

The Economic Relations between Israel and the Palestinian Authority

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My general conclusion regarding the Protocol on Economic Relations (Annex V of the Israeli-Palestinian Interim Agreement on the West Bank and the Gaza Strip) is that the provisions of this Protocol are not conducive to economic cooperation. Furthermore, its implementation so far raises serious doubts regarding its viability.

This statement requires explanation, especially in view of the Preamble to the Protocol, which states:

“The two parties view the economic domain as one of the cornerstones in their mutual relations with a view to enhance ... a just, lasting and comprehensive peace. Both parties shall

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cooperate in this field in order to establish a sound economic base for these relations, which will be governed ... by the principles of respect of each other's economic interests, reciprocity, equity and fairness.”

The provisions of the Protocol treat institutional, substantive and procedural issues relating to import taxes and import policy; direct and indirect taxation; monetary and financial issues; rules regarding Palestinian workers in Israel; free movement of industrial goods and agricultural produce; and the regulation and coordination of tourism and insurance.

This article first highlights the positive aspects of a customs union, were it properly implemented, and then explains why the Protocol, as drafted and implemented, cannot bring about the very noble aims set out in the Preamble.

The Establishment of an Israeli-Palestinian Customs Union

Whereas no express mention is made

of the type of arrangement chosen, the Protocol provisions make it clear that this is a customs union. A customs union entails a common level of external tariffs and the application of the same regulations of commerce to substantially all imports from non-members, combined with elimination of all duties and other restrictive regulations of commerce with respect to substantially all imports from members. Indeed, according to the Protocol, the Israeli customs rates, purchase tax, levies, excises and other charges and the Israeli rules of importation (standards, licensing, valuations for customs purposes *etc.*) apply to most goods imported into Israel and the Palestinian Authority (PA). It further provides for free movement of industrial goods, free of any restrictions between Israel and the PA.

A variety of options were available, namely a free trade area, a customs union, a common market and separate markets. Of these, the customs union is indeed the preferable solution. It does not entail the burdensome, costly, and indeed impractical, administrative measures

needed to monitor the origin of goods in a free trade area. The need of the Palestinian economy to have access to an advanced economy may be satisfied. In the long run this is the most important factor for Palestinian economic development.

This conclusion is supported by the economic development of the West Bank and Gaza in past decades. When fragmented and disconnected as they were before the Israeli occupation in 1967, and as they have become again since the *Intifada*, they are stricken by poverty and economic distress. Thus, before 1967, the economy was underdeveloped; agriculture, the main economic activity, was carried out by primitive methods; and only one modern factory existed in the whole area of both territories. The labour force in Gaza was estimated at 19% of the total population, and in the West Bank - at less than 50% of the labour force. The closure and separation policy that followed the terror attacks that took place during the *Intifada* and following the signing of the Interim Agreement, made the four years 1992-1995 the worst in recent history. GNP *per capita* declined by 36% and unemployment again reached pre-1967 levels.

It was only through market integration that a positive change could be brought about. This is evidenced by the 20 years prior to the *Intifada*, which were characterized by the trade of Palestinian labour for Israeli goods. In 1987 almost 40% of the Palestinian labour force was employed in Israel, creating a significant improvement in the Palestinians' standard of living. Private consumption *per capita* rose at an overall rate of 5% *per annum*. There was an increase in birth rate, a decline in child mortality, and life

expectancy increased by a decade. Education developed significantly. Access to the Israeli market was of special importance to the Palestinians. From the Israeli point of view, the importance of the economic connection was much smaller, as the Palestinians comprised only 7% of the total labour force.

Currently, freedom of movement of persons cannot be upheld due to security reasons. This makes access to the Israeli market, through the creation of a customs union, the best possible option.

The Required Domestic Law Rules

The successful establishment of a customs union depends upon the implementation of an economic order based upon open markets and undistorted competition. However, attaining free trade requires not only cooperation on the international level, but also the implementation of domestic rules which make the authorities support the rules. Only through such rules are citizens free to enjoy their rights to pursue international trade activities. Whereas the establishment of a customs union is a matter of public law, its functioning has to be guaranteed by the commitment to private law rules of competition mandated by an open market economy. Private sector initiative requires legal rules that govern property rights, their transfer and the settlement of disputes. The rules should be transparent, stable and enforceable in a fair and efficient manner.

Upon taking office, Mr. Arafat reinstated the Egyptian law prevailing in the Gaza Strip before 1967 and the Jordanian law prevailing in the West Bank. The legal system in the West Bank is based

mostly on the continental system with Jordanian influence, whereas in Gaza it is based more on common law from the time of the British Mandate. In most business areas there are separate laws in force in each of these Territories. This makes the legal system unsatisfactory, complex, uncertain and leads to high transaction costs. There is need to enact laws regarding, *inter alia*, unfair competition, monopolistic and oligopolistic behaviour, safety, and consumer protection. Some of the areas for review and revision include the commercial code, company law, bankruptcy law, securities and intellectual property. According to the World Bank Report, the system of taxation lacks transparency and due process and is administered unevenly.

Economic activity and investment necessitate a strong, independent and effective judiciary. At present there is a lack of coordination between the two court systems in the West Bank and Gaza. The rules of procedure are antiquated. There is also no legal way to enforce the payment of debts owed by Palestinians. Debts incurred by public authorities to the Israeli public utilities companies may only be collected through deductions by the Israeli Government from payments due to the PA. As a result of the insufficiency of the legal system, Palestinians usually use mediation, informal arbitration, and self-help to enforce their rights. Foreigners face even greater difficulties.

The Need for Accountability and Transparency

The objectives of a customs union can be achieved only when supported by a legal system that ensures transparent rules, observed by private citizens and

public authorities alike. Mr. Arafat's style of governance has so far been characterized by lack of transparency and lack of accountability. According to a report of the Budget Committee of the Palestinian Legislative Council (May 1997), funds from foreign donors were channeled through personal accounts of Palestinian officials. Members of the Palestinian Legislative Council claimed that 37% of the PA's annual budget was wasted or misused by ministries during the past year, and that taxpayers' money was used for private purposes of ministers and officials.

As a precondition to accountability, the legal system must protect individual rights and subject its authorities to open criticism. In the Interim Agreement the parties pledged to "exercise their powers and responsibilities ... with due regard to internationally-accepted norms and principles of human rights and the rule of law". Human Rights Watch and Amnesty International have both been very critical of the PA's approach to human rights. Human Rights activists and journalists were arrested for criticizing the PA. Dr. Iyad al-Sarraj, the Commissioner of Human Rights, and Bassem Eid, head of the Jerusalem-based Palestinian Human Rights Monitoring Group, have been arrested and threatened to cease their activities. Daoud Kuttab, a well-known Palestinian journalist and broadcaster, winner of the 1996 International Press Freedom Award of the Committee to Protect Journalists, was arrested for broadcasting sessions of the Palestinian Legislative Council. A Palestinian human rights group charged that Mr. Arafat's security forces systematically tortured and mutilated detainees. It has also been charged that the Chief of the

Preventive Security Service has exercised censorship over the *Al-Quds* newspaper through almost daily contact with the managing editor, who seeks approval for all articles critical of the PA.

Curtailed freedom of expression and freedom of the press may allow the PA to create distortions that frustrate the very basic tenets of a free market and avoid public criticism, yet the defiance of accountability precludes a customs union from being viable.

Finally: Why is this Customs Union Different from all other Customs Unions?

The Economic Protocol has created a customs union, the objectives of which are frustrated by its own provisions. Two aspects are especially troublesome: the competition between the parties over import revenues and the absence of rules prohibiting unfair competition.

(1) The import revenues: a Palestinian-Israeli zero-sum game

The Protocol provides that the clearance of revenues from all import taxes and levies, between Israel and the PA, will be based on the principle of place of final destination. Tax revenues are allocated to the PA if the final destination **stated in the import documentation** is in the territories under PA jurisdiction. There is no need for the goods to be sold there. In fact, they need not reach their Palestinian destination at all. Following clearance by the customs authority, they may lawfully reach the Israeli market directly. If the import documents state a destination in Israel, Israel collects the customs and purchase tax.

This means that Israel and the PA are

competing for the revenues from imports. The gain of one is the immediate loss of the other. The method adopted by the European Community, when faced with the same problem, is instructive. Following the completion of the customs union in 1968, customs duties were designated as a source of Community revenue. This is logical since the goods are imported into the customs union rather than into any of its members. Whatever their port of entry, the goods are then in free circulation throughout the customs union. The import duties are transferred by the Member States to the Community budget, less 10% allowed to cover collection costs by the national administrative authorities.

Complaints that diversion of trade is in fact taking place have already been sounded by the Israeli Ministry of Trade and Industry, the Association of the Chambers of Commerce and the Association of Manufacturers. The US Embassy Economic Department in Israel has reported that, "both PA and GOI [Government of Israel] Ministry of Finance have revealed to us that statistics on customs and VAT clearances ... confirm the counter-intuitive conclusions...: imports [to the PA] are indeed on the rise in spite of the very real economic woes ... imports rose across the board in all categories ... except in building materials". This increase has taken place despite the repeated closures imposed on the Territories and despite the economic depression and a diminishing real GNP.

(2) The absence of rules regarding competition and its impact

(a) The need to prohibit anti-competitive practices

The second fault is due to the absence of any rules regarding competition. Agreements that provide for the free movement of goods must take into account the inseparability of “domestic” anti-competitive behaviour from international trade policy. Therefore, customs union agreements, and even free trade area agreements, include provisions prohibiting anti-competitive behaviour.

Being aware that Member States may insulate public undertakings from market forces, finance them out of taxes, protect them from domestic or foreign competition, and favour their interests over those of consumers, the EC Treaty provides that special and exclusive rights, granted by Member States to public undertakings, must be abolished if incompatible with the free movement of goods and services. EC law could thus develop a level playing field for private and public undertakings and implement an economic order based upon open markets and undistorted competition. Such provisions are missing from the Protocol.

(b) The regulation of distribution in the Palestinian Territories through “direct agents”

The impact of the absence of competition rules was soon learnt by Israel. The PA has set up its own agencies, or monopolies, to import goods from Israel as well as from third countries. Reportedly, more than 100 exclusive importing agencies have been created. These are controlled by persons with close contacts to the PA Chairman, some of them serving simultaneously as officials of the PA. The monopolies enhance the trade with Israeli and foreign manufacturers linked to them. Others have been excluded from the Palestinian market. Israeli importers have been

excluded altogether. Whereas goods imported by the monopolies are freely sold on the Israeli market, a *de facto* boycott exists on importation of goods, especially those subject to high import taxes, from Israel.

The structure of the monopolies, controlled by senior PA officials, enables the PA to share with them some of the tax revenues that it collects from Israel upon clearance of the goods. Some of the taxes may even be passed on to the Israeli consumer, thus giving these imports a competitive edge. Independent Palestinian entrepreneurs lost a substantial share of their Palestinian market. Furthermore, The PA-controlled monopolies have served to transfer income from the poorer classes to a new economic class, causing a substantial rise in prices, more significant in Gaza than in the West Bank due to the tight closure there.

According to an IMF Report (February 1997), the PA has undertaken to dismantle import monopolies by the end of 1998, and to bring all revenues and expenditures, including revenues from PA commercial activities (particularly import monopolies) under the control of the Ministry of Finance by March 1, 1997. According to that report about one-fourth of domestic revenues were being diverted to accounts outside the Ministry of Finance.

Peace Through Trade: Conditions For a Viable Customs Union

The Economic Protocol was a step in the right direction on the road to peace. In creating a customs union it made the best institutional choice of the available options. Unfortunately, the results have been disappointing. A main obstacle has

been the deterioration of the state of security after the signing of the Agreement, manifesting the interdependence between economic cooperation and peaceful coexistence. Apart from the overriding security aspects, other obstacles exist. The Interim Agreement did not provide the conditions necessary for a rule-oriented customs union. A mode of sharing the revenues from imports has to be determined rather than have Israel and the Palestinians compete for them. The monopolies must likewise be dismantled and State intervention in the economy minimized.

A legal environment has to be created that will support a private sector operating in an undistorted market. There is a need for legal rules that govern commercial transactions and the settlement of disputes. The rules should be transparent, ascertainable and enforceable in a fair and efficient manner. Anti-competitive behaviour should be forbidden. The objectives of a customs union can be achieved only when the legal system is observed by private persons and public authorities alike. This requires a system that protects individual rights and subjects its authorities to open criticism.

In the absence of any of the above conditions, Israel and the Palestinians may feel obliged to separate their economies. The results of such a separation would be bad for all. On the other hand, the agreements already entered into have opened the way to a better future. Should the necessary rules be made and the parties truly committed to peaceful coexistence, then it would be exciting to know that good economics combined with an appropriate legal order could contribute to the peace process and - so it must be hoped - to the success of peace. ■