and security procedures would be revised to enable orderly movement of goods, business people, and tourists between Israel, Palestine and third party countries.

Finally, a new economic regime also assumes that Israeli and Palestinian governmental policies actively encourage new business cooperation and Israeli investments in Palestine.

Given that a positive political atmosphere is a pre-condition for engaging in negotiations on such an FTA new regime, the report anticipates that under this model Israeli and Palestinian negotiators can agree, in a few months from starting serious negotiations, on a set of transitional measures as presented in Part Three of this report. Such a package of transitional measures, applied collectively as a critical mass, will have an immediate positive effect. Collective measures will change private sector perceptions, trigger a new drive towards investment and exports, and boost economic growth, while negotiations on the details of a new economic and trade FTA are ongoing.

[37] The potential benefits of an FTA are also supported by the sectorial analyses conducted in Part 4 of this report.

Considering the huge growth potential of the Palestinian economy identified above, this economic boost is expected to be mirrored, immediately, in a new trend of fast economic growth. The removal of restrictions, as the economy shifts to the new FTA regime, will further free the untapped growth potential and power exceptionally fast double-digit growth for the first three years from regime change. This three year period will prepare the ground for the next stage of sustainable long-term export-driven growth, again as detailed above.

Macro-economic forecast under the three optional regimes

The tables below summarise our projections for GDP, export, and employment growth under the three optional economic and trade regimes, in comparison to a scenario of continuation of the present regime under a political assumption of “managed conflict”. Though the *status quo* is clearly unsustainable and unviable, both politically and economically, it helps as a “reference scenario”.

The quantitative factors of the projections reflect the considerations and analysis above, as well as the combined effect of the sectorial analysis in Part Four of this report. These factors are summarised in the notes to each of the three tables.

In Summary:

A Free Trade Agreement (FTA) represents the optimal new trade regime for Palestine. This new economic model offers significantly greater GDP, export, investment, and employment growth opportunities for Palestine than either the status quo, a Customs Union, or an MFN. This report forecasts that under an FTA Palestinian real GDP can increase from \$12 billion (today) to \$44 billion in ten years, benefitting from double-digit growth rates throughout this period. Most importantly, an FTA regime would also be the most promising regime for the purpose of eliminating or relaxing the restrictions on the Palestinian economy.

Table 2.4: Palestinian GDP Forecast under Optional Economic and Trade Regimes (2013 prices, US dollars, real annual growth rate)³⁸

Year	Continuation ⁶		Improved CU ⁷		MFN ⁸		FTA ⁹	
	USD million	Annual growth rate	USD million	Annual growth rate	USD million	Annual growth rate	USD million	Annual growth rate
Base Year	12,103	-	12,103	-	12,103	-	12,103	-
Three Year Forecast	12,844	2.0%	19,886	18.0%	15,247	8.0%	19,886	18.0%
Five Years Forecast	13,363	2.0%	24,945	12.0%	17,784	8.0%	26,299	15.0%
Ten Year Forecast	14,754	2.0%	35,602	7.4%	23,799	6.0%	43,910	10.8%
Fifteen Year Forecast	16,289	2.0%	43,316	4.0%	28,955	4.0%	58,761	6.0%

Table 2.5: Palestinian Export Forecast under Optional Economic and Trade Regimes (2013 prices, US dollars, real annual growth rate)³⁹

Year	Continuation ¹⁰		Improved CU ¹¹		MFN ¹²		FTA ¹³	
	USD million	Annual growth rate	USD million	Annual growth rate	USD million	Annual growth rate	USD million	Annual growth rate
Base Year (2015)	2,021	-	2,021	-	2,021	-	2,021	-
Three Year Forecast	2,208	3.0%	3,977	25.3%	2,021	0.0%	3,977	25.3%
Five Years Forecast	2,342	3.0%	6,032	23.2%	2,185	4.0%	6,443	27.3%
Ten Year Forecast	2,715	3.0%	10,612	12.0%	2,723	4.5%	15,368	19.0%
Fifteen Year Forecast	3,148	3.0%	14,201	6.0%	3,476	5.0%	24,680	9.9%

Table 3.6: Palestinian Employment Forecast under Optional Economic and Trade Regimes (thousand persons)⁴⁰

Year	Continuation ¹⁴		Improved CU ¹⁵		MFN ¹⁶		FTA ¹⁷	
	1000 persons	Annual growth rate	1000 persons	Annual growth rate	1000 persons	Annual growth rate	1000 persons	Annual growth rate
Base Year (2015)	949	-	949	-	949	-	949	11.7%
Three Year Forecast	992	1.5%	1,322	11.7%	1,130	6.0%	1,322	10.5%
Five Years Forecast	1,022	1.5%	1,554	8.4%	1,269	6.0%	1,614	9.2%
Ten Year Forecast	1,101	1.5%	2,106	6.3%	1,582	4.5%	2,504	6.0%
Fifteen Year Forecast	1,186	1.5%	2,562	4.0%	1,834	3.0%	3,351	11.7%

[38] Average annual growth for the presented periods. For example, 18% annual growth under Improved CU for the first three years, and 12% a year for the next two years; 18% and 15% under FTA during these periods.

[39] Average annual growth for the presented periods.

[40] Average annual growth for the presented periods.

Part 3: Transition Period Towards a New Trade and Economic Regime

Introduction

The process of transition to a new trade and economic regime may occur under two different political scenarios:

- **Final Status Negotiations:** A process in which a new trade agreement and economic arrangements are negotiated as part of, or in parallel to, significant and substantive Final Status negotiations with Israel.
- **Slower Political Track:** A process in which there is Israeli support for Palestinian economic development, economic facilitation measures, and economic infrastructure, but without a firm commitment to progress on the political track.

In either scenario, there will be a transition period from the current economic system to the new trade and economic regime. This transition period will involve extensive and complex negotiations between Palestinian and Israeli officials, and will require a planning framework, a set of organising principles, and commitment from both sides to a coordinated series of enabling measures, if it is to succeed. As mentioned earlier, the underlying political assumption for the transition period is that the Israeli political establishment realises that it is in Israel's interest to revive the Palestinian economy and have an economically viable neighbour, rather than manage a conflict aggravated by a steady Palestinian decline towards poverty and violence.

This report anticipates that, during the first quarter of 2015, the downward slide of the Palestinian economy will continue with declining per capita income, rising unemployment, and fiscal crises. This trend has been exacerbated by the recent (December 2014) freeze by Israel of Palestinian tax revenue under the clearance process. Unless decisive actions are taken to counter this trend, it may translate into political instability and possibly outbursts of violence and open conflict, as has recently occurred in Gaza. The survival of the Palestinian Authority would be at risk.

Given these risks, the first action needed is to release PA tax revenues so that salaries can be paid to PA employees. More fundamentally however, the immediate task at hand – necessary to begin the process of transition and to reverse the downward spiral of declining growth and rising unemployment, is to change the economic and political environment through a critical mass of measures. These measures need to be taken collectively to trigger a change in private sector perceptions towards investment and growth. If these measures are taken incrementally, or are not fully implemented, little will change. As these measures gain success and momentum, they will also significantly improve prospects for the political track.

The following set of measures can be agreed upon without undermining Israel's security considerations. As these measures gain success and momentum they will also significantly improve prospects for the political track. These are:

- Allow Palestinian development of Area C, including agriculture and tourism projects, industrial zones, and utilisation of land, water, and other natural resources;
- Restore free movement of goods and passengers between the West Bank and Gaza Strip, as foreseen in the Agreement of Movement and Access of 2005, with some amendments with respect to imports through Rafah;
- Liberalise travel of Palestinians abroad and travel of foreign visitors to Palestine, and allow Israeli civilians free access to areas under Palestinian jurisdiction (i.e. Area A), to stimulate trade and business opportunities;
- Allow West Bank and Gaza people and products access to the East Jerusalem market;
- Limit restrictions on the 'Dual Use' list to standard prohibitions, and enable unrestricted imports of capital

equipment by Palestinian businessmen;

- Facilitate the implementation of large Palestinian infrastructure projects, as outlined in the OQR Initiative for the Palestinian Economy (IPE) and elsewhere, including such projects as Gaza Marine, Gaza water desalination, and electricity generation in the West Bank.

A more comprehensive and systematic planning framework, with enabling measures, is listed below. It outlines the necessary steps for an orderly transition to a new economic and trade regime. Furthermore, this report judges these proposals to be of benefit to Israeli security considerations, given the significantly greater Palestinian stability and economic relations with Israel they will create.

Proposed framework, principles, and measures for transition

In the immediate term, the parties should reconvene a reformed version of the Joint Economic Committee (JEC). The JEC forum provides a mechanism for negotiators to review the state of implementation of the Protocol, agree jointly on amendments to resolve some of the acute problems identified in this report (detailed in Annex 3.1), and to manage the interim process of transition. However, previously the imbalance of powers between the two parties and the lack of an arbitration mechanism has resulted in a deadlock. Therefore, it is highly recommended that the reconvening of the JEC includes the participation of a neutral third party and developing an effective arbitration system.⁴¹

The process of transition should be managed according to a framework of five organising principles, which are essentially the fundamental requirements of Palestinian economic development, and therefore the key goals of the transition:

- Trade Facilitation
- Investment Promotion
- Reliable Infrastructure
- Access to Land and Resources
- Effective Government

Transition negotiations between Palestinian and Israeli officials should be conducted with these principles in mind, to ensure that all measures taken represent progress towards a positive (and mutually-beneficial) economic outcome. Using these principles as our framework, this report proposes a range of Palestinian-Israeli cooperation measures, below, as necessary steps to transition from the current situation to a new high-growth trade and economic model.

Trade Facilitation

To increase Palestinian trade, both internally in terms of movement and sale of goods to different internal markets, and externally as imports / exports to Israel and other countries, the following Palestinian-Israeli cooperation measures should be negotiated during the transition:

- Pre-2000 trade arrangements should be restored in line with the 15th November 2005 Agreement on Movement and Access (AMA), with some modifications relating to imports through Rafah. The free passage between Gaza and the West Bank for unimpeded movement of trade and people needs to be established. Movement of trade and people between East Jerusalem and the remaining parts of the West Bank should also be freed.
- The list of imports and quantities of imported commodities subject to Palestinian import policy (lists A1, A2

[41] A co-author of this study chaired the Palestinian team on the JEC in 2009 and 2010.

and B) should be expanded. An impartial mechanism within the Joint Economic Committee (JEC), with third party representation, should be established to periodically update the composition of the lists and quantities allowed.

- Imports of capital equipment should be liberalised. Restrictions on the transfer of materials and equipment under the 'Dual Use' list to the West Bank and the Gaza Strip should be reduced to standard prohibitions (drugs, armament, explosives) only.
- A clear policy should be defined on the movement of Palestinian labour into Israel and the granting of permits which meet the interests of both countries.
- An import/export facility should be established at the ports of Haifa and Ashdod, under Palestinian oversight, to facilitate and expedite Palestinian external trade. The development of a seaport should commence. However, since the construction of a deep water port in Gaza may take several years, immediate sea access to Palestinian external trade can be secured by establishing sea lanes to Cyprus and by constructing roll-on roll-off facilities for smaller vessels.
- Opening hours of existing commercial crossings should be extended (ideally 24/7), and their import / export capacity expanded (in particular at Allenby Bridge and Kerem Shalom). Full containerisation of all trade at all West Bank commercial crossings (with Israel and Jordan) should also be put in place, fully equipped with container scanners, to provide a significant upgrade to trade capacity.
- Fast track lanes should be established at all crossings to service Palestinian industrial zones in both the West Bank and Gaza Strip.
- The reduction of paperwork and processing time, by increasing capacity of customs and other officials ("single window process") in both PA and Israeli administrations, should be implemented. Clear transit time requirements should be established, with defined arbitration and compensation process for delays.

Investment Promotion

To facilitate and promote major new investment in Palestinian businesses, enterprise, and the economy, the following Palestinian-Israeli cooperation measures should be negotiated during the transition:

- Restrictions limiting foreign visitors from travelling to Palestine should be removed.⁴² Tourists, consultants, and investors should to be given free and unrestricted access to both the West Bank and Gaza Strip. This is particularly needed for visitors from Muslim or Arab countries, especially from the GCC countries.
- Restrictions limiting Palestinians from travelling to Israel and/or abroad should be removed, particularly for student and business travel.
- The process for obtaining or renewing entry permits and visas for travel to or from Palestine, for both Palestinians and foreigners, and in particular where these relate to business or study, should be standardised and made predictable. Accurate information on the process should be made publically available and accessible in both English and Arabic.
- Restrictions and limitations preventing Israeli travel to areas under Palestinian Jurisdiction should be removed, to stimulate new trade, business, and tourism opportunities.
- The existing Israeli permitting process for new building construction in the West Bank should be substantially revised and simplified, to provide a fundamental boost to all sectors of the Palestinian economy. This would ide-

[42] Israel's rejection of foreign visitors who would normally be allowed free entry amounted to 9% in 2013, whereas OECD countries have a rejection rate around 2%. The high Israeli rejection rate, including for US-Palestinian dual nationals, has been cited by the US Department of State as the main reason for refusing to grant Israeli citizens visa waivers upon entry to the US.

ally involve a transfer of powers to the PA, but progress could also be achieved through developing the existing process into one that is open, predictable, and rules-based. A moratorium on house demolitions in the West Bank and Jerusalem should be enacted.

- Ease of movement for tourists (including tour buses) across borders and at Israeli checkpoints within the West Bank should be improved.
- Tourism cooperation between Palestine and Israel should be significantly improved. Joint Palestinian-Israeli tourism packages and marketing should be developed to improve the overall offer to international tourists and create a win-win scenario. Israel should expedite permits for the restoration of major historical sites currently located in Area C, facilitate the construction of improved access roads to the Bethlehem city centre, and permit Dead Sea developments to allow Palestinian construction of a publically accessible beach and resort.

Reliable Infrastructure

To construct and maintain reliable infrastructure, essential for the Palestinian productive sectors to function and prosper, the following Palestinian-Israeli cooperation measures should be negotiated during the transition:

- Development of genuine and effective Palestinian-Israeli cooperation within the Energy and Water infrastructure sectors should be prioritised throughout the transition.
- With regards Energy infrastructure, priority should be given to negotiating the construction of feeder lines transporting increased volumes of IEC electricity to Gaza, and the construction of additional substations and Grid upgrades in the West Bank. Israeli support should be given (where needed) for Palestinian plans to construct a gas-fuelled power plant in the West Bank.
- Within the Water infrastructure sector, priority should be given to completing the Nahal Oz connection in Gaza. In the West Bank, Israel should agree to expedite rapid permitting for construction and upgrade of wells,
- Approval should be given for rain harvesting dams, irrigation transmission pipes, and wastewater treatment plants. Israel support should be given (where needed) for Palestinian plans to build a major desalination plant in Gaza.
- Permission should be given for the entry of a range of telecommunication equipment and material into both the West Bank and Gaza, to enable both new development and upgrade of ICT infrastructure.
- Agreement should be reached to improve road infrastructure in and around key checkpoints, crossings, and industrial zones.

Access to Land and Resources

To increase Palestinian access to the land and resources necessary for transformative economic development, the following Palestinian-Israeli cooperation measures should be negotiated during the transition:

- Agreement should be reached to secure Palestinian access to and administrative governance over land and resources in Area C. During this process, interim measures should be taken to identify areas of Area C land which are suitable for (a) agriculture and open these up to Palestinian cultivation; and (b) for new housing construction, near existing Palestinian urban centres, (c) industrial zones and open these up for construction (including necessary connections to Palestinian infrastructure in Areas A and B). Data and files regarding all land in Area C should be shared, to facilitate titling and real estate transactions.
- Agreement should be reached to allow Palestinian access to and management of water resources, as specified in the 1995 Interim Agreement. In the West Bank priority should be given to substantially reforming or replacing the Joint Water Committee (JWC) system. Some of the powers of the JWC should be transferred to the PA,

to enable Palestinian construction of routine water infrastructure independently of Israeli approval, and the JWC should be reformed as a forum for Palestinian-Israeli cooperation on issues affecting the aquifer only. The new agreement should ensure that abstraction from the West Bank aquifer is permitted as per the quotas set out in the 1995 Interim Agreement.

- Israel should allow Palestinian access to the Electromagnetic Spectrum, to enable Information and Communication Technology (ICT) development and the use of modern technologies (such as 3G and 4G).
- Agreement should be reached for an expanded zoned area and improved permitting process for new quarries, including retroactive permitting for those currently in operation without the required permits. Permits should be issued to additional Palestinian quarry operators for controlled use of explosives, or to allow current permit-holders to use explosives on additional quarries.
- Firm Israeli support for Palestinian access to natural gas reserves off-shore from Gaza should be given, and the potential for Palestinian purchase of Israeli natural gas should also be negotiated, to provide Palestinian power plants in both the West Bank and Gaza with access to cheaper fuel supplies than are currently available.
- Access to the no-go 'buffer' zone in Gaza should be negotiated to allow for agricultural activity to take place. In-principle agreements for the possible installation of energy and water infrastructure in these locations (such as solar PV utilities, irrigation pipes, etc.), should be sought.
- The existing master plan in East Jerusalem should be amended to create more residential and commercial areas for Palestinians, and to allow for greater housing density. New master plans should be processed as a priority, and existing lengthy permitting procedures for new construction in Jerusalem (which currently take 24 – 84 months) should be drastically reduced.
- Rules regarding fertiliser imports should be revised and eased, to increase access to fertilisers for agricultural use, and to lower their cost.

Effective Government

To increase the capabilities and effectiveness of Palestinian governance, the following Palestinian-Israeli cooperation measures should be negotiated during the transition:

- The authorities and responsibilities for the clearance of imports and exports and collection of due taxes will be transferred to the Palestinian government in line with the recommendations in Annex 3.1.
- The Palestinian Civil Police and Civil Defence should be allowed to move and act freely in all areas of the West Bank to provide essential services to Palestinian residents.
- The Palestinian Customs and Border Police should assume the responsibilities for managing the movement of passengers and cargo through the crossings with Israel, Jordan and Egypt.
- Palestinian tax authorities should be allowed to move freely in Area C, to enforce tax collection and compliance.
- Palestinian Ministry of Finance claims against revenue leakages from the clearance process in favour of Israel should be addressed.

Role of the donor community and the Palestinian government

The international community can play a very important role in supporting both trade facilitation and infrastructure development. There is a major opportunity for the donor community to play a significant role in financing an increase in public investment, to stimulate economic growth and public revenues and help reduce the current

fiscal deficit.

With substantial improvements expected in the recurrent fiscal balance following a lifting of Israeli economic restrictions, the donor community will then be able to shift some of its resources from budget support for recurrent expenditures to public investment.

The Palestinian Government will need to accelerate the pace of reforms, particularly with respect to the Pension Fund and the Civil Service. Local governments will play a critical role in the development of Area C and the Gaza Strip. Developing master plans for villages, promoting land registration, and regulating land purchases and acquisition will be essential. The Palestinian Government will need to work closely with local governments to help them establish a uniform and robust financial system, with auditing of accounts and transfers to poorer municipalities. The legislative backlog of pending laws will have to be addressed, particularly the Land Law, the Mortgage and Foreclosure Law, and the Public Private Partnership Law. A Telecommunication Regulatory Commission also needs to be established.

In Summary:

The immediate reactivation of a reformed Joint Economic Committee (JEC) will be necessary to review the state of implementation of the Paris Protocol, agree jointly on amendments to resolve some of the acute problems identified in this report, and to manage the interim process of transition.

A range of interim measures need to be taken collectively, as a critical mass, to trigger transformative new investment and economic growth. This set of measures should include the roll-back of major economic restrictions, which can be agreed upon without undermining Israel's security considerations.

Part 4: Sectorial Analyses

Introduction

In-depth analyses of key sectors of the Palestinian economy have been presented in several important studies published in recent years, including the Office of the Quartet Representative's "Initiative for the Palestinian Economy" (IPE), which focused on eight economic sectors as catalysts for growth; The Portland Trust's "Beyond Aid" report, which identified five economic sectors with the greatest growth potential; the "National Export Strategy 2014 – 2018" study, which selected nine priority sectors based on their capacity to contribute to export growth; the "National Development Plan 2014 – 2016", which identified four priority economic sectors; as well as several other reports, including publications by the World Bank.

On the basis of a survey of all these studies, combined with our own analysis, this report has identified three priority economic sectors for consideration in this report: agriculture, manufacturing, and tourism. These three sectors have been identified as being, by far, the most important in terms of their potential contribution to Palestinian GDP growth, exports and employment.

The present (2013) situation for each of these three sectors, as summarised below in table 4.1, serves as the starting point of our forecast for the coming 15 years, applying the analysis and forecasting methodology presented in Part 2 above. Based on this analysis, this report presents detailed findings on each sector's growth potential under optimal growth conditions, and summarises the enablers required to realise this growth potential. This report evaluates the effect of all three optional trade and economic regimes (introduced in Part 2) for each sector's growth potential.

Finally, this report identifies that the development of new infrastructure is of critical importance to develop these three sectors. For example, this report identifies the need for new water infrastructure as a critical enabler to the agricultural sector. This report also highlights, in this context, certain specific projects that can have significant macro-economic impact.

Table 4.1: Agriculture, Manufacturing and Tourism – Summary of Present Situation (2013 figures at current prices)

	Agriculture¹⁸	Manufacturing Industry	Tourism¹⁹	All other sectors	Total
GDP - USD millions²⁰	517	1,595	300	10,064	12,476
GDP - % of total	4.1%	12.8%	2.4%	80.7%	100%
Exports - USD millions²¹	147	794	255	876	2,072
Exports - % of total	7.1%	38.3%	12.3%	42.3%	100%
Employment – thousand persons²²	93	108	15	669	885
Employment - % of total	10.5%	12.2%	1.7%	75.6%	100.0%

Agriculture

The present situation

The Palestinian agricultural sector has been hurt severely by the existing system of restrictions. The evolution of this system, in particular in relation to restrictions on the supply of water for irrigation, has impacted all components of the agricultural value chain. These restrictions have eroded productivity and diminished incentives for investment in agriculture.

The Sharp Decline in Agricultural Production, Exports, and Productivity

The effect of these restrictions can be seen in the sharp decline of the share of agriculture in Palestinian GDP, which fell by two thirds over the last two decades from 12 – 13% in the mid-1990s to 4% in 2013. The impact on agricultural exports was no less dramatic. Agricultural exports to Israel fell by three quarters in real terms over the last three decades (between the early 1980s and the early 2010s), while exports to Arab markets fell even more sharply. This sharp decline in agricultural production (both GDP and exports) occurred in spite of a substantial increase in the number of employed persons in agriculture. This phenomenon was mirrored in a sharp decline in labour productivity in agriculture, which halved between the late-1990s and 2013.⁴³

The Overwhelming Impact of Water Shortage on Irrigation

Shortage of water for irrigation has evolved as a major agricultural constraint since the 1980s (and in Gaza since the end 1970s), and has grown to become the main cause of this sector's decline.

In the West Bank only around 12% of cultivated land is irrigated, whilst in Gaza this figure is much higher at 77%;⁴⁴ however Gaza has seen a considerable decline in its area of land under cultivation over the last three decades (far more so than the West Bank), so this figure is artificially high (as it does not include the area of unirrigated cultivatable land that is currently not in use). In comparison, irrigation levels in Israel are about 60%, and in Jordan close to 40%.⁴⁵

Where cultivated land is not irrigated Palestinian farmers are forced to grow olive trees and other low-value crops, which have lower water needs. Productivity and value of production are further impacted by low levels of fertiliser-use (Palestinian fertiliser-use is only 40% the average Jordanian levels and 20% of the Israeli level), restrictions on access to land, and poor links to vertical processing value-chains and markets.⁴⁶

The impact of these lower productivity levels and crop-values on the value of productions per dunam has been devastating for Palestinian farmers. PCBS agricultural survey data (2007/2008) shows that the average value of production per dunam of unirrigated land was as low as \$160 per dunam, versus an average value for irrigated land of up to \$2,350 per dunam. This is equivalent to an average value of production for irrigated land that is fourteen times higher than unirrigated land; a huge difference when it is taken into account that 86% of land under cultivation (1.55 million dunams) was unirrigated at this time.

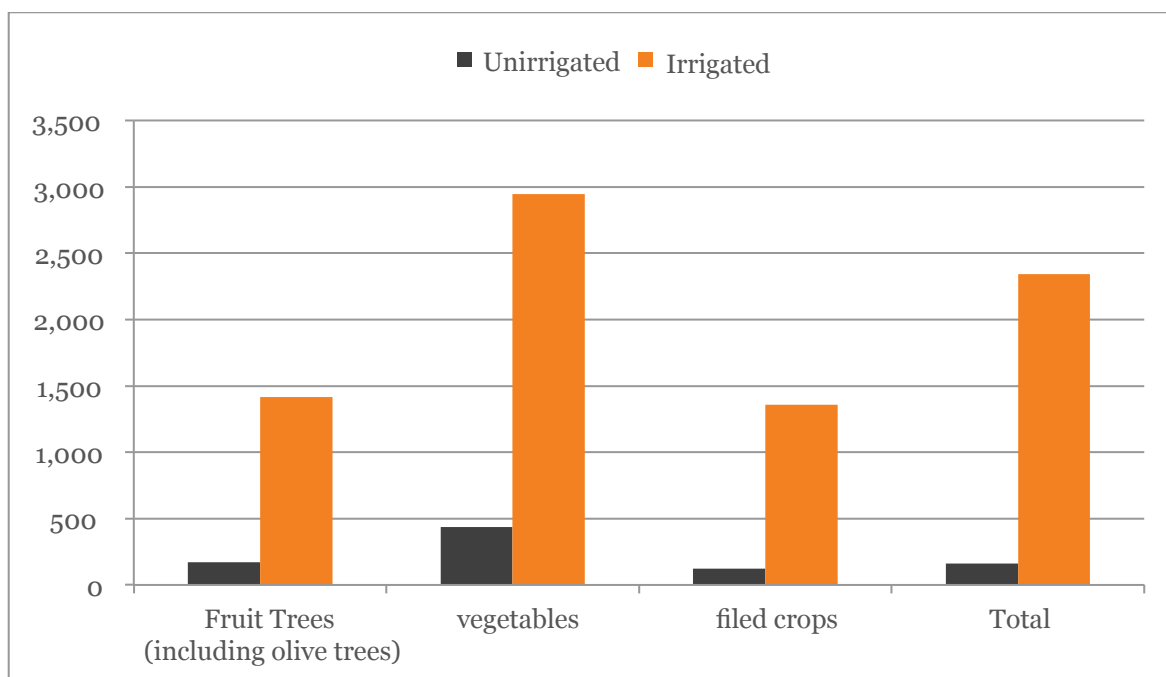
[43] "Labour productivity" is defined as the physical production or value of production (or value-added) per a given amount of time, usually a year in a macro-economic context. In this context the analysis relates to value added in USD per worker per year. Later the report refers to "productivity", meaning physical production in tons per dunam; and to "value of production per dunam", meaning USD value of production per dunam (ex-field value). Labour productivity in the Palestinian agriculture was \$10,000 - 15,000 per year in the late-1990s (as computed by the World Bank from PCBS surveys; World Bank, Area C and the Future of the Palestinian Economy (2014), p. 19). It fell to \$5,500 in 2013 (computed from Table 4.1).

[44] As of the early 2010s.

[45] PCBS Agriculture Survey and Agricultural Statistics, various dates; IPE: Agriculture, p. 4.

[46] IPE: Agriculture, p. 3, 4.

Chart 4.1: Average Value of Production per Dunam by Type of Crops, Irrigated and Unirrigated Land (USD, current prices, 2007/2008 Agricultural Survey)



Source: PCBS, Agriculture Survey 2007/2008

This report estimates that the losses inflicted by the shortage of water for irrigation are even larger than shown in Chart 4.1. Throughout large parts of the West Bank increased availability of water would have enabled farmers to shift away from low-value crops, such as unirrigated olive trees (which cover ~55 percent of all Palestinian cultivated land, and yield as little as \$100 per dunam per year), and shift towards cultivation of high-value irrigated crops such as citrus or grapes (which yield ~\$1,500 – 4,500 per dunam), cucumbers (~\$4,000 per dunam), and tomatoes (~\$6,000 per dunam, if grown under cover such as plastic tunnels).⁴⁷

Potential growth under optimal conditions

Potential GDP Growth

The growth of agriculture under a new economic and trade regime is anticipated to be powered by the combination of the following:

- **Expansion of irrigation** from the present ratio of 12% of cultivated land to between the Jordanian and Israeli ratios (40 – 60%) by the end of the fifteen-year forecast period; namely 50% by 2030.
- **Expansion of land area under cultivation** to include all cultivable and reclaimable land in the West Bank and Gaza, estimated at around 3 million dunams, by the end of the fifteen-year forecast period. This includes approximately 1 million dunams which have either been deserted or are only under partial cultivation because of access restrictions and lack of water, as well as nearly half a million dunams of uncultivated but reclaimable lands.⁴⁸
- **Improving productivity of irrigated lands** through the increased use of fertilisers, improved growing methods (advanced precision irrigation, plastic tunnels, etc.), extension and related activities, and upgraded post-harvest services.

[47] Computed from PCBS, Agriculture Survey 2007/2008

[48] IPE: Agriculture, p. 36; and PCBS Agricultural Statistic Survey 2010/2011

• **Shifting to a crop mix of higher value products**, primarily through the replacement of low-value field crops with irrigated vegetables on flat lands, and shifting from olive production to irrigated fruit trees on hilly lands. Additionally, this report anticipates the introduction and expansion of new high-value crops such as strawberries, apricots, mangoes, etc. Our forecast assumes that the present West Bank crop mix of about 80% of cultivated land producing low-value olives and field crops, and only 20% of cultivated land producing higher value vegetables and (non-olive) fruit trees, will change. Under a new optimal economic and trade regime, this report assumes that by the end of the fifteen-year forecast period all fully irrigated lands (1.5 million dunams) will be used for high value vegetable and non-olive fruit trees, primarily to export, while unirrigated lands will be used for low-value olive trees and field crops.

Given adequate availability of water for irrigation, use of advanced growing methods, and upgraded agricultural services, this report expects average value of production to increase to \$3,000 per dunam of irrigated land.⁴⁹

The value of production of unirrigated lands will also improve, as the lifting of access restrictions, better growing methods, and even partial irrigation (of olive trees in certain areas, for example) or better use of rain water, will enhance the productivity of these lands. This report therefore assumes that the value of production of these crops will increase from the present average of \$100+ per dunam to around \$200 per dunam.

Value-added in agriculture is relatively high (not including livestock). Considering the 78% ratio of agriculture value-added to output applied in the Palestinian National Accounts, the value-added per dunam of irrigated land would be about \$2,350, and in rain-fed lands about \$150. Our forecast for the GDP of the Palestinian agriculture (not including livestock) by the end of the forecast period is therefore \$3.75 billion.⁵⁰

This report estimates the livestock sector would add about \$1 billion to this figure; and the total GDP of agriculture as forecasted for 2030 is therefore \$4.75 billion.⁵¹

Potential Export Growth

Export products will account for a very large part of agricultural sector growth. This report anticipates that export-orientated projects, where production will be solely (or almost solely) for export, will account for a large component of this growth.

Indirect exports will also account for a large component of production, especially in livestock sectors, in the form of food processing activities by the Palestinian food industry for export. This report estimates that the total value of Palestinian agricultural production used as inputs for food industry exports will amount to 15 – 20% of plant production and ~50% of livestock production by 2030 (see the section on industry below for further details).

[49] Note: as demonstrated by the key projects presented below, in export-oriented agricultural projects using advanced cropping methods and Israeli technical and marketing support, average value of production per dunam is about \$5,000. Under the optimal economic and trade regime, which will include agricultural cooperation agreement with Israel, we expect a few hundred thousands of dunams of such projects (in Gaza, the Jordan valley and other parts of the West Bank).

[50] \$3,750 million = 1.5 million dunam x \$2,350 + 1.5 million dunam x \$150; at 2013 prices.

[51] The livestock sector is today about 40% of Palestinian agricultural production. Its value-added is much lower than plant products, estimated at no more than 35 – 40%. Consequently, its share in the GDP of agriculture is about 25%; approximately \$130 million in 2013. Over the fifteen-year forecast period it is expected to grow in two ways. Firstly, responding to local market demands at a rate similar to that of total Palestinian GDP under optimal conditions, will see 370% growth on the 2013 figure, equivalent to \$613 million by 2030 (\$130 million x 4.7, at 2013 prices). Secondly, indirect exports will increase as the Palestinian Food Industry increases the production of meat products for export. This industry is considered to have remarkable export potential, and expected to be among the leaders in industrial exports. Livestock-based export products are estimated to grow to about \$1.5 billion by 2030; and the derived growth of livestock agricultural production at more than \$1 billion by 2030. Considering the 35 – 40 value-added ratio to production, this would add another \$400 million to the GDP of the agriculture sector in 2030.

In summary, this report estimates that agricultural exports will, in 2030, increase in magnitude to account for two thirds of the value of plant production; about \$3 billion.

Potential Employment Growth

As agricultural production recovers and shifts to faster growth, labour productivity will climb back to its pre-Second-Intifada level of around \$10,000 - 15,000 per worker (in terms of value-added). Given this labour productivity rate, total employment in agriculture is forecast to rise to around 380,000 workers by 2030.

See Table 4.2 below for the predicted development of agricultural GDP, exports and employment during the forecast period.

Table 4.2: Agriculture: Potential Growth under Optimal Conditions (2013 prices, US dollars, real annual growth rate)⁵²

Year	GDP		Exports		Employment ²³	
	USD million	Annual growth rate	USD million	Annual growth rate	USD million	Annual growth rate ²⁴
Base Year (2015) ²⁵	517	-	147	-	93	-
Three Year Forecast (2018)	806	15.9%	269	22.3%	93	0.0%
Five Years Forecast (2020)	1,083	15.9%	402	22.3%	118	12.5%
Ten Year Forecast (2025)	2,268	15.9%	1,098	22.3%	211	12.5%
Fifteen Year Forecast (2030)	4,750	15.9%	3,000	22.3%	380	12.5%

Enablers and Key Projects

Main Enablers

The most critical enabler of agricultural development, beside the removal of access and other restrictions on Palestinian agricultural activities and exports, is the availability of water for irrigation.

The present quantity of water available to Palestinian agriculture for irrigation is about 85 million cubic meters per year (mcm/y): 50 mcm/y in Gaza and some 35 mcm/y in the West Bank.⁵³ Palestinian extraction from the main joint aquifer, the Mountain Aquifer, has been limited to 17% of joint water; additionally, Palestinians do not have access to water from the Jordan River.⁵⁴ In comparison, water supply to Israeli and Jordanian agriculture is around 6-7 and 14 times higher respectively (about 1,200 mcm/y in Israel, half of which is treated wastewater; and 500 – 600 mcm/y in Jordan).

Expanding irrigation to an additional 1.25 million dunams by 2030, as per our forecast, will require an increase in the water supply of approximately 600 mcm/y (500 cm/y per dunam) – around an eightfold increase.

Such an increase is not as problematic as it may first appear. All of Palestine's neighbouring countries experience acute water shortages: some (such as Israel and the Gulf countries) have taken innovative steps to develop large water desalination infrastructure, which is now a primary source of water for these countries; others (such as Jordan) are in the process of developing this infrastructure themselves (by 2030 desalinated water is also expected to be a primary water source). By 2020, total installed desalination capacity in the Middle East is

[52] Average annual growth for the presented periods. Annual growth rates represent development without substantial growth rate differences between the sub-periods.

[53] IPE: Water, p. 8

[54] World Bank, 'West Bank and Gaza: Assessment of water restrictions on the Palestinian economy', 18 April 2009

predicted to be at around 12,000 – 15,000 mcm/d. For the agricultural sector to grow as predicted (as well as for other uses), Palestine must follow this trend and also make the shift to investing in major desalination infrastructure. With a desalination program of 600 mcm/y (and possibly around 100 mcm/d for domestic use), it will still be one of the smallest producers of desalinated water in the region. In this context, additional allocations from the Mountain Aquifer may be part of the new water supply solution for Palestine, which a reformed Joint Water Committee could discuss.

The critical importance of a desalination program to Palestinian development highlights the importance of Palestinian cooperation with Israel – given the likely need to install necessary desalination plants on both the shorelines of Gaza *and* Israel; the shoreline of Gaza is too short to support the necessary infrastructure alone. Furthermore, desalinated water will need to transit from Gaza to the West Bank, also necessitating Israeli cooperation.

However, this infrastructure will inject an additional element of dependence and vulnerability. Palestine will be critically dependent on Israel for an uninterrupted flow of desalinated water. A proper mechanism needs to be developed to ensure the uninterrupted flow of water to the West Bank.

Other bottlenecks currently impeding agricultural production and exports also require Palestinian-Israeli cooperation. These include the need to create an economic environment that ensures the uninterrupted access of farmers to their lands; that encourages farmers to use more land and invest in irrigation networks; that allows farmers access to high quality fertilisers and seeds; and reliable access to markets. Palestinian-Israeli cooperation will also be useful for unlocking wider sector potential, for example through providing market-orientated vocational and advanced training; improving agricultural extension services; and all other aspects of the eco-system required for the development of advanced export-oriented agriculture.

Cooperation with Israel in all these areas is the best and fastest way for this sector to successfully shift to higher yield crops, increased land under cultivation, and increased integration across the value chain through aggregation of productive units and vertical integration.

Key Projects

Given the small size of the Palestinian economy, a small number of large agricultural projects can serve as important growth engines for the Palestinian agriculture sector as a whole. Such projects – being export-orientated, high-value projects – can be developed in Gaza, the Jordan Valley, the governorates of Jenin and Hebron, and a few other locations. In each of these areas there is the potential to use 100,000 dunams or more for these projects.

The potential value of this type of project has already been substantiated by the successful application of this model in the West Bank in the 1970s and early-1980s, and again in Gaza in the late 1990s and the early-2000s; as well as by larger-scale Israeli farming projects in the West Bank and Gaza (though owned by Israelis, these projects were essentially based on the same economic model: the combination of a trained Palestinian workforce, ample water supply, a supportive agricultural eco-system, and Israeli technology and marketing).

The following is a short summary of two such cases:

- **Gazan vegetable and flower export-oriented project (late-1990s, early-2000s):** This project lasted for almost a decade. It started with the growing of strawberries and flowers for export to European and North American markets; and in its later stages expanded to include cherry tomatoes, peppers, and a few other export crops, on a total area of 3,000 dunams. Israeli experts supplied agricultural instruction and extension, and the products were exported via Israeli agricultural export companies. This cooperation enabled production and packaging which met the high standards required in the target markets, successfully reaching high-end clients at high prices. Average selling prices were around \$4,000 – \$5,000 per dunam. Despite the small land-area of this project (only 0.15% of total cropping area) its exports constituted a large proportion of the total Palestinian agricultural

exports during this period.

- Israeli agricultural settlements in Gaza (up until disengagement in 2005): This project produced various high-value crops, for export to European and other markets, and for the Israeli market, on a total area of about 10,000 dunams. In comparison to the Palestinian projects, this project benefited from more intensive cropping methods, more generous water supply (per dunam), and stronger professional and marketing support. These differences resulted in an especially high value of production of about \$10,000 per dunam.

Manufacturing Industry

The present situation

The Palestinian manufacturing industry includes a diverse group of subsectors, including up to 40 subsectors demonstrating significant activities. The primary subsectors of the manufacturing industry today are: textiles and garments, food processing, engineering and metallurgical industries, chemical industries, pharmaceuticals and veterinary, construction industries, handicrafts, paper and printing, furniture, leather and shoes, processed stone products, and plastics.⁵⁵

The Palestinian manufacturing industry has been hurt severely over the last two decades, though to a lesser degree than the agricultural sector. The share of manufacturing industry in the Palestinian GDP declined from 19% in 1994 to 12% in 2013.

Potential growth under optimal conditions

The Palestinian manufacturing industry is expected to show the strongest surge of growth, in comparison to other sectors, in the first years after shifting to the new, optimal economic and trade regime. This sector will benefit the most from the removal of restrictions, as it will be able to employ unused capacities almost immediately in response to the new opportunities that will be opened in export markets, as well as in the domestic market. Such surges of manufacturing industry growth were recorded in the past, when restrictions were partially removed in the West Bank and in Gaza.

Similar growth have been recorded in other Middle Eastern countries during the first few years of recovery following periods of economic crisis or stagnation. In Egypt the manufacturing industry recorded 38% annual export growth between 2004 – 2007, after a period of economic stagnation. In Jordan 35% annual export growth was recorded between 1996 – 1999, during the first stage of recovery from the economic crisis of the early 1990s; and in Turkey 31% annual export growth was registered between 2001 – 2004, the first years of recovery following a long period of Turkish economic crises and stagnation.⁵⁶

After the first three years of rapid growth, the Palestinian manufacturing industry will benefit more than other economic sectors from the long-term untapped strengths of the Palestinian economy (outlined in Part Two above), including in particular: Palestine's unique bilateral agreements with large markets, its strategic geographical location (proximity to Israel and the GCC markets), and the ample size of its highly-educated and trainable workforce.

Main growth engines of the manufacturing industry

Given these growth-conducive advantages, this report expects the following main growth engines to sustain long term growth of manufacturing industry for the rest of the forecast period:

Enhanced exports to Israel

A detailed analysis of the export-growth potential of key manufacturing subsectors, including the food process-

[55] Paltrade and Peres Centre for Peace, Needs Assessment Study: Increasing Palestinian exports to the Israeli market (NAS Report), p. 7

[56] IPE: Summary, p. 19.

ing and textile and clothing subsectors, shows that – even with only a partial removal of restrictions – exports of manufactured products to Israel can more than triple in 3 – 5 years.⁵⁷ Considering Palestinian industries' proximity advantage to Israel and other strengths, Palestinian share in Israeli import of goods is expected to grow over the fifteen-year forecast period from 1.5% to over 5% (its approximate share prior to the First Intifada).

Exports to Arab Markets

Present Palestinian exports to Arab markets (excluding Jordan) are negligible. The long-term strengths mentioned above would enable Palestine to develop its exports of manufactured products to these markets at least as well as Jordan has done. Jordan sold to Arab markets more than \$4 billion of manufactured goods, equivalent to around 0.5% of total Arab imports of manufactured products.⁵⁸ Our forecast assumes that by the end of the fifteen-year forecast period Palestine is able to gain a market share of between 0.3 – 0.5% of total Arab imports of manufactured products; less than the ratio of Jordan today.

Development of New Export-Orientated Industries led by Multi-National Corporation Investments

Given the high education levels of Palestine's workforce, its advantageous trade agreements with the US, the EU and others, and its membership in GAFTA, this report anticipates that Palestine will be able to attract investment from both multi-national corporations and regional industrial groups. These corporations will set up production facilities in Palestine as a part of their global or regional manufacturing system.

Whilst this report does not expect Palestine to become a major hub on the scale of the large Gulf business centres, it does anticipate that Palestine will develop as a secondary site of production, in line with similar developments in Jordan. Several reports, including the National Export Strategy, point to the following Palestinian industries as having the highest potential for attracting investment from multi-national-corporations: medical and measuring equipment; pharmaceuticals; wire, cable and batteries; electricity distribution and control; soap, cleaning and cosmetics; parts and accessories for motor vehicles; and domestic appliances.⁵⁹

This trend will be encouraged by developing integrated and business-friendly Special Economic Zones (SEZ), providing risk insurance, financial incentives, and developing coordinated marketing of "made in Palestine" brands. Special QIZ-style multi-lateral trade agreements – with Israel, Jordan and other parties such as the US or the EU – can generate new billion-dollar exports as similar agreements did in both Jordan and Egypt.

It is important to note that an individual plant of a multinational cooperation will typically produce and export products to a value of around \$100+ million. Considering the small size of the Palestinian economy, any industrial zone that hosts several such plants – i.e. with a total production value of around \$1+ billion – will more than double the existing Palestinian export of manufactured goods.

Import Substitution and Domestic Market Growth

The Palestinian manufacturing industry has made some advancement, in recent years, in substituting import of consumption products – primarily of processed food products, but also of other categories. This report expects this trend to continue under the new economic and trade regime. Furthermore, as the Palestinian manufacturing sector expands and develop, it will be able to supply a larger proportion of the inputs and intermediate products required for agricultural and industrial production, as well as for construction and other sectors of the economy. This will significantly increase Palestinian value-added across all sectors of the economy. This trend is anticipated to include several large basic industrial projects such as a cement plant, a refinery, an animal feed plant, etc., each contributing \$100+ million to Palestinian GDP; as well as hundreds of new small and medium sized import-substituting plants.

[57] The NAS Report, p. 9-10

[58] Jordan, Department of Statistics, External trade statistics database.

[59] IPE: Summary, p. 21-22

Consequently, the growth in domestic consumption and economic activity – which has been translated until now mainly in terms of import growth – will be translated to a much larger degree into growth of Palestinian industrial GDP in the years following the transition to a new trade and economic regime.

Potential Export Growth

Considering all these export-growth engines, our forecast for exports of manufactured products by 2030 is around \$15 billion, split between export markets as follows: around \$6 billion to each of the Israeli and Arab markets, and around \$3 billion to other markets.

In the first 3 years manufacturing exports are forecast to grow at an exceptionally high rate of 30 – 35% per year. After this initial period growth rates will gradually slow, however the strength of the export growth-engines will still be reflected in double-digit annual average growth until the end of the fifteen-year forecast period.

Potential GDP Growth

Sector GDP is forecast to grow at a rate of 1.25 times the GDP growth rate of the economy as a whole, mirroring the higher value-added of manufacturing industry production. Additionally, this sector is anticipated to account for up to 40% of the increase in export value, representing the expected average ratio of the value-added content of manufacturing sector exports.

Potential Employment Growth

Our employment growth forecast is based on an estimate of an additional job per \$15,000 growth in GDP for the first five years, when growth is expected to occur primarily in more labour-intensive traditional industries. After the first five-years, as new, more capital-intensive industries account for a larger part of growth, this figure will rise to an additional job per \$18,000 GDP growth.⁶⁰

Table 4.3: Manufacturing Industry: Potential Growth under Optimal Conditions (2013 prices, US dollars, real annual growth rate)⁶¹

Year	GDP		Exports		Employment ²⁶	
	USD million	Annual growth rate	USD million	Annual growth rate	USD million	Annual growth rate
Base Year (2015) ²⁷	1,595	-	794	-	108	-
Three Year Forecast (2018)	3,236	27%	1,953	35%	217	27%
Five Years Forecast (2020)	4,660	20%	3,301	30%	312	19%
Ten Year Forecast (2025)	9,358	15%	8,213	20%	573	13%
Fifteen Year Forecast (2030)	15,072	10%	15,000	13%	891	9%

Tourism

The present situation

Palestine is endowed with an exceptionally high concentration of tourist attractions – including religious, historical, cultural, and natural sites. Furthermore, its geographical location is also ideal for joint tourism packages with neighbouring countries (Israel, Jordan and Egypt), which benefit from combined annual tourist entries of close to 20 million per year.

[60] The estimates of the IPE are \$14,000 to \$18,000 per workplace. See IPE: Summary, p. 20.

[61] Average annual growth for the presented periods

Nevertheless, and in spite of a significant recovery since the post-Intifada years, the performance of the Palestinian tourism sector is far below that of neighbouring countries. Number of incoming overnight tourists are around only 0.5 million, compared to ~3 million in Israel, and ~4 million in Jordan.⁶²

Palestinian revenues per tourist are also lower than per neighbouring countries. Palestinian tourism revenues amount to \$250 – 300 million a year, less than 10% of Jordan's incoming tourism revenues of \$4 - 4.5 billion in 2014.⁶³ The share of tourism in Palestinian GDP is small at 2.4% in 2013, and its contribution to employment is almost negligible at no more than 15,000 workers (1.7 percent of employed persons, Table 4.1 above).

Potential sector growth and main tourism growth-engines

The growth potential of Palestinian tourism is second only to the Palestinian manufacturing industry. Given the multiple advantages of Palestine as a tourist destination, under a new economic regime it can – in the long-term – surpass Jordan in both the number of incoming tourists and tourism export revenues. This report forecasts that by 2030 tourism export revenues will reach the present level of Jordanian tourism revenues, namely, around \$4.5 billion. This will be achieved through the primary tourism growth-engines detailed below.

Conversion of “same-day tourists” into overnight visitors

Immediately upon removal of access and movement restrictions, this report expects a trend where existing “same day tourist” numbers will convert into overnight stays (including multiple night stays) in Palestine. Over time the ratio of overnight tourists to same day tourists will increase to somewhere between the Jordanian and Israeli levels (2:1 in Jordan and 4:1 in Israel, compared to almost 1:4 in Palestine at existing levels).

Palestinian hotels have enough existing unused capacity to service double or even triple the number of current overnight tourists. The average occupancy rate in Palestinian hotels is about 25% of capacity (compared to more than 60% in Israel and Jordan).⁶⁴

Israeli-Palestinian Cooperation in Marketing a “Holy Land” Tourism Product

The tourism sector is one of the clearest cases where Palestinian-Israeli cooperation can enable both sides to benefit from significant new revenues. Joint marketing of a combined “Holy Land” product can result in very significant increases to both overall tourist numbers, overnight stays, and spend per tourist, increasing both sector GDP and sector employment in both the Palestinian and Israeli economies. A well-developed and successful “Holy Land” joint-brand could appeal to hundreds of millions of potential Christian, Muslim, and Jewish tourists worldwide; a comprehensive agreement on cooperation in the tourism sector should therefore be an important component of a new trade and economic regime.

Another facet of any cooperation agreement with Israel should be to facilitate and encourage tourists who visit Israel to also spend a night or more in Palestine (and vice versa). Similarly, efforts should be made to encourage tourists who visit Jordan and Egypt to do the same.

Increased Investment and Removal of Restrictions on Tourism Infrastructure

Palestinian tourism infrastructure must be developed, simultaneously, to allow for the anticipated growth in the number of incoming overnight tourists.

[62] We relate to tourists who spend at least one night in Palestine, as the revenue from “same day tourists” who enter and leave the country on the same day is very low. The present number of same day tourists is 1.8 million in Palestine, 0.7 million in Israel, and ~2 million in Jordan. Source: IPE: Tourism, p. 21.

[63] IPE: Tourism, p. 5, 7; Central Bank of Jordan, Monthly Bulletin, Balance of Payment.

[64] IPE: Tourism, p. 7.

Tourism growth forecast under optimal conditions

Considering these growth engines, this report forecasts the number of overnight incoming tourists to triple in the first three years following the transition to the new economic and trade regime, from 0.5 million today, to around 1.5 million. This figure will then continue to rise, at a gradually declining rate, to reach around 6 million by 2030.

Revenue per tourist will increase from the present \$519 per tourist up to around \$800 in 2030, half way between the current levels of Jordan (\$700) and Israel (\$850 – 900).⁶⁵ Given the relatively high ratio of value-added to revenue in tourism, GDP is forecast to grow at a ratio of 0.8 of export revenue.⁶⁶ Employment growth is forecast based on an estimate of an additional job per \$20,000 - \$25,000 growth of export revenue.⁶⁷

Table 4.4: Tourism: Potential Growth under Optimal Conditions (2013 prices, US dollars, real annual growth rate⁶⁸

Year	GDP		Exports		Employment ²⁸	
	USD million	Annual growth rate	USD million	Annual growth rate	USD million	Annual growth rate
Base Year (2015) ²⁹	300	-	255	-	15	-
Three Year Forecast (2018)	756	36%	825	48%	44	43%
Five Years Forecast (2020)	1,246	28%	1,437	32%	74	30%
Ten Year Forecast (2025)	2,416	14%	2,990	16%	141	14%
Fifteen Year Forecast (2030)	3,936	10%	4,800	10%	217	9%

Sectorial analysis of growth potential under different economic and trade regimes

Considerations and Analysis

As emphasised in the Macro Analysis (Part Two above), only a clear and fundamental change in the nature of Israeli – Palestinian economic relations would make it possible for the parties to agree on the termination of the present system of economic and civic arrangements, and negotiate a new system.

Shifting to a MFN or an FTA regime, based on the guiding principle of “Palestinian economic sovereignty”, can enable this change. Whilst the Improved Customs Union (ICU) regime has certain significant advantages in terms of potential growth in exports to Israel and related growth in GDP and employment, it has two very important disadvantages. Firstly, if this regime is chosen, there is a high risk that a large part of the present web of restrictions will remain in place, given the dominating position of Israel in the ICU; consequently a significant proportion of the forecast economic benefits will not materialise. Secondly, it will be much less supportive to the development of trade with non-Israeli markets, primarily Arab markets.

The most promising trade and economic regime, which would enable the Palestinian economic potential to materialise in full, is replacement of the present Quasi-Customs Union trade regime with the FTA. The supplementary enabling elements of the Israeli – Palestinian FTA are also crucial elements for all the key sectors analysed in this report.

[65] See IPE: Tourism, p. 7.

[66] This estimate takes into consideration domestic tourism as well.

[67] Based on IPE: Tourism, p. 28.

[68] Average annual growth for the presented periods

As identified above, realisation of the growth potential of the manufacturing industry will require the negotiation of preferential agreements with third parties, including: QIZ-style arrangements with the US, the EU and other markets; special arrangements for export-oriented free zones; special economic development zones (in the Jordan Valley or in Gaza); and special-status industrial estates. Realisation of the growth potential of agriculture will require comprehensive cooperation agreements between Israel and Palestine on water, marketing to third markets, etc.; and a similar meaningful and comprehensive cooperation agreement between Israel and Palestine is required for tourism. Palestinian exports of agricultural as well as manufactured products to third countries will be enhanced by the freedom to benefit from preferential trade agreements that Israel is not party to, on the one hand, and by business cooperation and Israeli investments in Palestine, on the other.

All these crucial enabling elements can be achieved only under an FTA. The nature of an MFN regime is not supportive of the kind of comprehensive economic cooperation between Israel and Palestine which is essential for the strong and sustainable development of the Palestinian economy as a whole, and for these three key sectors in particular.

Sectorial forecast under the three optional regimes

The tables below summarise our projections for GDP, export, and employment growth for these three sectors, and the rest of the economy, as per the three optional economic and trade regimes. The quantitative factors of the projections reflect the considerations and analysis above, and are explained further in the notes to the tables below.

In Summary:

The strong advantages of the FTA option, in comparison to the MFN option, are shown clearly in this quantitative analysis, which thus supports the analysis in Part 2 of this report. Agriculture, manufacturing industry, and tourism are identified as being the priority sectors for development under an FTA option, as these sectors have the greatest export potential.

Table 4.5: Summary of Sectorial Forecast for 2030 - Improved CU Regime (2013 prices, US dollars, real annual growth rate)

	Year	Agriculture	Manufacturing Industry	Tourism	All other sectors	Total
GDP - USD millions	2015	517	1,595	300	10,064	12,476
	2030	1,962	8,143	2,082	31,129	43,316
GDP - annual growth (%)	-	9.3%	11.5%	13.8%	7.9%	8.7%
GDP - % of total	2015	4.1%	12.8%	2.4%	80.7%	100.0%
	2030	4.5%	18.8%	4.8%	71.9%	100.0%
Exports - USD millions	2015	147	794	255	876	2,072
	2030	1,132	8,553	3,071	1,445	14,201
Exports - annual growth (%)	-	14.6%	17.2%	18.0%	3.4%	13.7%
Exports - % of total	2015	7.1%	38.3%	12.3%	42.3%	100.0%
	2030	8.0%	60.2%	21.6%	10.2%	100.0%
Employment – thousand persons	2015	93	108	15	669	885
	2030	216	488	86	1,772	2,562
Employment - annual growth (%)	-	5.8%	10.6%	12.4%	6.7%	7.3%
Employment - % of total	2015	10.5%	12.2%	1.7%	75.6%	100.0%
	2030	8.4%	19.0%	3.4%	69.2%	100.0%

Table 4.6: Summary of Sectorial Forecast for 2030 - MFN Regime (2013 prices, US dollars, real annual growth rate)

	Year	Agriculture	Manufacturing Industry	Tourism	All other sectors	Total
GDP - USD millions	2015	517	1,595	300	10,064	2015
	2030	1,431	4,415	830	22,279	2030
GDP - annual growth (%)	-	7.0%	7.0%	7.0%	5.4%	-
GDP - % of total	2015	4.1%	12.8%	2.4%	80.7%	2015
	2030	4.9%	15.2%	2.9%	76.9%	2030
Exports - USD millions	2015	147	794	255	876	2015
	2030	284	1,538	721	933	2030
Exports - annual growth (%)	-	4.5%	4.5%	7.2%	0.4%	-
Exports - % of total	2015	7.1%	38.3%	12.3%	42.3%	2015
	2030	8.2%	44.2%	20.7%	26.8%	2030
Employment – thousand persons	2015	93	108	15	669	2015
	2030	169	196	38	1,431	2030
Employment - annual growth (%)	-	4.1%	4.1%	6.5%	5.8%	-
Employment - % of total	2015	10.5%	12.2%	1.7%	75.6%	2015
	2030	9.2%	10.7%	2.1%	78.0%	2030

Table 4.7: Summary of Sectorial Forecast for 2030 – FTA Regime (2013 prices, US dollars, real annual growth rate)

	Year	Agriculture	Manufacturing Industry	Tourism	All other sectors	Total
GDP - USD millions	2015	517	1,595	300	10,064	12,476
	2030	4,750	15,072	3,936	35,003	58,761
GDP - annual growth (%)	-	15.9%	16.2%	18.7%	8.7%	10.9%
GDP - % of total	2015	4.1%	12.8%	2.4%	80.7%	100.0%
	2030	8.1%	25.6%	6.7%	59.6%	100.0%
Exports - USD millions	2015	147	794	255	876	2,072
	2030	3,000	15,000	4,800	1,880	24,680
Exports - annual growth (%)	-	22.3%	21.6%	21.6%	5.2%	18.0%
Exports - % of total	2015	7.1%	38.3%	12.3%	42.3%	100.0%
	2030	12.2%	60.8%	19.4%	7.6%	100.0%
Employment – thousand persons	2015	93	108	15	669	885
	2030	380	891	217	1,863	3,351
Employment - annual growth (%)	-	9.8%	15.1%	19.5%	7.1%	9.3%
Employment - % of total	2015	10.5%	12.2%	1.7%	75.6%	100.0%
	2030	11.3%	26.6%	6.5%	55.6%	100.0%

General notes

(1) The FTA regime – growth rates equivalent to that of optimal conditions.

Notes to GDP growth:

(2) The Improved CU regime is projected to enable optimal level of growth for the first 3 years. Then growth starts weakening, to 80% of optimal level in the coming 2 years, gradually weakening towards a level of 60% of the optimal level by the 10th year, before stabilising at 4% per annum – one percentage point above population growth.

(3) Under the MFN regime the removal of restrictions will be partial, Palestinian exports to Israel will face new custom duties and other barriers, while transaction costs in trading with third countries through Israeli controlled passages (and Israeli ports) will remain high. There will be partial solutions for water supply to Palestinian agriculture, and partial cooperation in tourism. In all three sectors, the initial boost to GDP growth as a result of partial removal of restrictions will generate, in the first 3 years, 50% higher growth than GDP growth of the whole economy, namely 12% a year. Then it will weaken gradually to a level of 2 percentage points above that of continuation of present regime, namely, 4% a year in the last 5 years.

Notes to export growth:

(4) Under the Improved CU regime, exports are projected to develop as follows: the 3 first years – as per optimal forecast, reflecting the effect of removal of restrictions. Then up to the 10th year, gradual weakening towards 70% of optimal, as only exports to Israel will continue to show strong growth, and tourism weakening towards 70%

of optimal growth. Then, agricultural and manufacturing export growth will stabilise at about 6%, and tourism at 50% of optimal growth .

(5) Under the MFN regime, agricultural and manufactured exports to Israel will stagnate, and exports to other markets will take time to develop considerably. Hence, total agricultural and manufactured exports in the first three years will not rise; and in tourism it will rise as per tourism GDP growth. Then, exports to non-Israeli markets will moderately develop. Total growth rate of agricultural and manufactured exports will be 4% a year from the 4th year, and 6% a year from the 6th year (in tourism 6% from 4th year).

Notes to employment growth:

(6) Employment growth under all three optional regimes per all sectors – as per the ratio of annual employment growth to GDP growth in tables 4.2 – 4.4 above.

Part 5: Israeli Benefits

Introduction, methodology, and political assumptions

The costs to Israel of the conflict with the Palestinians has been analysed in several studies over the last few decades, and recently in two comprehensive ones. These two studies have not yet been officially published in full, but the latest drafts have been reviewed and incorporated into the findings of this report.⁶⁹ The following section draws on both these works and combines them with our own research and analysis.

This analysis identifies two types of costs to Israel:

- Explicit costs (such as the direct costs of defence and security);
- Costs of untapped potential (such as the indirect costs of lost tourism and lost exports to Arab countries).

The shift towards a new political and economic environment will enable the gradual elimination of the explicit costs of conflict, and the gradual materialisation of the untapped potential. This report quantifies these benefits in terms of the expected contribution to Israeli GDP, exports, and employment.

The present situation, for each of these three sectors, serves as the starting point for our forecast for a period of 10 years from shifting to the new regime.⁷⁰ The forecast is presented under two possible scenarios. The first scenario assumes that, concurrently with the agreement on the new FTA regime, Arab markets are opened to direct Israeli exports. The second scenario assumes that only indirect Israeli exports are permitted to enter Arab markets; namely, through Palestinian (or other third-country) exporters, or as inputs / semi-finished products embedded in Palestinian (or other third-country) exports to Arab markets. Under the first scenario Israel is forecast to enjoy the full extent of the “peace dividend”, while under the second scenario Israel’s benefits are partial.

The underlying political assumption is that the positive political atmosphere, which is a precondition for engaging in serious negotiations and achieving an FTA agreement, will also involve the moderate Arab countries (Egypt, Jordan, the Arabian Gulf countries, and certain North African countries). The first scenario assumes that this positive atmosphere will be translated into gradual opening of Arab markets to direct exports from Israel. The second scenario assumes that formal and informal restrictions on direct Israeli exports to Arab markets will not be removed until the signing of a final status agreement, but that indirect Israeli exports will be allowed.

Direct costs

The main costs of the Israeli-Palestinian conflict are identified as:

- **The burden of defence and defence-related costs:** Formal defence costs have been at a magnitude of about 7% of GDP in recent years. However, according to detailed analysis of a wide set of additional defence-related costs, overall defence costs are estimated at about 11% of GDP.
- **Loss of GDP associated with periodic escalation of the conflict:** The loss of GDP in the wake of the Second Intifada was at the magnitude of 4 percentage points in 2002 (compared to growth rates of previous

[69] Zeira & Wolfson (the Aix Group), “Barriers and Obstacles and The Cost of Occupation” (unpublished draft, 2014); and Yarom Ariav, Eldad Brik and others (the Israeli Peace Initiative Movement), “The Effects of Regional Political Settlement on the Israeli Economy” (in Hebrew, unpublished in full, 2014).

[70] Given the much stronger position of the Israeli economy, this report expects the benefits of shifting to the new regime to develop in full over a shorter period than in the Palestinian case. A 10-year forecast period is therefore judged to be sufficient for demonstrating the magnitude of these benefits.

- years), while the GDP loss of “smaller-scale” rounds of violence was usually between 0.5 – 1 percentage points.
- **Costs of settlements:** Estimated at between 0.5 – 1% of GDP per year.
- **Costs of economic boycott:** In recent years the tendency to boycott Israel, with or without the settlements, and to boycott investment in Israel or in specific areas in Israel, is gaining momentum. Until now the GDP or export loss caused by this trend has probably been relatively insignificant. However, if the present situation continues this effect may become more substantial.

The shift towards a new political and economic environment is expected to gradually lower the defence costs, eliminate the loss of GDP associated with recurrent rounds of violence, prevent economic boycott, and gradually lower the cost of settlements. The cumulative effect of all these elements may reach the magnitude of at least 1.5 – 2 percentage points of GDP per annum, over the ten-year forecast period.

Untapped growth potential

Under the first scenario (i.e. assuming the full extent of benefits to Israel), the envisioned FTA regime is expected to enable the following:

- **Enhanced exports to the Palestinian market:** Enhanced exports to Palestine will be seen in (a) finished products, as demand for Israeli consumption products will increase with Palestinian GDP growth and higher Palestinian household incomes; (b) equipment and inputs to the fast growing Palestinian industry, agriculture, etc., and (c) Israeli exports of inputs for the growing volume of Palestinian exports to Arab and other markets. Given the forecast of Palestinian GDP and export growth under the envisioned FTA regime (as detailed in Part Two above) the derived figure of Israeli exports of goods and services to Palestine is forecast at \$8 – 10 billion by the tenth year of shifting to the new regime. Although this figure is only double the present figure of approximately \$4.5 billion, more than 50% of present Israeli exports to Palestine are fuels, energy, and imported goods of low Israeli value-added. These exports will be eliminated under the new trade regime, and almost all of the projected \$8 – 10 billion of Israeli exports will be industrial or agricultural products (or services) with significant Israeli value-added.
- **The opening of Arab markets (in due time) to Israeli exports of goods and services:** The opening of Arab (primarily Gulf) markets both directly and via various types of cooperation with Palestinian exporters. Considering the technological and other advantages of Israel in comparison to regional competitors such as Jordan or Turkey, this report expects that Israel can gain, in ten years, a much larger market share in Arab markets than Jordan (which is today about 0.5 percent of Arab imports of goods), and probably aim at a long-term market share that will be closer to that of Turkey (which is today about 4%). Given total Arab import volume of above \$150 billion (at constant 2013 prices), predicted in ten years, and assuming Israeli market share of no less than 2% under an FTA regime, Israeli exports of goods and services to Arab markets is forecast at above \$30 billion by the tenth year from shifting to the new regime.
- **Tourism:** Israeli tourism growth is expected to develop at least as fast as Palestinian tourism under the FTA regime. Assuming 8 million tourists by the tenth year (in comparison to about 3 million incoming tourists today), at an average revenue of USD 1,000 per tourist, this report forecasts additional tourism export revenue of about \$5 billion.
- **Expansion of other sectors:** Expansion of other economic sectors, including transportation and logistical services, small and medium businesses in the Israeli Arab sector, and more, would be translated into additional significant growth.
- **Foreign investment:** Foreign investment is also expected to experience significant growth.

Israeli benefits under the “Full Extent” scenario

GDP Growth and the effect on GDP per capita

Considering the analysis above, this report forecasts GDP gain of at least 2 percentage points per annum, on average, over the ten-year forecast period (in 2013 constant prices).

This additional growth is very important for Israel. Under the present economic and political situation, Israel can expect annual real long-term growth of about 3% a year; equivalent to merely 1 – 1.5 percent growth per capita. The additional growth of 2 percentage points per year (and maybe even more) under the new economic and political regime will more than double the GDP per capita growth rate. As a consequence, Israeli GDP per capita of about \$37,000 in 2013 can rise to about \$50,000 in ten years (at 2013 prices). At this level of GDP per capita, Israel will have jumped by the end of the ten-year forecast period close to the top fifteen richest countries in the world.

Export Growth

Considering the analysis above, the cumulative annual export gain (goods and services) as a result of shifting to the new FTA regime and the new political environment is expected to be \$45 --50 billion in ten years. This is approximately a 50% increase of Israel’s present export levels (goods and services, at constant 2013 prices). Palestine’s share of Israeli exports will be \$8 – 10 billion, and other Arab markets will absorb \$30 billion of Israeli exports. At this level of exports Arab markets will become, side by side with the EU, the most important destination for Israeli exports, far above Israeli exports to the US or other markets. This prediction may look strange at present, this is the normal situation for other exporting countries in the region, such as Turkey or Jordan. Once Israel is accepted into the regional trading system, under this scenario, one can expect it to become an important player in this arena.

The Effect on Employment

The ratio of GDP per employed person in Israel – \$84,000 in 2013 – can be used as a rough estimate for the contribution of GDP growth to employment.⁷¹ At an additional real growth rate of 2% per annum, the cumulative contribution to GDP of shifting to the new regime would be \$64 billion in ten years. Hence, the derived total contribution to employment is around 750,000 new jobs; namely, 75,000 new jobs per annum. This figure represents an addition of almost 75% to the annual number of new jobs that have been created in Israel over the last decade (2003 – 2013). Even more importantly, a large part of these new jobs are expected to be lower-level jobs in industry, tourism, transportation, logistical services, etc., and in the Israeli Arab sector – where Israeli unemployment is presently the highest.

[71] GDP of \$290 billion to 3.45 million employed persons. Source: ICBS and the IMF.

Chart 5.1: Israeli GDP and Exports Ten-Year Forecast: Contribution of Shifting to the FTA Economic and Trade Regime with Palestine (billion US dollars, ten-year from shifting to the new regime, 2013 prices)⁷²

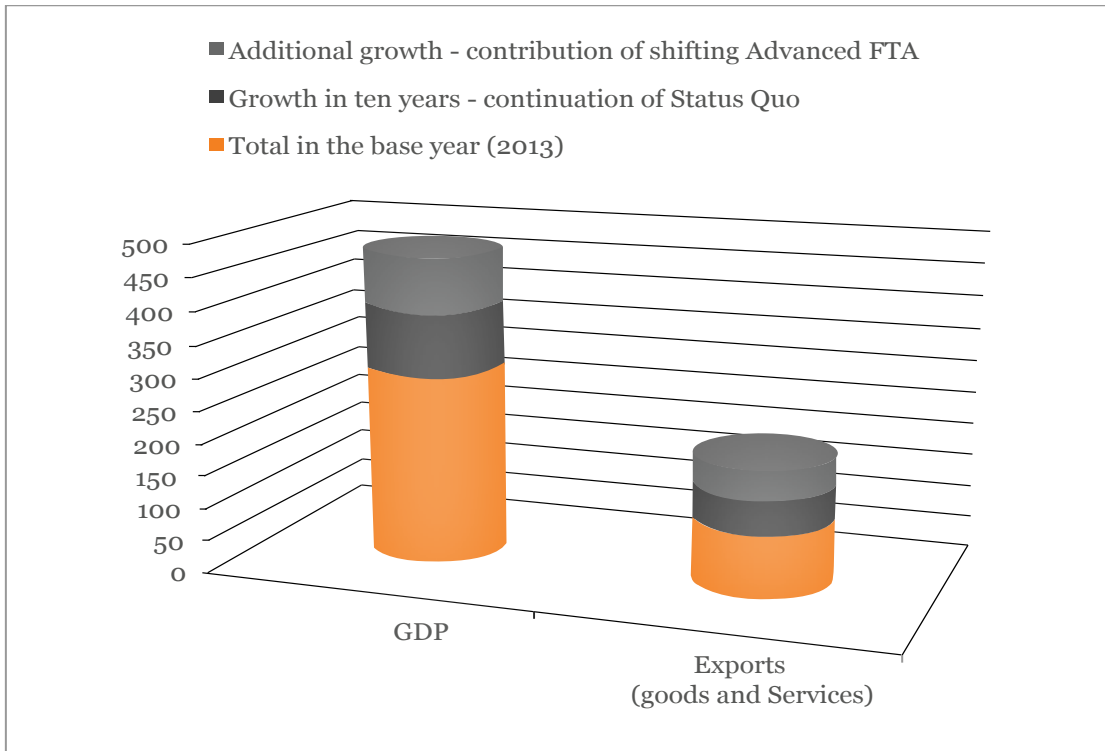
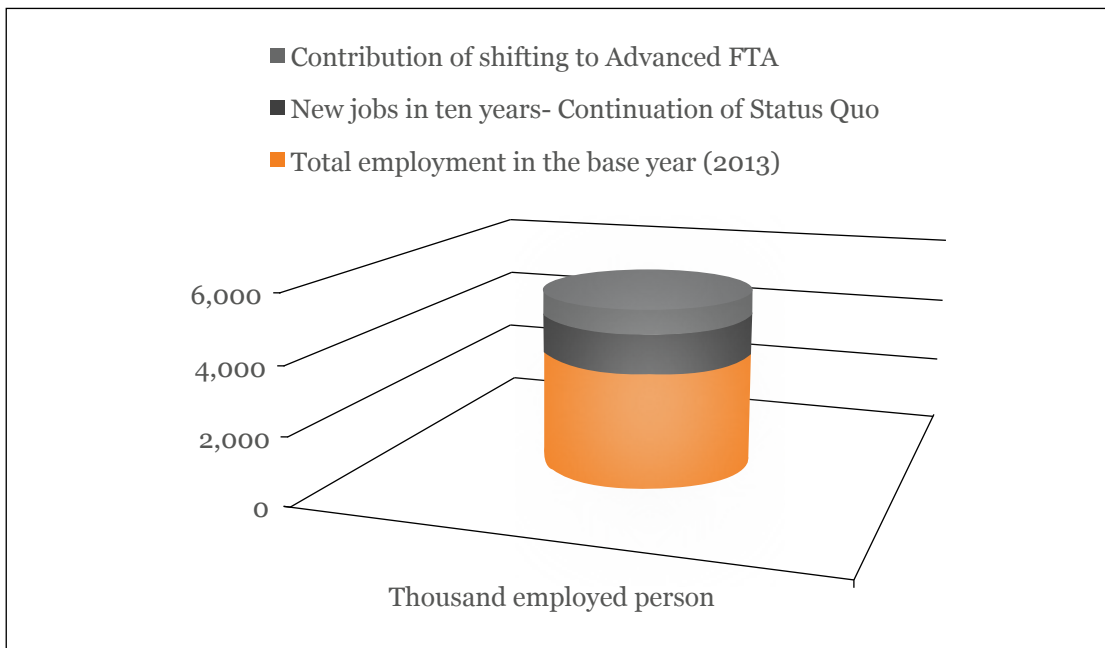


Chart 5.2: Israeli Employment Ten-Year Forecast: Contribution of Shifting to the FTA Economic and Trade Regime with Palestine (thousand employed persons, ten-year from shifting to the new regime, base year - 2013)⁷³



[72] 2013 base-year figures: ICBS National Accounts in constant prices, Balance of Payments statistics, and labour force statistics; IMF – 2013 GDP in USD

[73] 2013 base-year figures: ICBS National Accounts in constant prices, Balance of Payments statistics, and labour force statistics; IMF – 2013 GDP in USD

The “Partial Benefits” scenario

The main effect of this scenario, in comparison to the previous one, is on Israeli exports to Arab markets. If Israeli is not allowed to export directly to Arab markets (in particular, to the very significant markets of the Arab Gulf countries), this report expects that Israel will lose around one half of its potential sales to these markets. The other half, approximately \$15 billion after ten years, will be channelled to these markets through Palestinian (and other third-country) exporters.

Cumulative Israeli export gain will therefore be reduced to around \$30 - \$35 billion. GDP gain will be lower by about 0.5 percentage points (compared to the 2 percentage point gain under the “full extent” scenario), and employment gain will decrease accordingly.

In Summary:

Israel will gain tremendously from shifting to the new FTA economic and trade regime with Palestine. This change can be a major growth-engine of Israel in the forecast period, raising Israeli GDP per capita to a level close to the top fifteen richest countries in the world, generating cumulative export gain of 50% of the total present exports of Israel, and contributing as many as 75,000 new jobs per annum. However the benefits to Israel will be between one-quarter to one-third lower if Arab markets are not opened to direct Israeli exports.

Conclusions

Palestinian – Israeli economic relations are at an impasse. The West Bank is now experiencing declining income per capita, rising unemployment, and higher poverty, while Gaza continues to endure recurrent humanitarian and economic crises. The unsustainability of the *status quo* is painfully clear.

The economic viability and fiscal sustainability of the current economic regime have been lost; a paradigm shift is necessary to break the impasse and transform the future of the Palestinian economy. Only a clear and fundamental change in the nature of Palestinian – Israeli economic relations will make it possible to cut through the constraints, restrictions and bureaucracy which hold back Palestinian economic development and impede progress on the political track.

The optimal economic and trade regime for Palestine is a FTA with Israel. Under this strategy Palestinian real GDP is estimated to increase from \$12 billion to \$44 billion in around ten years, experiencing double-digit growth rates for a decade (as has been the experience of other post-conflict countries, such as Bosnia).

A package of transitional measures, as presented in this report, if taken collectively, will create a critical mass for change, start a process of dismantling the matrix of economic restrictions, and put in motion a virtuous circle of private sector confidence, new investment, and growth momentum for the Palestinian economy.

The recommended agreement on the new FTA economic and trade regime can be achieved without necessarily reaching a final status agreement. The underlying political assumption is that a good faith political process will resume with the aim of reaching an agreed resolution to the conflict. Furthermore, the FTA negotiations can take place under the umbrella of the Euro-Mediterranean economic and financial partnership process.

The clear comparative advantage for Palestine of the FTA economic and trade regime is consistent with the findings of the 2007 PIBF-NIR Study. This consistency, in spite of the substantial changes in circumstances, reaffirms the conclusion that an FTA is the best economic and trade regime for Palestine.

The process of transition to a new trade and economic regime may occur either as an accompanying part of a Final Status negotiation with Israel, or separately, as an economic agreement, should the political track be proceeding more slowly.

In the first five years, the most important growth engine will be the removal of Israeli economic restrictions on Palestinian activity. As restrictions are removed, existing unused Palestinian production capacity and investment potential can be harnessed to generate fast and sustainable growth. Once the initial 'booster' effect of removing restrictions has passed, exports become the single most important long-term growth engine of the Palestinian economy. Continuous fast development of Palestinian exports is identified as the single most important long-term growth engine of the Palestinian economy, generating continued economic growth long after the initial 'booster' effect of removing restrictions has passed.

Israel will also gain, tremendously, from shifting to the new FTA economic and Trade regime. This change can be a major growth-engine of Israel in the forecast period. It could raise Israeli GDP per capita to a level close to the top fifteen richest countries in the world.

Annexes

Annex 1: Economic Restrictions Imposed by Israel on the West Bank and Gaza

For over a decade, the Palestinian economy has been subjected to severe restrictions imposed by the Government of Israel (GoI). In doing so, Israel has assumed full control of the key parameters of Palestinian economic life. The main vectors of these controls can be summarised under four headings:

1. Market fragmentation
2. Limitations on use of national resources
3. Restrictions on internal and external movement and access
4. Permit requirements

Market fragmentation

The West Bank and Gaza, with different resource endowments, investment potential, and income levels, are complementary economies. The free flow of people and goods between the two areas would benefit both economies and would reduce income differences. Gaza's seafront and the possibility of a deep water seaport would turn it into the gateway for Palestinian international trade. Its offshore natural gas reserves would endow the Palestinian economy with cheaper sources of energy and strengthen its competitiveness. Yet Gaza has been cut off from the West Bank and East Jerusalem, either through movement restrictions or through the imposition of a siege, which has now been lasting for eight years. As of 2015, the Gaza economy is completely delinked from the West Bank due to the continuing Israeli siege.

East Jerusalem, which was the hub of Palestinian economic and cultural activity, has also been cut off from the West Bank. Its 250,000 residents, with the highest per capita income in Palestine, constituted a major market for West Bank and Gaza producers until 2005 when it was physically divided by the separation wall.

Conversely, much of the East Jerusalem population was employed in the service, tourism and trade sectors serving West Bank and Gaza visitors. These visits and trade links have been sharply reduced due to the separation wall and the denial of permits to access the Palestinian capital.

In addition to being cut off from Gaza and East Jerusalem, the West Bank has suffered its own fragmentation. The carving of the West Bank into areas A, B and C under the Oslo agreements and Israeli refusal to redeploy from Area C, has given Israel full sovereignty over Area C. The proliferation of Israeli settlements in Area C, and associated "closed military zones", checkpoints, and the road networks required to protect them, have taken most of the West Bank's agricultural land out of economic development. This is particularly true of the Jordan Valley, which has been depopulated due to restrictions on access and the loss of investment and job opportunities. The construction of the separation wall, in some areas deep into the West Bank, has taken out another 8% of West Bank land. Access to this "seam zone" by farmers has been very difficult, with many farmers giving up on exploiting their land.

Israeli settlements, the separation wall, and the Israeli military infrastructure have parcelled the West Bank landscape into small enclaves where Palestinian villages attempt to survive economically. With a very limited land mass, the carving out of the West Bank into these scattered enclaves has prevented the establishment of large, profitable enterprises, from benefitting from economies of scale. Thus, the Palestinian agriculture and manufacturing sectors have regressed into small enterprises, mostly catering to local demand.

Limitations on use of natural resources

Palestine has substantial natural resources which are left largely unexploited due to Israeli imposed restrictions on land utilisation, water usage, energy resources and mineral deposits.

Land

Land utilisation is limited by virtue of Israel's full sovereignty over Area C. Expansion of settlements, which have taken up 68% of the West Bank when counting municipal boundaries, road networks, and areas dedicated under master plans for development, have deprived Palestinians of large areas of fertile land as well as territorial contiguity. In addition, land closures under military and firing zones have absorbed another 21% of Area C and 10% have been dedicated to "Natural Reserves". Nevertheless, Palestinians could have access to 326,400 dunums of fertile land if allowed to develop it.⁷⁴

Water

Water usage has also been restricted under the Oslo agreements to 17% of joint water allocation of 601 MCM, while Israel has appropriated 83%. It should be pointed out that the Mountain Aquifer, which is the source of most of the water for both countries, lies essentially under the West Bank. Yet only 20% of its discharge benefits the West Bank. Moreover, after 1967, when Israel took control of all water resources in Palestine, Palestinians lost access to water from the Jordan River.⁷⁵ Water per capita is one fourth of what is available in Israel and it has been declining over time, resulting in the lowest access to fresh water in the region. Nor are Palestinians allowed to dig wells, which in many cases are drying out. This water scarcity has not only reduced the quality of life for the population but it has also inhibited agricultural development.

Gaza is suffering a far more acute water crisis. Over-abstraction from the coastal aquifer has increased the level of salinity to the extent that it is virtually undrinkable. Yet the Israeli water company (Mekorot) is unwilling to raise its water supply to Gaza, while Israeli restrictions on imports of capital equipment prevent Gaza from developing its own desalination projects.

Energy resources

Natural gas resources were discovered offshore from Gaza about eight years ago, and crude oil has also been discovered in the northern West Bank within the last two years. Yet development of these resources has been delayed by the Israeli Government. In the case of natural gas, a full-fledged extraction project – Gaza Marine – has been developed and ready for execution for several years. However, it cannot be implemented unless approval is given by Israel.

Palestine is largely reliant on the IEC to supply it with its electricity needs (about 300 MW). The pricing of Israeli electricity is the highest in the region, and reduces competitiveness. Exploiting Gazan natural gas is particularly important to reducing Palestinian dependence on the IEC and developing efficient electricity generating stations. Plans to upgrade and expand the Gaza electricity generating station and to build two electricity generating stations in the West Bank are also relevant. However, this will only be possible when a reliable source of natural gas becomes available.

Mineral deposits

Extraction of potash, bromine and magnesium from the Dead Sea has been a major source of income and employment for both Israel and Jordan. Israel generates annual sales of \$3 billion of Dead Sea minerals, while Jordan earns \$1.2 billion or 4% of its GDP. The World Bank estimates that Palestine could generate yearly income equivalent to 9% of GDP if it had access to Dead Sea minerals.

[74] World Bank: West Bank and Gaza: Area C and the Future of the Palestinian Economy. October 2, 2013.

[75] World Bank: West Bank and Gaza: Assessment of water restrictions on the Palestinian Economy April 18, 2009.

The Palestinian mining and quarrying industry has been the source of a major Palestinian export (stone and marble). Nevertheless, it is a struggling industry because of its inability to open new quarries, which requires licensing from Israel. No new permits have been issued for mining and quarrying since 1994 and many existing licenses, which have expired, have not been renewed. Moreover, some of the key machinery and inputs needed for quarrying is under the “Dual List”, and cannot be imported, thereby preventing new investment in existing quarries. The World Bank estimates that current stone output of \$250 million could be doubled if these restrictions were lifted.⁷⁶

Electromagnetic spectrum

Under the Oslo agreements, Palestinian access to the Palestinian electromagnetic spectrum is supposed to be allocated based on need, via a process managed by the Joint Technical Committee. In practice, Israel has used the Committee to heavily restrict Palestinian access to Palestinian spectrum on security grounds, and has treated the electromagnetic spectrum in both the West Bank and Gaza as being part of the Israeli electromagnetic spectrum.

The Israeli approach in dealing with spectrum has resulted in huge limitations on the development of the Palestinian telecommunications sector, with categories of spectrum needed for the deployment of modern technologies, such as 3G and 4G, having been restricted entirely. Moreover, this approach has strengthened Israeli commercial interests unfairly, providing the Israeli cellular communications industry with unequal access to the Palestinian market. Without access to the Palestinian electromagnetic spectrum, the Palestinian telecommunications sector will be unable to provide modern services and therefore unable to grow or remain competitive.

Restrictions on movement and access

Restrictions on movement and access within the West Bank, and between the West Bank and Gaza and East Jerusalem, have been amply documented in World Bank, PALTRADE, OCHA and UNSCO reports.⁷⁷

Palestinians cannot move between the West Bank and Gaza, or within the West Bank to East Jerusalem, unless they get permission from the Israeli authorities. This undermines labour mobility and makes it difficult for students to study at the Palestinian university of their choice. Most students in Gaza had to forego higher education for lack of travel permits to the West Bank or abroad. Moreover, many Palestinians residing in East Jerusalem or the West Bank are reluctant to travel abroad for extended periods of training, education, or work, for fear of losing their residency status. Under this restriction, over 9,000 Jerusalem residence permits have been withdrawn from Jerusalemites during 2001-2013.⁷⁸

Nor are Israelis allowed to go to Area A unless they obtain a permit. This has markedly reduced business interaction between Israel and the West Bank, particularly Israeli subcontracting to Palestinian enterprises, or the initiation of any joint projects. Israeli shopping in neighbouring Palestinian towns, such as Qalqilya, has been eliminated by the construction of the separation wall and movement restrictions. Palestinian border trade in fruits, vegetables, and handicrafts with Israel was both substantial and lucrative for Northern West Bank Palestinian communities, but was virtually eliminated by the construction of the Wall and restrictions on Israeli movement to Area A.

The many checkpoints and barriers within the West Bank, the isolation of the West Bank from East Jerusalem and from Gaza, the loading and unloading of goods going in and out of the West Bank and the inability to travel freely in and out of Palestine, have raised transaction costs, undermined competitiveness, and stymied investment and technological change.

[76] World Bank: Area C and the future of the Palestinian Economy, p13 op. cit.

[77] World Bank: Stagnation or Revival? December 2004; PALTRADE, Gaza Strip Crossings: Bimonthly Monitoring Report; West Bank Crossings: Bimonthly Monitoring Report, several issues. UNSCO Socio-Economic Reports 2009.

[78] UN OCHA protection of civilians, weekly reports.

Severe limitations imposed on trade links with Gaza undermined its export oriented economy and hindered economic integration with the West Bank. These trade links were expected to be institutionalised and expanded under “The Agreement on Movement and Access” of November 15, 2005, drafted by the World Bank, the US, the PA and the GoI, by increasing the volume of trade through the crossings with Israel, establishing a free corridor to the West Bank for the passage of people, and by opening export and import trade with Egypt through Rafah. However, under adverse political pressures and repeated obstacles set against it, this agreement was never implemented.⁷⁹

Control by Israel of all external borders have also prevented most Palestinians from traveling abroad and many Diaspora Palestinians from visiting Palestine, through denial of permits or visas. This has been particularly costly for industries which needed to invite professionals from abroad or send workers and management to other countries for training. Palestinian Universities, which must maintain a free flow of scholars in and out of Palestine to bolster their research and teaching activities, have been stifled and isolated from the rest of the world.

These travel restrictions have severely limited transfers of technology, stymied innovation and inhibited the exchange of ideas which is becoming all the more critical, as Palestinian exporters, including exporters in knowledge-based industries, attempt to position their products favourably in the global economy.

Permits

For the Import of Equipment and Materials:

Israel restricts the import and transfer of a long list of civilian machinery, spare parts equipment, chemical and telecommunication equipment to the West Bank and the Gaza Strip under a vague and unprecedented “dual use goods” list. Thus imports of capital equipment by Palestinian enterprises either face long delays at Israeli ports, ostensibly for security reasons, or are prevented altogether. For instance, capital equipment destined for Wataniya Mobile in Gaza has been held at the port of Ashdod for over two years. Farms and factories have been denied permits to import a wide variety of raw material, inputs such as chemicals and fertilisers, and capital equipment. Aside from the cost entailed in seeking approval, and the long delays incurred in obtaining them (sometimes stretching into years), Palestinian enterprises seeking permits have been inhibited from replacing obsolete machinery, upgrading technology, and improving labour productivity. Restrictions under dual use in agriculture, industry, and ICT, are estimated to have cost the West Bank economy at least \$160 million per year or 5% of GDP.⁸⁰

Infrastructure Development

Infrastructure projects in Area C, such as building a school, digging a well or paving a road, must be approved by the Civil Administration (COGAT) in charge of the occupied territory. Considering that Area C covers a large area of the West Bank (61% of the West Bank), and that land distances in the West Bank are all short, most infrastructure projects would need to be at least partly located in Area C. Water mains and sewage treatment facilities have often been stymied at the Joint Water Committee for lack of approval by the Civil Administration. The Rawabi housing project near Ramallah was delayed for a couple of years because it needed approval of a short access road through Area C; it is now delayed again because it has not been provided access to water by Israeli authorities.

[79] See the former World Bank President, Jim Wolfensohn’s interview with Haaretz, March 2006.

[80] See: The Impact of Israeli restrictions on the Transfer of Dual-Use goods to the West Bank; USAID, Trade Facilitation Project January 2010.

Labour in Israel

Movement of Palestinian labour into Israel has also been highly restricted, reducing the number of workers allowed to work in Israel from 132,000 in the third quarter of 2000, to about 50,000 in 2013.⁸¹ This has reduced workers' remittances from close to \$1 billion in 1999 (16% of GDP) to about \$380 million in 2013, at constant prices, or 7% of GDP.⁸²

Construction in Area C and East Jerusalem

The most severe permitting requirement has targeted construction of new housing and expansion of existing housing in Area C and in East Jerusalem. The denial of most permit requests has forced Palestinian residents to build houses without permits, which in turn, has led to house demolitions by the Israeli authorities. Over 10,000 houses have been demolished since 2001.⁸³ This trend has accelerated in the last two years. In 2014, 1,177 houses have been demolished in Area C and East Jerusalem.⁸⁴ This, coupled with higher demand for housing by a rapidly growing Palestinian population, has forced many residents to live in overcrowded conditions, move to areas A or B, or migrate abroad.

Finally, the granting of permits, whether for the construction of housing or for workers to work in Israel, or for the import of capital equipment, is essentially discriminatory. It favours some workers over others, and some businesses or communities over others. It is both a distortion in the allocation of resources and inequitable in its impact, with some negative consequences on productivity and income distribution. In keeping with the historical "divide and rule" policy favoured by most occupying countries, it adds to the fragmentation of Palestinian society, exacerbating divisions between those who have been privileged by the permitting policy, and those who have been denied.

These restrictions, coupled with the absence of any Israeli public investment in infrastructure in the West Bank, except for projects needed to service the settlements, have resulted in a degradation of Palestinian infrastructure to levels well below those consistent with lower middle income countries. In particular, the lack of seaports and airports, and the limited capacity of the King Hussein Bridge to Jordan in handling Palestinian exports and imports, have channelled most Palestinian trade through Israeli agents and port facilities at a substantially higher cost.

[81] In addition, in 2013, there were about 30,000 working in Israel without permits, and 22,200 working in settlements. PCBS labour surveys, and Israel's Central Bureau of Statistics.

[82] PCBS: National Accounts and Balance of Payments statistics

[83] Israeli Committee against House Demolitions Press Statement, August 2013. Amnesty International: Under the Rubble: House demolition and destruction of land and property. May 18, 2004.

[84] UN OCHA January, 2015.

Annex 2.1: Econometric Regression Model of Palestinian GDP Growth

Executive Summary

Regression techniques enable a statistical analysis of the quantitative relationship (correlation) between one or more independent (explanatory) variables and one dependent variable. The specific method used here, namely OLS (Ordinary Least Square), refers to the statistical method of applying the line of best fit to the data available. This method indicates the quality of the model being examined, providing a statistical evaluation of the ability of the explanatories to explain the dependent variable.

The 'security and other restrictions' model uses a synthetic index data, built using data on Israeli casualties (source: Shabak) and the number of movement obstacles and days of closure in the West Bank (source: Betselm) over multiple years. Relaxed years such as 1998-1999 received the index of 0, the worst years of the second intifada received an index of 3. This method provided us with the ability to estimate the effect of each escalation level (1,2,3) on the economy.

The results of this regression analysis are statistically very robust, with high explanatory levels and solid significance, both in general and by any individual factor. The effect of the 'security and other restrictions' level on the Palestinian economy stands at 10% for every escalation level, and is therefore highly significant.

The coefficient of "global growth" is about 2 and this result is also highly significant.

In a world with of minimal level of conflict and restrictions (level 0, such as in 1998-99), along with annual "global" growth rate of 6%, the West Bank annual medium-term predicted growth (five years) according to this model is more than 15%.

Methodology

Our quantitative analysis of data regarding the West Bank and Gaza is based on an econometric method which evaluates the effect of explanatory factors on the subject of interest. The analysis uses regression techniques that enable a statistical analysis of the quantitative relationship (correlation) between one or more independent (explanatory) variables and one dependent variable. The specific method used here, namely OLS (Ordinary Least Square), refers to the statistical method of applying the line of best fit to the data available, in which the distance between each data point and the regression line is squared and added together. The OLS model minimises this number, essentially minimising the total distance of data points from the line of best fit. The line of best fit is characterised by the coefficients of each.

OLS coefficients: Each explanatory variable of an OLS model has a value associated with it. These values are the model coefficients. If the independent (explanatory) variable increases by one unit, then the dependent variable (subject of interest) should increase by the coefficient value. This method also indicates the quality of the model that is examined, which means a statistical evaluation of the ability of the explanatories to explain the dependent variable. The terms below are used to explain the statistical quality of the models.⁸⁵

R-square: The R^2 value describes how much of the variance data is explained by the model, based on how much variation there was to explain in the first place. It does so by comparing the differences between the data points

[85] This source was used for some of the terms: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/182368/vt-annex3.pdf

and the mean (original variation) to the differences between the model function and the mean (model variation). The value ranges from 0 to 1, with values closer to one representing greater explanatory power of the model.

P-value: This provides a measure of the statistical significance of coefficients by stating the probability of that coefficient estimate being equal to zero; i.e. the variable has no effect on the dependent variable. A p-value ≤ 0.1 indicates that the coefficient is statistically significant at the 10% level; i.e. there is a 10 percent that the variable has no real effect on the dependent variable. Normally a p-value of 0.05 or below is the criteria for significance.

T-test: A statistical test used to determine the p-value of a parameter (including coefficients). For regressions, it is generally used to determine if the parameter is statistically different from zero. Once the t-value is determined, it can be compared to the threshold value on a t-test lookup table to determine what level of significance the parameter has based on the p-values of those threshold t-values (e.g. the chance of being wrong is 10 percent, 5 percent, 1 percent, etc.).

Confidence interval: These indicate the within which the estimated parameter lies based on the set confidence level. For example, if an interval is given for 95 percent confidence, there is a 95 percent probability that the true value lies within the range of the estimated parameter.

F-test: A test of significance similar to a t-test, but rather than testing one coefficient or parameter, an F-test is global/evaluating the significance of the entire model. It is used for simple bi-variate and multiple regression. The F-ratio compares the average variability in the data that a given model can

The advantage of this method is that it obtains quantitative results and gives a statistical self-examination of prediction quality regarding the data that it supplies. The weakness of this method, for our purposes, is that an absence of an explanatory variable might be reflected through the variables in use (if correlated) and cause a bias coefficient. Another factor that is significant in our examination is the small number of observations. Higher number of observations might have produced more robust results.

The source of the national accounting data is the Palestinian Central Bureau of Statistics, which has collected this data since 1994. In this period of time the Palestinian Authority has started to develop its own distinct economy, which is the subject of this research. The last year of data used in this research is 2013.

All prices are in US Dollars adjusted on the base of 2004, as per the publicised material. Therefore, all variations are real and not nominal. In 2009 the Palestinian Central Bureau of Statistics made a few changes regarding the sub-sector constituents of several of the economic sectors under review (e.g. air-conditioning and steam were added to the water and electricity sectors). We judge the potential effect these changes could have on our analysis to be negligible; any areas where these changes could potentially be of any relevance are accompanied by an explanatory comment.

Analysis: Security and restrictions in the West Bank

Data

The models regarding security are restrictions use a synthetic index data, built using the number of Israeli casualties and number of movement obstacles and days of closure in the West Bank over multiple years. During the first decade under analysis (1994 – 2000) the number of Israeli casualties is taken to be a good proxy for the number of restrictions, including closed routes, closures, and curfews. From 2000 onwards (including the period of the Second Intifada and after) the system of restrictions existed independently from Israeli casualties to a much greater extent (i.e. restrictions would still be in place even on relaxed days), and do therefore not necessarily correlate to one another. For these years, information regarding the number of days of closure and the number of obstacles is easier to obtain, and is used as the dominant component in defining the level of restrictions along with the number of casualties. Relaxed years such as 1998-1999, with considerably lower number of casualties (and lower number of correlating obstacles and closure days) received the index of 0, whereas the

worst years of the Second Intifada received an index of 3.

This method provided us with the ability to estimate the effect of each escalation level (1,2,3) on the Palestinian economy. The shortcoming of such a method is that it enforces a linear relationship between the escalation levels and the implications, meaning that differentiation of each escalation level from the level below will be similar in the model but not necessarily in reality.

Table A2.1.1: The Security and Restrictions Data and Index, 1994-2012:

Year	Number of Days of Closure ³⁰	Movement Obstacles in the West Bank ³¹	Israeli Casualties by Palestinians ³²	Israeli Casualties origin by WB ³³	Security and Restrictions Index-WB
1994			68		2
1995			49		1 ³⁴
1996			71		2
1997			22		1
1998			11		0
1999			4		0
2000	73		44 ³⁵		2
2001	244		207		3
2002	77		452		3
2003	178		208		3
2004	163	659 ³⁶	117		3
2005	132	376	56		2
2006	122	528	30		2
2007	34	561	13		1
2008	52	630	36	17	1
2009	55	613	15	5	1
2010	44	504	11	8	1
2011	31	524	22	10	1
2012	11	542 ³⁷	10	0	1

Table A2.1.2: GDP and Growth Data of the West Bank and Related Countries: GDP in USA million \$, constant price -2004; growth in decimal number:

Year	GDP ³⁸	Growth	Growth Before ³⁹	Arab World Growth ⁴⁰	Lower and Middle Income Countries' Growth
2012	5409	0.06	0.09	0.06	0.05
2011	5101	0.11	0.08	0.03	0.05
2010	4609	0.07	0.10	0.05	0.08
2009	4305	0.09	0.12	0.02	0.05
2008	3947	0.12	0.08	0.06	0.04
2007	3530	0.13	0.05	0.06	0.08
2006	3131	0.04	0.09	0.07	0.07
2005	3004	0.06	0.11	0.06	0.07
2004	2836	0.12	-0.02	0.09	0.08
2003	2533	0.10	-0.13	0.05	0.06
2002	2306	-0.15	-0.09	0.02	0.04
2001	2703	-0.12	0.03	0.02	0.04
2000	3070	-0.06	0.14	0.05	0.04
1999	3272	0.12	0.15	0.01	0.05
1998	2912	0.15	0.09	0.03	0.01
1997	2531	0.16	0.05	0.04	0.04
1996	2191	0.02	0.09	0.05	0.06
1995	2159	0.09	0.00	0.03	0.05
1994	1981	0.00	0.00	0.03	0.03

Growth Analysis: West Bank 1994 – 2012

This analysis measures the effect of the 'Security and Restrictions' level on West Bank growth, along with complementary factors, using the previous two years' average growth and a natural parallel growth of related economies during the years 1996-2012.⁸⁶ Two related types of economies were compared: Arab world growth, and lower-middle income country growth.

Image A2.1.1 Analysis based on Security and Restriction index, previous growth and the Arab world growth:

Source	SS	df	MS	Number of obs = 17		
Model	.094876944	3	.031625648	F(3, 13) =	11.13	
Residual	.036923056	13	.002840235	Prob > F =	0.0007	
Total	.1318	16	.0082375	R-squared =	0.7199	
				Adj R-squared =	0.6552	
				Root MSE =	.05329	

growth	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
growthbefore	-.5843608	.2422016	-2.41	0.031	-1.107606	-.0611161
arabworldg~h	2.233681	.6603009	3.38	0.005	.8071882	3.660175
securityad~b	-.1002166	.0190656	-5.26	0.000	-.1414053	-.0590279
_cons	.1534003	.0462938	3.31	0.006	.0533887	.2534119

It can be seen from the results that this model has a strong statistical ability to explain West Bank growth. In general, first the R-squared which is equal to 0.7199 suggests that the explanatory variables of this model have high

[86] This model starts from 1996 as the first year that contains the "growth before" data. The growth before is the average growth of the previous two years, except for 1996 which is composed of 1995 growth only.

ability to explain the changes of growth in the West Bank; actually, it can be said that more than 70% of the variations of growth in these years can be explained by the factors in the model. Also, this analysis receives a very low “Prob > F” which indicates that this model is very significant (significant level much lower than 1%) which means that the model’s results are considered to be statistically robust, and it is very unreasonable that the model does not have such prediction abilities.

Regarding the specific factors in this model (the explanatories) this analysis receives the following results:

- The coefficient of “growth before” is about -0.58, which means that the average growth of the previous two years has a counter factor on the present ability to grow, a previous recession holds a higher growth potential for the years to come, and a vast previous growth has a moderating effect. More precisely, an average growth of 10% on the last two years is a cause of burden of 5.8% on the growth this year. This result individually is highly significant in the model ($P > |t| = 0.031$) which means that the significant level is about 3% which is considered a high standard of reliability. This result is also reasonable from economical point of view, it means that fast execution of the growth potential in previous years is a cause of moderation in the next years or on the opposite, when there are exogenous breaks on the economy, there is a greater potential to catch up faster in the years after. It is even more relevant in a developing and instable economy.
- The coefficient of “Arab world growth” is 2.2 and this result is highly significant (significant level lower than 1%). The meaning is that the global related economy has also a significant effect on the Palestinian (West Bank) economy. Each 1% of addition growth in the Arab world might reflect an addition growth of 2.2% in the WB economy. This result suggests that the Palestinian economy is a highly developing economy regarding its natural surroundings.
- The coefficient of “Security and Restrictions” is -0.1. The meaning is that every escalation level has a contribution of -10% to the growth. The result is statistically highly significant. The 95% confidence interval is between -0.14 and -0.059 which means that statistically there is a 95% chance that the effect of each escalation level is between -14% to -6% and not away from this interval.
- The “constant” is 0.15 and highly significant or statistically reliable. The meaning of the constant is that if all the other factors had zero influence (zero growth the years before, rescission of zero growth in the Arab world, and zero level of security and restrictions with Israel) than the predicted WB growth would have been 15%.

Summary: The results of this regression analysis are very robust statistically, with high explanatory level and solid significance, both in general and by any individual factor. The effect of the security and restrictions level on the Palestinian economy stands at 10% for every escalation level and is highly significant as such. In a world with no conflict and restrictions, along with 4.4% growth of the Arab world⁸⁷, the Palestinian stable predicted growth according to this model is 15.8%.⁸⁸

[87] The average 1994-2013

[88] This growth contains the reduction from same “growth before” and is expected for few years until closing the gaps from the surrounding economies.

Image A2.1.2: Analysis based on Security and Restriction index, previous growth and the Lower middle income countries growth:

. reg growth growthbefore lowermiddleincomecountriesgrowth securityadministrativeindexwb if year >=1996						
Source	SS	df	MS			
Model	.085808443	3	.028602814	Number of obs =	17	
Residual	.045991557	13	.003537812	F(3, 13) =	8.08	
Total	.1318	16	.0082375	Prob > F =	0.0027	
				R-squared =	0.6511	
				Adj R-squared =	0.5705	
				Root MSE =	.05948	
growth	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
growthbefore	-.5818446	.2711384	-2.15	0.051	-1.167603	.0039142
lowermiddl~h	2.289816	.8897078	2.57	0.023	.3677196	4.211913
securityad~b	-.1000397	.0216194	-4.63	0.000	-.1467455	-.0533339
_cons	.1310282	.0578527	2.26	0.041	.006045	.2560114

This analysis is very similar to the previous one but using a different group of naturally-related economies as a partial explanatory of the Palestinian growth in the West Bank: the “lower middle income” countries growth (instead of the Arab world).⁸⁹

This report can see that, even though this model has less significant and explanatory ability according to the statistical terms, it still stands in the high criteria of significance in general and for every explanatory factor by itself. More importantly, this report can see that the influence of the security level is statistically solid here as well and indicates on the “very same” result of 10% decrease from the natural growth for every escalation in the security and restriction level. The stable growth with zero level restrictions involving all factors is 15.8% here as well,⁹⁰ although the constant and the multiplier regarding the lower middle countries growth are different.

Summary note

This section’s purpose is primarily to examine the effects of the Israeli Security and Restrictions on the West Bank economy through the method of econometric regression. This analysis receives a statistically solid result of -10% growth effect as an outcome of every escalation level from zero to three along with other economic effects. In both models this analysis received the same significant result of -10% to each escalation level and the same natural potential of 15.8% growth. These results suggest that that the Security and Restrictions factor, as well as the potential growth in natural environment,⁹¹ are statistically strong matches, even when two different global economy explanatory factors are considered.

[89] The World Bank Data: <http://data.worldbank.org>

[90] With average growth of 5.2% of the Lower middle income countries as is in the years of the model.

[91] Average surrounding growth and no conflict effects.

Annex 2.2: Expansion on Basic Long-Term Strengths of the Palestinian Economy

The basic characteristics of the Palestinian economy indicate promising potential for sustainable long-term economic growth under a new growth-supportive economic regime. Palestine's development potential stems from a combination of the following strengths and advantages:

Size: The Palestinian economy is very small, about 3 percent of the Israeli economy and one-quarter of Jordan's (measured by the size of the GDP). Developmentally, this is a great advantage: (a) from a macro-economic point of view, it is easier and quicker to change the course of a small boat than a giant ship; and (b) the small size of the economy combined with the small geographical size of the West Bank and Gaza make it possible for a set of well-chosen local and sectorial projects to serve as growth engines and employment generators for the Palestinian economy at large, and put it on a sustainable high growth path.

Workforce: Palestine has an ample and highly-educated workforce. Once economic recovery begins, the Palestinian economy will be able to benefit from its ample, unused workforce: (a) more than 300,000 unemployed working-age persons ready to accept new work opportunities; and (b) more than 50,000 new entrants a year into the workforce. This, in combination with the high percentage of unused production capacity in industry and other branches of the economy, will enable a fast double-digit growth for the first period of economic recovery, and then the continuation of long-term sustainable growth of above 5% a year.

Israel: Palestine has close ties with the large and advanced Israeli economy. The original aim of the Paris Protocol was to support Palestinian economic development through free trade and economic cooperation with Israel. The original aim of the Paris Protocol failed to materialise under the *status quo*, and economic integration with Israel has impeded the development of the Palestinian economy. Nevertheless, under a new growth-supportive economic regime, close economic relations with Israel would turn into an important asset for Palestinian development prospects. The significantly larger Israeli economy provides huge economic growth opportunities for Palestine through the following: (a) Israel is an immediate, ready market for Palestinian exports and for sub-contracting to Israeli industries; (b) Palestine will continue to export labour services to Israel, albeit to a lower extent than in pre-Intifada times; (c) Israel is a ready reservoir of technical know-how, production infrastructure, and marketing channels; and (d) partnerships with Israeli companies would enable Palestinian businesses access to various development projects and export-oriented joint-ventures directed at other markets.

Arab Markets: Palestine would have free access to Arab markets in addition to other large trading partners. The Palestinian Authority has favourable trade agreements with all its main potential trade partners. These agreements are expected to serve as a major enabler of export-driven economic growth, once the barriers that are locking Palestinian export potential are removed.

International Support: Palestine enjoys exceptionally large international economic support. The international donor community is ready to generously support viable Palestinian economic rehabilitation and development program as soon as political and security conditions allow it.

Annex 2.3: The Rules of Origin

Executive Summary

To utilise the lower tariff in a preferential agreement the Rules of Origin (RoO) has to be met. However fulfilling the origin criteria brings with it certain costs for the economic operator, and if these costs exceed the benefit of the lower preferential tariff, the trade agreement will not be utilised. The purpose of the RoO is to function as a safeguard mechanism for the contracting parties of the agreement. Without the origin rules countries outside of the agreement would be able to access the preferential tariff via, for example, transshipment of goods (called *trade deflection*).

Finding a balance between the core purpose of the RoO, and the costs that these rules entail, is key. There are various different ways to define and to prove origin, and it is up to the parties of the agreement to draft a set of RoO that suit the local conditions and capacity. In Israel and Palestine capacities differ widely. The former is a modern, advanced, and open economy, while the latter in many ways has an infant industry structure. To a large extent the same description can be used to describe the institutional and administrative capacity of the two parties.

With these differences in capacity in mind, two RoO-alternatives are discussed and compared: one *bilateral option* where the two parties negotiate a tailored solution depending on the local conditions, and the *Pan-Euro-Med* (PEM) system of diagonal cumulation which links around 60 regional Free Trade Agreements (FTA) to one common origin protocol. From this discussion it was concluded that PEM RoO would be the most suitable alternative in an FTA between Israel and Palestine. Arguments in favour of PEM include:

- PEM offers a broad base to source inputs from, which is important in order to make efficient use of the regional value chains;
- PEM offers a harmonised set of RoO with many of both Israel and Palestine's most important trading partners;
- It is impossible to know the outcome of a bilateral negotiation on RoO and there is no guarantee that the origin rules will be the best possible for the local conditions. The PEM-convention offers more predictability.
- Even if PEM RoO cannot be as tailored as the bilateral option, there is still room to manoeuvre via the derogation clause in Appendix II of the convention.

However it was also noted that PEM is not an easy system to adapt to and significant capacity building and investments will be required, mainly in Palestine but to some extent in Israel as well.

Introduction

For Israel and Palestine to transition from the current customs union to a Free Trade Agreement (FTA) means entering into a new trade regime. One of the most significant changes under such a transition is the introduction of preferential Rules of Origin (RoO). These rules are a necessary part of every FTA but the way that they are drafted can vary significantly; this variation in turn decides the impact that RoO has on trade flows. The purpose of this report is to discuss and analyse the different RoO-alternatives in a future FTA between Israel and Palestine.

This annex is technical in its nature and therefore starts with a background on RoO and its main components, followed by a chapter on the capacity to manage the RoO in Israel and Palestine. Two different RoO-alternatives are thereafter presented and compared, followed by our conclusions.

Background

Under a deep and comprehensive FTA between Israel and Palestine, only originating goods can benefit from the available tariff preferences. Therefore every FTA comes with a specific set of origin rules. These rules are subject to negotiation between the parties of the agreement and can thus differ from agreement to agreement. The purpose of RoO is to prevent trade deflection, i.e. stopping third country goods from using the lower tariffs within the FTA via transshipment of goods (for example, by repackaging or relabeling goods).

While RoO ensures that the benefits of the FTA stay with its partner countries, they also come with a downside. Proving the origin can be a costly process for economic operators and government authorities alike. The administrative procedures can be extensive, but RoO can also limit the input sourcing options for economic operators leading to two types of costs; *administrative costs* and *efficiency costs*. These costs are unavoidable but can be limited depending on the design of the RoO.

The fact that there are various different ways to determine and obtain origin is both a blessing and a curse. It allows countries to tailor RoO after specific local conditions but doing so leads to a lack of harmonisation, which can be very costly for companies exporting to different markets.

Weighing together the different aspects of RoO it becomes clear that it is all about balance. The need to protect the FTA from trade deflection has to be balanced against the risk of a too costly procedure to obtain and prove origin. There is also the benefit of giving economic operators a broad base to source inputs from, that has to be weighed against deepened economic integration between the FTA-partners, something which is the core purpose of every trade agreement. If the costs of conferring origin outweigh the benefits of the preferential tariff, companies will not utilise the FTA. It is therefore crucial that the local conditions are studied carefully before the RoO are established. What is the institutional capacity of the economic operators and government entities? Where does the industry source their inputs from? Is production fragmented into value chains or is most of the value added locally? These are the type of questions that have to be answered before drafting the RoO.

Capacity

Israel and Palestine are two entirely different economies, the former being an advanced modern economy, while the latter is more characterised by infant industry. The gap in economic development aside, the two economies are closely integrated with one another. Israel is by far the most important market for Palestinian goods, and for Israel Palestine is the second largest export market after the USA.⁹²

The trade between the two parties today is currently conducted under a customs union arrangement. However Israel controls and governs the customs union with limited influence for Palestine. In terms of origin the customs union allows for free circulation of goods, making RoO almost a non-issue. An FTA would therefore generate an increased administrative burden for economic operators in the two parties.

Israel: Public sector

Israel's economy is characterised by openness and the country enjoys extensive preferential access to a number of foreign markets. The government authorities are thus no strangers to managing all the aspects of an FTA, including RoO. The Israeli customs are responsible for the origin certificates and the origin verification. They handle the traditional EUR1 and FormA origin certificates but also have the capacity to manage more technical solutions like electronic certification, a feature in the new FTA between Colombia and Israel.

The only question regarding Israeli capacity is the increase in the number of certificates and verifications that an FTA with Palestine would lead to. Compared to the situation today the additional administrative burden for the responsible authority would probably be significant.

[92] Palestine International Business Forum. *Future Economic Relations between the Palestinian and Israeli Economies*. 2007, p.35

Israel: Private sector

At first look the Israeli private sector has all the necessary capacity to manage the practical aspects of an FTA in terms of RoO. For the multinational companies that already utilise the preferential agreements Israel has today, it would most likely be only a small step to adapt to the RoO in an FTA with Palestine. These companies are used to interpreting different types of RoO and are familiar with both the FormA and EUR1 certificates, for example. But what should be remembered is that not all companies export. It is only the largest and most competitive ones who are able to penetrate markets abroad, especially on a global scale. Smaller economic operators that export often do so only to a well-known market in close proximity.⁹³ In this case Palestine is the obvious destination for many Israeli companies. The question is whether these companies also have the capacity to manage the RoO? Introducing RoO in the trade with Palestine will result in an increased administrative burden and higher costs of trade. Capacity building can be one way to lower these costs and minimise the risk of a negative impact on companies export decisions. Another way to reduce the costs is for the RoO to match local production methods and conditions.

Palestine: Public sector

Palestine's preferential market access is relatively high, but the actual utilisation of the different bilateral, plurilateral and regional trade agreements is low. Reasons for the low utilisation rate include fragmented enforcement of FTA's by trading partners, complicated RoO, and lack of recognition of Palestinian certificates of origin.⁹⁴ Having a range of different trade agreements does however guarantee that the responsible government authority has some experience in dealing with different types of RoO, certification and verification. The Palestinian Ministry of Finance (MoF) is responsible for the EUR1 certificates while the Chambers of Commerce have the delegated authority to issue other types of origin proofs. The MoF also manages the origin verification process.

Even if the responsible entities have both the knowledge and the experience to manage the RoO, the government sector still suffers from a lack of capacity. The infrastructure needs to be strengthened, especially in the case of an FTA with Israel. According to several stakeholders, current procedures regarding the certification and verification of origin could also be made more efficient. For example, many economic operators today choose to export in small quantities in order to not have to obtain an origin certificate, which is viewed as too time consuming.

Palestine: Private sector

As previously mentioned, the private sector in Palestine has more of an infant industry character compared to Israel. Few economic operators have the capacity to export to countries outside of Israel and the most economically important sectors in Palestine produce relatively simple goods in terms of manufacturing processes. Inputs are mostly sourced from Israel or neighbouring countries like Jordan and Turkey, but certain sectors also rely on both European and Asian countries. Sub-contracts from Israeli companies are common, especially in the textile and garment sector. Other sectors that do not import as much source their inputs locally. The stone and marble industry is an example of such a sector, where everything from the raw material to the finished product is made in Palestine. Common across all of the most economically important sectors is that a significant portion of the end product value is added locally.

The low utilisation of preferential agreements, coupled with the fact that most of Palestine's exports go to Israel, leads to a lack of knowledge and capacity concerning RoO among the industry. Many sectors do not view the trade with Israel as export, but describe it more as "selling". Introducing RoO in an FTA with Israel would formalise the trade, but would also lead to increased costs of business for those companies who export.

[93] Eaton et al. *Dissecting Trade: Firms, Industries and Export Destinations*. 2004, Federal Reserve Bank of Minneapolis Staff Report 332, p.2

[94] Palestine Ministry of National Economy. *The State of Palestine National Export Strategy 2014-2018*. 2014, p.51

The different rules of origin alternatives

RoO in an FTA between Israel and Palestine will have to cater to many different, and sometimes conflicting, needs. Balancing the two parties' differences in capacity with the general need for a broad base from which to source inputs is one aspect. Another is the fact that the industrial structure of the two parties differs widely, and that the current trade regime has created a relatively deep economic integration and a high level of interdependence. The challenge is, in other words, to draft RoO which create an enabling environment for trade and further strengthens the economic integration, but at the same time does not jeopardise the close connection between the two economies today.

Bilateral option

Bilateral negotiations are probably the most adequate option to find the best possible RoO for the specific conditions in Israel and Palestine. The RoO could then be designed in a way that strengthens the local value chains and deepens the economic integration.

As stated previously, an FTA will lead to a higher cost of business for those Israeli and Palestinian companies that regularly export under the current customs union. Minimising the RoO-related costs should therefore be an objective in the bilateral option. This is especially important since Israel on average has very low tariffs, especially on non-agricultural goods.⁹⁵ If the cost of RoO-compliance is higher than the gain from the preferential tariff, economic operators will not utilise the trade agreement. One way to minimise costs is to deviate as little as possible from the current situation in the customs union. *Full cumulation* can be one such way. The free movement of goods in the customs union allows economic operators to freely use inputs that have been released in the area or produced in either of the two parties. A system of full cumulation permits the accumulation of production processes to commonly count towards the origin rule, regardless if the process is deemed as a qualifying operation or not, and is in terms of RoO the closest one can get to free movement of goods. It can however be relatively complicated to utilise because of the administrative demands that the system poses. Another example of an origin rule which does not differ a lot from the current trade regime is the *approved exporter system* and *invoice declaration* of origin. Origin certificates are not used in the customs union and origin is instead established via a unified invoice. An approved exporter system would offer the possibility to continue to prove origin on the invoice, but also have the added benefit of simplifying the cumbersome certification procedures in Palestine today.

If a tailored RoO-approach is used under the bilateral option, careful consultations would have to be made in order to establish a negotiating position. The structure of the Palestinian private sector is mostly based on inputs from Israel, sub-contracts with Israeli companies, or goods wholly obtained locally. In terms of RoO this signals that fulfilling the actual qualifying operations would not be a major issue for the economic operators. The real difficulties in Palestine instead seem to be related to the capacity to manage and administer the RoO. In case of a bilateral solution, the target should be a simple and liberal RoO without too many exceptions, primarily for two reasons: firstly, Israel has very liberal RoO in many of their other FTAs, and their private sector is already used to working with these liberal rules; secondly, Palestine is a developing economy and strict origin criterions would harm their ability to utilise the agreement.

The upside of being able to tailor RoO to local conditions has its downside in the lack of market access. Both Israel and Palestine depend on inputs from third countries, and having a broad base to source from is important to counter the efficiency costs that RoO can bring. Narrowing down the choice of inputs leads to a higher probability of not buying from the most efficient producer, which in economic terms can be counted as a cost. Lack of market access can, however, be offset by extending cumulation; the most natural alternative in a bilateral negotiation would probably be with common FTA-partners, like the USA for example.

Palestine is a member of the Greater Arab Free Trade Area (GAFTA) where RoO are based on a 40% across-the-board value added criterion combined with a wholly obtained rule. This model would also be an alternative

[95] WTO. *Tariff profile Israel 2014*, http://stat.wto.org/TariffProfiles/IL_e.htm

under the bilateral option. A similar model based on value added would probably suit the industry in Palestine, since they have some experience using the GAFTA-RoO. The benefit of having an across-the-board criterion is simplicity, but it lacks precision. A broad value added rule will suit some industries well but be difficult to fulfil for others; this dilemma is even more apparent for two FTA-parties like Israel and Palestine, where the industrial structure differs a lot. One way to counter this risk is to have a low value added percentage, but setting the percentage too low would increase the risk of trade deflection.

The Pan-Euro-Med system of diagonal cumulation

The bilateral option above is balanced more towards deeper economic integration between the two parties than increased market access. The Pan-Euro-Med system of diagonal cumulation (PEM) is the opposite. This system aims to link all FTAs (more than 60 individual protocols) in the PEM-zone⁹⁶ to the same RoO-protocol (known as “the Convention” in PEM), thus making diagonal cumulation possible.⁹⁷ This opens up a very large market to source inputs from. This is not the only benefit of PEM however. Having a common RoO-protocol makes it easier to make amendments, while it also harmonises the RoO across many different FTAs. This last point is especially important for economic operators, since it is often the ‘spaghetti-bowl’ of different RoO that creates difficulties for operators, rather than the actual origin-conferring operations.

Both Israel and Palestine have been part of PEM since the Barcelona process in 1995, and the subsequent individual association agreements that the Med-countries concluded with the EU. However since there is no FTA in place between Israel and Palestine, diagonal cumulation between the two parties and the rest of the PEM-zone cannot be utilised.⁹⁸ In order to benefit from the system of diagonal cumulation, an FTA which links to the common PEM-convention needs to be in place between the countries of final manufacture and of final destination.

The current RoO in the PEM-convention are of a standard EU-model; a number of general provisions such as the list of minimal operations, tolerance rule, and cumulation, plus an annex with the product specific list rules. The convention is currently undergoing a revision, and even though the structure of the RoO will not change, the actual origin rules will. One of the core purposes of the PEM is to strengthen the regional integration and RoO plays a crucial part in this. It is therefore likely that the undergoing revision will lead to less strict RoO in the new convention.

Bilateral option vs Pan-Euro-Med

Many of the contracting parties in PEM are very important markets for Israel and Palestine (EU, Turkey and Jordan for example), both in terms of imports and exports. Having a common set RoO and the possibility to cumulate inputs with these partners would be hugely beneficial for Israeli and Palestinian companies. As mentioned before, under the bilateral option it is the market access and increased harmonisation issues which have to be balanced against the more tailored RoO.

Both Israel and Palestine are used to liberal RoO and it is therefore unlikely that the bilateral option would yield strict origin rules with the purpose to protect the two parties from countries outside the FTA. A modern and technologically advanced economy like Israel is normally dependant on value chains and fragmented production, which further argues against strict RoO. The Palestinian economy is less advanced, but most goods in the majority of the private sector are either wholly obtained or have a significant portion of their final value added

in Palestine. Fulfilling the origin criterion does therefore not pose a problem. Question marks instead circle

[96] European Union, *Albania, Algeria, Bosnia and Herzegovina, Egypt, Faeroe Islands, Iceland, Israel, Jordan, Kosovo, Lebanon, the former Yugoslav Republic of Macedonia, Montenegro, Morocco, Norway, Serbia, Switzerland (including Liechtenstein), Syria, Tunisia, Turkey and West Bank and Gaza Strip*

[97] European Commission. *System of Pan-Euro-Mediterranean Cumulation*, 2014:http://ec.europa.eu/taxation_customs/customs/customs_duties/rules_origin/preferential/article_783_en.htm

[98] European Commission. *Pan-Euro-Med Matrix*, 2013/C, Official Journal of the European Union 205/3, p.3

around the institutional capacity to administer and manage the RoO, especially in Palestine, where significant investments would be needed. But smaller economic operators in Israel, which do not export outside Palestine, would also face increased RoO-related costs in an FTA. It should be noted though that these capacity-issues will surface regardless of which RoO-model is adopted.

The actual origin provisions in PEM are more complicated in comparison to GAFTA, for example. The product specific list rules can be difficult to adapt to, and the administrative procedures are more cumbersome than usual, due to the EUR-MED certificate which has to be filled out in order to use diagonal cumulation. Furthermore, it needs to be repeated that the RoO in PEM are based on the standard EU-model which does not take any special consideration to the local conditions in Israel and Palestine.

But several features in PEM could also be an improvement to the current situation, and there is room for flexibility in the agreement. The approved exporter system is one example. It would significantly reduce the administrative burden for companies, compared to obtaining origin certificates via government authorities for every consignment. PEM also has a special provision clause in Appendix II allowing more liberal origin provisions than in the PEM-convention. One such example is the many Association Agreements that followed the Barcelona Process, where full cumulation between EU and the partner country (Algeria, Morocco and Tunisia for example) is allowed. It is in other words possible for Israel and Palestine to go beyond the PEM-convention in certain cases, given that it does not affect other contracting parties in a negative way.

Comparing the two alternatives is complicated from another viewpoint as well; on one side there are very clear preconditions with a set of RoO already in place (PEM-option), on the other there is total flexibility but a lot of uncertainty (bilateral option). Finding RoO under the bilateral option that fits well with the economic reality requires extensive ground work. Other factors such as negotiating power and capacity also play into the final result. There is, in other words, no guarantee that the bilateral option will yield the best possible RoO for the local conditions in Israel and Palestine.

Conclusions

The RoO in an FTA between Israel and Palestine will lead to increased business costs. The challenge is to minimise these costs so that they do not exceed the gain from the preferential tariff in the FTA. Otherwise the FTA will not be utilised. Israel and Palestine have very different capacity to meet the challenges that RoO pose; one economy is modern, open, and used to managing the origin rules, the other is in many ways the opposite. Striking a balance between the two parties' different needs and capacities is therefore key.

Two RoO alternatives were identified and discussed; a bilateral option and the Pan-Euro-Med system of diagonal cumulation. The first option offers a tailored solution to the local conditions in Israel and Palestine while the second provides a harmonised set of RoO along with extensive market access to many of the two parties most important markets. Weighing these two options against each other, our conclusion is that the PEM-system offers the best alternative for RoO in an FTA between Israel and Palestine. There are several reasons for choosing the PEM-model:

- Today's economic climate is characterised by value chains and fragmented production. Having a broad base to source inputs from is therefore extremely important in order to make efficient use of the regional value chains. PEM offers exactly this.
- The lack of harmonisation across FTAs is a major issue for economic operators, as having to adjust to different origin rules depending on export destination creates costs. PEM offers a harmonised set of RoO with many of both Israel's and Palestine's most important trading partners. The fact that both parties are already connected to PEM via agreements with the EU (and therefore have some experience in managing the PEM RoO) means that the adjustment period to PEM RoO should be fairly short.
- The harmonisation aspect ties into the argument that PEM offers clarity and predictability, something which is very important for the private sector. No one knows how a bilateral negotiation on RoO will turn out and there is no guarantee that the origin rules will be the best possible for the local conditions. Even if the PEM-convention is currently undergoing a revision there is still a baseline set of rules in place now.
- Lastly even if PEM RoO cannot be as tailored as the bilateral option there is still room to manoeuvre via the derogation clause in Appendix II of the convention. One area which could be suited for such derogation is a provision on full cumulation. Considering the current customs union where goods can move freely if released for free circulation, a provision on full cumulation would probably fit well with the local conditions in the two parties.

Both Israel and Palestine have substantial preferential access today, but the latter faces considerable difficulties utilising these benefits. In order for any set of RoO to be implemented and utilised in a fruitful way some capacity building is necessary. In the case of Palestine, there would be a considerable need to strengthen the capacity within both the private and public sector. However it is not unlikely that smaller economic operators in Israel also would need support to adjust to a new system of RoO.

Annex 2.4: The Quantitative Forecast – Methodological and Technical Aspects

Introduction

This technical annex presents the detailed computation, in relation to the quantitative forecast for Palestine and Israel.

The first section of the Annex presents the technical computations in relation to Part Two of the main report, which examines the benefits for Palestine; and the second section presents the technical computations in relation to Part Six, the benefits for Israel.

Benefits for Palestine

The first stage of the analysis, in Part Two of the main report, relates to the economic growth potential of the Palestinian economy under an optimal new economic and trade regime.

Such a new regime will enable the following:

- (a) In the short term (first three years from shifting to the new regime): removal of the complex web of administrative, security and other constraints, under which the Palestinian economy has been functioning in the last two decades.**
- (b) In the short and medium term (first five years): harnessing the unused Palestinian production capacity.**
- (c) In the medium and long term (after three years, and more fully after five years): supporting export-oriented long-term sustainable fast economic growth.**

The analysis relates to the main macro-economic parameters: GDP growth, exports, investment and employment.

Then, in the second stage of the analysis (in Part Two of the main report) the report presents our assessment of the optional trade regimes, according to their potential contribution to the said macro-economic parameters, considering also the contribution of related supplementary arrangements. Insights from the sectorial analysis (Part Four) help us in refining and detailing the results and conclusions of the macro-economic analysis.

Palestinian Economic potential Under an Optimal New Economic and Trade Regime

GDP growth forecast under optimal conditions

Short and medium term GDP growth potential is discussed in Part Two pages 18 – 20, in reference to historical evidence and econometric (regression) analysis. Long-term growth engines are discussed in Part Two pages 20 – 22, focusing on export-driven growth of the main productive sectors and the basic long-term strengths of the Palestinian economy.

The real growth potential of Palestinian real GDP, under a new, growth-supportive economic and trade regime, is estimated at 18% per annum for the first 3 years, declining to lower double digit growth levels for the next seven years, and settling to a long-term growth trend of 6% till 2030 – as per the following:

- **Short term** (first three years from shifting to the new regime).

Historical evidence shows several instances of 12 – 15 percent growth in the West Bank, in periods of shifting to situations of relatively calmer political atmosphere and less restrictive constraints, and 12 – 20 percent in Gaza. The regression analysis shows 16 percent growth upon shifting to calmer and less restrictive situations in

the West Bank, and higher rate of growth in Gaza.

As we assume that the envisioned shift towards the new optimal regime will involve a much more far-reaching relaxation of restrictions (considering also the set of interim measures suggested in Part Three of the main report), Palestinian GDP (West Bank and Gaza) is expected to grow by 18-plus percent a year in the first three years from shifting to the new regime.

- **Medium term** (after three years, up to the 10th year).

Partial relaxation of restrictions in the West Bank, in the relatively calmer period of 2003 – 2012, enabled this region to achieve an impressive real growth rate of 9%, on average, for a period of ten years. Similar annual growth rate was registered, for a decade, over the 1970s. Under the new regime, the unused Palestinian production capacity will be harnessed to generate similar growth rates, for the first decade. Furthermore, the additional growth-engine of exports, and an increase in investment to pre-Second Intifada levels (as a percentage of GDP), will add 2 – 3 percentage points of growth, which will bring cumulative growth to 12-plus percent, on average, between the 4th and 10th years.

- **Long term** (after ten years).

Exports, and increased investment, will maintain longer-term real growth, at a level equivalent to long term growth rate of low-medium level income countries over the last two decades, about 6 percent (approximately similar rates were recorder in Egypt and Jordan in the relatively calm second half of the 2000s). This long term growth rate will be supported by two other growth-engines: (a) healthy demands of an expanding domestic market; and (b) further expansion of production capacities, as a result of entrance into the work force of large number of young and educated workers every year (in addition to the continuous stream of increased investments).

Table 2.4.1: Palestinian GDP forecast Under Optimal Conditions (US dollars, 2013 prices, annual real growth rates)¹

Year	Palestinian GDP (million US dollars)	Palestinian GDP (annual growth rates)	GDP per Capita (US dollars)	GDP per Capita (annual growth rates)
2013	12,476		2,992	
2014	12,164	-2.5%	2,830	-5.4%
2015	12,103	-0.5%	2,734	-3.4%
2016	14,282	18.0%	3,132	14.6%
2017	16,853	18.0%	3,589	14.6%
2018	19,886	18.0%	4,111	14.6%
2019	22,869	15.0%	4,590	11.7%
2020	26,299	15.0%	5,125	11.7%
2021	29,455	12.0%	5,573	8.7%
2022	32,990	12.0%	6,060	8.7%
2023	36,289	10.0%	6,472	6.8%
2024	39,918	10.0%	6,911	6.8%
2025	43,910	10.0%	7,381	6.8%
2026	46,544	6.0%	7,596	2.9%
2027	49,337	6.0%	7,817	2.9%
2028	52,297	6.0%	8,045	2.9%
2029	55,435	6.0%	8,279	2.9%
2030	58,761	6.0%	8,521	2.9%

Sources: Palestine GDP and GDP per capita figures for 2013 – PCBS National Accounts for 2013 (published December 2014), p. 50, 58. Figures for 2014 – as per PCBS estimated change on 2013 in the economic forecast for 2015 (published Dec 30 2014). Figures

[1] This report’s forecast period starts from 2016, assuming 2015 to be the base year. This is a technical assumption, as we use the most updated available data as the starting point for the forecast. One should refer to 2015 as “Year Zero” of the forecast, and 2016 as “Year One”.

Export Growth Potential

Continuous fast development of Palestinian exports is the single most important long-term growth-engine for the Palestinian economy. It is the only means of sustaining economic growth, once the initial boosting effect of relaxation of restrictions weakens.

- **Untapped exports to Israel** – discussed in Part Two page 27.

Israel, as the only significant export market of Palestine, is presently absorbing the Lions' Share of Palestinian exports, equivalent to about 15 percent of Palestinian GDP.

Under optimal conditions, exports to Israel (goods and services) will grow rapidly over the fifteen-year forecast period, but not faster than GDP. So, exports to Israel will remain about 15 percent of GDP.

- **Untapped exports to Arab markets** - discussed in Part Two page 27.

Exports to Arab markets are currently negligible, only 1 percent of GDP. Under the new regime, exports of goods and services to Arab markets (chiefly industrial and agricultural products and tourism) will grow, over the 15 years of the forecast period, at a rate equivalent to the growth of exports of Jordan over the 2000s, generally a rate double as fast as GDP growth. This will raise total exports to Arab markets to 18 percent of GDP, by the end of the fifteen-year forecast period. This rate is still much lower than the present (2013) rate of Jordan's exports to Arab markets (goods and services), and approximately one half of the forecasted rate of Jordanian exports to Arab markets to Jordan's GDP, in 2030.

- Untapped exports to other markets (*the EU, US, and other global markets*) - discussed in Part Two page 28 – 29. Exports of goods and services to these markets will grow too, but considerably less than exports to Arab markets. Tourism and related services are projected to lead export growth to these markets.

**Table 2.4.2.1: Palestinian Exports to Israel (Goods and Services)
Forecast Under Optimal Conditions (US dollars, 2014 prices, annual real growth rates)**

Year	Total Exports (million US dollars)	Annual growth rates	Export as % of GDP
2015	1,755		15%
2016	2,142	22%	15%
2017	2,528	18%	15%
2018	2,983	18%	15%
2019	3,430	15%	15%
2020	3,945	15%	15%
2021	4,418	12%	15%
2022	4,949	12%	15%
2023	5,443	10%	15%
2024	5,988	10%	15%
2025	6,587	10%	15%
2026	6,982	6%	15%
2027	7,401	6%	15%
2028	7,845	6%	15%
2029	8,315	6%	15%
2030	8,814	6%	15%

**Table 2.4.2.2: Palestinian Exports to Arab Markets (Goods and Services)
Forecast Under Optimal Conditions (US dollars, 2014 prices, annual real growth rates)**

Year	Total Exports (million US dollars)	Annual growth rates	Export as % of GDP
2015	121		1.0%
2016	182	50.0%	1.3%
2017	272	50.0%	1.6%

2018	408	50.0%	2.1%
2019	613	50.0%	2.7%
2020	919	50.0%	3.5%
2021	1,379	50.0%	4.7%
2022	2,068	50.0%	6.3%
2023	3,102	50.0%	8.5%
2024	4,343	40.0%	10.9%
2025	5,645	30.0%	12.9%
2026	6,774	20.0%	14.6%
2027	7,791	15.0%	15.8%
2028	8,764	12.5%	16.8%
2029	9,860	12.5%	17.8%
2030	10,846	10.0%	18.5%

**Table 2.4.2.3: Palestinian Exports to Other Markets (Goods and Services)
Forecast Under Optimal Conditions (US dollars, 2014 prices, annual real growth rates)**

Year	Total Exports (million US dollars)	Annual growth rates	Export as % of GDP
2015	145		1.2%
2016	247	71%	1.7%
2017	402	63%	2.4%
2018	586	46%	2.9%
2019	988	69%	4.3%
2020	1,579	60%	6.0%
2021	2,156	37%	7.3%
2022	2,551	18%	7.7%
2023	2,704	6%	7.5%
2024	2,843	5%	7.1%
2025	3,136	10%	7.1%
2026	3,465	10%	7.4%
2027	3,803	10%	7.7%
2028	4,310	13%	8.2%
2029	4,553	6%	8.2%
2030	5,019	10%	8.5%

**Table 2.4.2.4: Total Palestinian Exports (Goods and Services)
Forecast Under Optimal Conditions (US dollars, 2014 prices, annual real growth rates)**

Year	Total Exports (million US dollars)	Annual growth rates	Export as % of GDP
2013	2,072		17%
2014	2,051	-1.0%	17%
2015	2,021	-1.5%	17%
2016	2,571	27.2%	18%
2017	3,202	24.6%	19%
2018	3,977	24.2%	20%
2019	5,031	26.5%	22%
2020	6,443	28.1%	25%
2021	7,953	23.4%	27%
2022	9,567	20.3%	29%
2023	11,250	17.6%	31%
2024	13,173	17.1%	33%
2025	15,368	16.7%	35%
2026	17,221	12.1%	37%
2027	18,995	10.3%	39%
2028	20,919	10.1%	40%
2029	22,728	8.6%	41%
2030	24,680	8.6%	42%

Sources: 2013 figures – PCBS 2013 Balance of Payments Statistics. 2014 – 2015 growth rates – PCBS economic forecast for 2015 (published Dec 30 2014), average of pessimistic and base-line scenarios for 2015.

Employment Growth Forecast Under Optimal Conditions

In the first period of 3 years, the jump of the GDP will be driven to a large extent by trade and other less labor intensive sectors of the economy. Following this period employment to GDP growth ratio will accelerate, gradually, as the new growth engines of export and investment will take the lead, and growth will be driven by labor intensive sectors of the economy such as agriculture, labor intensive industry, tourism, etc. This trend is mirrored in the sectorial GDP and employment growth analysis (Part Four).

In the first three years of the forecast period each percentage point of GDP growth is predicted to generate 0.65% growth in employment. Then, the ratio of employment growth to GDP growth will gradually rise, as shown in Table 2.4.3.1

The fast growth in employment under such an optimal new economic and trade regime would enable absorption of all new entrants into the labour market, and a gradual decrease in unemployment, from about 30% in 2015 (measured according to the LOI standards), to about 17% in 2020; and then stabilize at 7 – 8% from 2025 onwards.

Table 2.4.3.1: Palestinian Employment Forecast under Optimal Conditions

Year	Annual GDP real growth	Employment growth ratio to GDP growth	Annual employment growth	Thousand employed persons
2015				949
2018	18.0%	0.65	11.7%	1,322
2020	15.0%	0.7	10.5%	1,614
2025	10.8%	0.85	9.2%	2,504
2030	6.0%	1	6.0%	3,351

Table 2.4.3.2: Palestinian Employment Forecast under Optimal Conditions

Year	Labour Force (thousand persons)	Labour Force – Annual Growth Rate (%) ¹	Employment – Number of Employed Persons (thousand persons) ²	Employment – Annual Growth Rate (%) ³	Unemployment Rate – LOI standards (%) ⁴
2013	1155	3.7%	885	3.1%	23.4%
2014	1,254	8.6%	925.5	4.6%	26.2%
2015	1,329	6.0%	949	2.5%	28.6%
2018	1,674	8.0%	1,322	11.7%	21.0%
2020	1,935	7.5%	1,614	10.5%	16.6%
2025	2,714	7.0%	2,504	9.2%	7.7%
2030	3,632	6.0%	3,351	6.0%	7.7%

Source: PCBS, Labour force survey 2013 (published April 2014), p. 79; Labour force survey Q2 2014 (published October 2014), P. 12. Note - labor force aged 15 and above.

Macro-economic forecast under the three optional regimes

The forecast relates to the three optional economic and trade regimes, in comparison to a scenario of continuation of the present regime under a political assumption of “managed conflict”.

The quantitative factors of the projections reflect the considerations and analysis in Part Two, pages 33 – 41.

GDP growth forecast

- Continuation of present regime under “managed conflict“. Long-term annual real GDP growth projected to be no more than 2%, 1 percentage point below population growth.
- The Improved CU regime is projected to enable optimal level of growth for the first 3 years. Then growth starts weakening, to 80% of optimal level in the coming 2 years, gradual weakening towards level of 60 % of optimal level by the 10th year, and then it stabilises at 4% per annum – one percentage point above population growth.
- Under the MFN regime the removal of restrictions will be partial, Palestinian exports to Israel will face new custom duties and other barriers, while transaction costs in trading with third countries through Israeli controlled passages (and Israeli ports) will remain high. The initial boost to GDP growth (in the first 5 years) will therefore be at best equivalent to the average real growth rate of the first ten years of recovery after the second Intifada = 8% a year. Then it will weaken gradually to a level of 2 percentage points above that of continuation of present regime, namely, 4% a year.
- The FTA regime enables achieving the growth rates equivalent to that of optimal conditions.

Export Growth

- Continuation of the present regime under “managed conflict“. Long-term annual export growth projected to be 1 percentage point above GDP growth.
- Under the Improved CU regime, exports are projected to develop as follows: the first 3 years as per optimal forecast, reflecting the effect of removal of restrictions. Then, up to the 10th year, gradual weakening towards 50% of optimal, as only exports to Israel and tourism will continue to show strong growth. Then, export growth will stabilise at about 6%.
- Under the MFN regime exports to Israel will stagnate, and exports to other markets will take time to develop considerably. Hence, exports in the 3 first years will not rise (and probably even fall). Then, exports to non-Israeli markets, and tourism, will moderately develop; and export growth rate will stabilise at a rate of 6%.
- The FTA regime represents export growth rates equivalent to that of optimal conditions.

Employment Growth

- Continuation of present regime under “managed conflict“; ratio of annual employment growth to GDP growth 0.75, similar to the average ratio over the last decade.
- Under the Improved CU regime the ratio of annual employment growth to GDP growth is the same as that of optimal conditions (and FTA): 0.65 in the first three years, 0.7 in the next two years, 0.85 in the next five years, and 1 in the last three years.
- Under the MFN regime the ratio of annual employment growth to GDP growth is 0.75, similar to the average ratio over the last decade.
- The FTA regime represents employment growth rates equivalent to that of optimal conditions.

Table 2.4.4.1: Palestinian GDP Forecast under Optional Economic and Trade Regimes (2013 prices, US dollars, real annual growth rate)²

Year	Continuation		Improved CU		MFN		FTA	
	USD million	Annual growth rate	USD million	Annual growth rate	USD million	Annual growth rate	USD million	Annual growth rate
Base Year	12,103	-	12,103	-	12,103	-	12,103	-
Three Year Forecast	12,844	2.0%	19,886	18.0%	15,247	8.0%	19,886	18.0%
Five Years Forecast	13,363	2.0%	24,945	12.0%	17,784	8.0%	26,299	15.0%
Ten Year Forecast	14,754	2.0%	35,602	7.4%	23,799	6.0%	43,910	10.8%
Fifteen Year Forecast	16,289	2.0%	43,316	4.0%	28,955	4.0%	58,761	6.0%

Table 2.4.4.2: Palestinian Export Forecast under Optional Economic and Trade Regimes (2013 prices, US dollars, real annual growth rate)

Year	Continuation		Improved CU		MFN		FTA	
	USD million	Annual growth rate	USD million	Annual growth rate	USD million	Annual growth rate	USD million	Annual growth rate
Base Year (2015)	2,021	-	2,021	-	2,021	-	2,021	-
Three Year Forecast	2,208	3.0%	3,977	25.3%	2,021	0.0%	3,977	25.3%
Five Years Forecast	2,342	3.0%	6,032	23.2%	2,185	4.0%	6,443	27.3%
Ten Year Forecast	2,715	3.0%	10,612	12.0%	2,723	4.5%	15,368	19.0%
Fifteen Year Forecast	3,148	3.0%	14,201	6.0%	3,476	5.0%	24,680	9.9%

Table 2.4.4.3: Palestinian Employment Forecast under Optional Economic and Trade Regimes (thousand persons)

Year	Continuation		Improved CU		MFN		FTA	
	1000 persons	Annual growth rate	1000 persons	Annual growth rate	1000 persons	Annual growth rate	1000 persons	Annual growth rate
Base Year (2015)	949	-	949	-	949	-	949	11.7%
Three Year Forecast	992	1.5%	1,322	11.7%	1,130	6.0%	1,322	10.5%
Five Years Forecast	1,022	1.5%	1,554	8.4%	1,269	6.0%	1,614	9.2%
Ten Year Forecast	1,101	1.5%	2,106	6.3%	1,582	4.5%	2,504	6.0%
Fifteen Year Forecast	1,186	1.5%	2,562	4.0%	1,834	3.0%	3,351	11.7%

Israeli benefits

The quantitative factors of the Israeli benefit forecasts, under the recommended new FTA regime, reflect the considerations and analysis in Part Five, pages 66 - 70.

The "Full Extent" scenario - GDP Growth

- Under the present economic and political situation, Israel can expect annual real long-term growth of about 3% a year; equivalent to merely 1 – 1.5 percent growth per capita.
- The cumulative effect of the benefits analyzed in Part Five is estimated to be GDP gain of at least 2 percentage points per annum, on average, over the ten-year forecast period (in 2013 constant prices).

[2] Average annual growth for the presented periods. For example, 18% annual growth under Improved CU for the first three years, and 12% a year for the next two years; 18% and 15% under FTA during these periods.

Table 2.4.5.1: Israeli GDP Forecast Under the Recommended new FTA Regime (US dollars, 2014 prices, annual real growth rates)

Years from shifting	Continuation of Status Quo	Contribution of shifting to Advanced FTA	Total Under Advanced FTA
Base Year	290		290
Year 1	299	6	305
Year 2	308	12	320
Year 3	317	19	336
Year 4	326	26	352
Year 5	336	34	370
Year 6	346	42	389
Year 7	357	51	408
Year 8	367	61	428
Year 9	378	72	450
Year 10	390	83	472

The “Full Extent” scenario - Export Growth

- Israeli long-term export growth rate (2006 – 2013 constant prices): 4.5 percent a year.
- Israeli exports to Palestine in the tenth year, under the new regime: 12 percent of GDP = USD 6 billion
- Israeli export of inputs to industry and agriculture to Palestine in the tenth year, under the new regime: 20 percent of Palestinian industrial and agricultural sectorial GDP = USD 3 billion
- Israeli exports to Arab markets in the tenth year, under the new regime: 2 percent market share of total Arab imports = USD 30 billion
- Total addition to Israeli exports as a result of shifting to the new regime, in the tenth year, including also tourism and other benefits - in addition to exports to Palestine and Arab markets = USD 45 billion
- Annual addition to export growth as a result of shifting to the new regime: 2.81 percent

Table 2.4.5.2: Israeli Export Forecast Under the Recommended new FTA Regime (US dollars, 2014 prices, annual real growth rates)

Years from shifting	Continuation of Status Quo	Contribution of shifting to Advanced FTA	Total Under Advanced FTA
Base Year	95.7		95.7
Year 1	100.0	3	102.7
Year 2	104.5	6	110.2
Year 3	109.2	9	118.3
Year 4	114.1	13	126.9
Year 5	119.3	17	136.2
Year 6	124.6	22	146.1
Year 7	130.2	27	156.8
Year 8	136.1	32	168.3
Year 9	142.2	38	180.6
Year 10	148.6	45	193.8

The “Full Extent” scenario - Effect on Employment

- The ratio of GDP per employed person in Israel, \$84,000 in 2013, is used as a rough estimate for the contribution of GDP growth to employment.³
- Annual addition to employment under the present regime: 2.83 percent = approximately 100,000 new jobs per year (2003 – 2013 data).
- Annual contribution of shifting to the new regime to employment: 756,000 in ten years = 1.55 percent per year.

Table 2.4.5.2: Israeli Employment Forecast Under the Recommended new FTA Regime (thousand employed persons)

Years from shifting	Continuation of Status Quo	Contribution of shifting to Advanced FTA	Total Under Advanced FTA
Base Year	3,450.0		3,450.0
Year 1	3,547.6	53	3,601.1
Year 2	3,648.0	111	3,758.8
Year 3	3,751.3	172	3,923.5
Year 4	3,857.4	238	4,095.3
Year 5	3,966.6	308	4,274.7
Year 6	4,078.9	383	4,461.9
Year 7	4,194.3	463	4,657.4
Year 8	4,313.0	548	4,861.4
Year 9	4,435.0	639	5,074.3
Year 10	4,560.6	736	5,296.5

The “Partial Benefits” scenario

- The main effect of this scenario, in comparison to the previous one, is on Israeli exports to Arab markets.
- Israel is expected to lose around one half of its potential sales to Arab markets.
- Cumulative Israeli export gain will therefore be reduced to around \$30 - \$35 billion.
- GDP gain will be lower by about 0.5 percentage points (compared to the 2 percentage point gain under the “full extent” scenario)
- Employment gain will decrease accordingly.

[3] GDP of \$290 billion to 3.45 million employed persons. Source: ICBS and the IMF.

Annex 3.1: Reform of Palestinian – Israeli Trade, Fiscal, and Monetary Arrangements

In the immediate term, the parties should reconvene a reformed version of the Joint Economic Committee (JEC), including the participation of a neutral third party and an effective arbitration system. The purpose would be to review the state of implementation of the Protocol and agree on amendments to resolve some of the acute problems identified in this report and allow the transfer of authorities and responsibilities to the Palestinian Government.

Import policy

- Implement the Wye River Economic Committee Recommendations of June 2000 regarding expanding List A1 and convene an expert committee under the Protocol Article III (16) to further update the A1, A2 and B Lists, to enable the Palestinian Government to have more jurisdictions over its foreign trade with third countries.
- Agree on new petroleum standards that would allow the Palestinian Government to import petroleum products from other markets.
- Israel coordinates customs, standards and administrative procedures it applies to Palestinian imports with the Palestinian Government to improve efficiency and to equalise treatment between Palestinian importers and Israeli importers.
- Israel should allocate additional staff and resources to provide equal services for Palestinian importers in terms of processing time and quality of service – as they do for Israel importers.

Improve tax sharing and clearance

Direct Palestinian imports

- Palestinian importers will submit import declarations through Palestinian Customs Agents, who will report the due taxes to the Palestinian Ministry of Finance Customs Department using ASYCUDA.
- All Import Taxes will be paid by the importers directly to the Palestinian Ministry of Finance bank account.
- The PCD will send the Israeli Customs Department a copy of the Import Declaration and payment certificate to release the goods from the Israeli port.

VAT clearance

- The VAT departments of both sides will exchange full information in real time on all (I) and (P) invoices issued or received by each department through a computer interface.
- The Clearance of VAT revenues will be based on the actual amounts of (I) and (P) invoices issued and received.
- Increase the number of Israeli companies included in the “Large Companies List” whereby the indirect taxes paid by their clients in the PA is transferred directly from Israel to the PA without the need to submit the Tax Clearance (I) Invoices.

Purchase tax

- Israel has to transfer to the Palestinian Government all of the Purchase Tax on goods imported to the PA or manufactured in Israel and sold to the Palestinian Government.

- An authorised declaration will accompany shipments of locally manufactured goods that are subject to purchase tax and sold to the other party. When the goods are transferred to the other party, these taxes will be credited to that party and transferred to it as part of the Tax Clearance.

Imports from and through Israel

- A Free Circulation Certificate will be used for goods traded between the two sides. The Certificate will specify whether the goods are imported or manufactured / obtained locally.
- Locally manufactured / obtained goods will be allowed to cross without paying any import taxes other than VAT. If purchase tax applies, these goods have to be accompanied by an approved tax declaration that specifies the purchase tax paid on these goods.
- If the goods are imported they will be accompanied by a customs declaration approved by the seller Customs Department specifying the customs, purchase tax and excise paid for these goods.
- When the goods are transferred to the other side, these taxes will be credited to the receiving party and transferred to it as part of the Tax Clearance.
- Nonetheless, the Customs services of the final destination may re-examine the import declaration and require the payment of additional taxes before the goods are cleared to enter its territory.

Taxation on labour

- The JEC should agree on arrangements for the payment of Palestinian employees' salaries directly to their bank to allow the Palestinian Government to tax their income.
- Allow the transfer of the equalisation and pension payments collected from Palestinian labour since 1995 to a Palestinian fund.

Movement of goods and customs control

Bilateral crossings

- The parties will agree on a number of designated commercial points to serve for the movement of goods between them. These points will be considered as Trade Facilitation and Tax Control Centres and will not be considered as border crossings. They will work at their maximum capacity 24 hours a day and will be expanded as to prevent any bottlenecks.
- All Trade Facilitation and Tax Control Centres will be subject to joint Palestinian – Israeli tax supervision and control.
- The Palestinian Government will have the full authority to apply Palestinian legislation on these Centres, to supervise the movement of cargo and ensure that the Tax Clearance (I) Invoices are declared according to the real value of the goods and verify the origin of these goods.
- The entry and/or exit of all commercial vehicles to and/or from the West Bank will be allowed only through the Trade Facilitation and Tax Control Centres and will be subject to tax supervision and control over their final destination.
- Palestinian tax officials will be allowed to deploy and practice their authorities in all areas subject to Palestinian jurisdiction including in Area C. These authorities include stopping and examining the cargo and papers of any truck or commercial vehicle on all roads.

- Allow the presence of Palestinian tax officials at Karm Abu Salem (aka Kerem Shalom) Trade and Tax Facilitation Centre.

International border crossings

- Palestinian Customs should be allowed to assume customs responsibility and powers in the Palestinian cargo and passenger lanes at the Allenby Bridge in accordance with the Protocol.
- An arrangement for the operation of the Rafah Crossing for commercial imports and exports needs to be agreed between the Palestinian and Egypt in accordance with the 2005 Agreement on Movement and Access.

Liberalising trade

- Israel should allow Palestinian manufacturers who meet the required standards to market their products in the Israeli market. The parties will agree on a mechanism to allow the certification of these factories.
- Israel should allow Palestinian manufacturers to market their products in East Jerusalem as was the case until 2005.

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