LONDON SCHOOL OF ECONOMICS

Economic Policy Programme II

<u>Confidential</u>

Overview of Palestine's Economic Policy and Foreign Trade Regime

Draft Memorandum for application for Observer Status at the WTO

Submitted to the Economic Policy Programme
London School of Economics

by

Professor Thomas Cottier
Institute of European & International Economic Law
Berne

and

Serge Pannatier
Baker & McKenzie
Geneva

January 2000

The Economic Policy Programme

The Economic Policy Programme is an initiative launched in 1996 as part of the European Community's programme of assistance to the Palestinian Population of the West Bank and Gaza Strip. The objective is to provide the Palestinian Authority with policy support that will both assist in clarifying and shaping trade policy options and thereby strengthen its capacity to negotiate with current and future trading partners on economic policy issues.

During Phase I, the programme worked with a team of experts - trade lawyers, economists and political scientists - in support of the work of the Ministry of Economy and Trade. It held, in collaboration with the Ministry, a number of roundtables and produced a series of papers on economic and trade-related issues.

The Economic Policy Programme Phase II is funded by the UK government's Department for International Development (DFID) and is co-ordinated by the Palestinian Ministry of Economy and Trade in collaboration with the London School of Economics and Political Science. This one-year programme carries on from where the EC-funded Phase I left off in May 1998, building on and consolidating earlier work undertaken as part of carefully targeted technical support extended to the Ministry, in particular in relation to trade relations with third parties (EU, EFTA etc.), trade relations with Israel, and WTO issues.

Economic Policy Programme
London School of Economics
Houghton Street
London WC2A 2AE

Programme Co-ordinator:
Valerie Yorke
Tel: +44 020 7955 6966
Fax : +44 020 7955 6950
e:mail: v.yorke@lse.ac.uk

or Tel/Fax: +44 020 7209 4281
e:mail valyorke@compuserve.com

This document is an output from a project funded by the UK Department for International Development (DFID) for the benefit of developing countries. The views expressed are not necessarily those of DFID.

OVERVIEW OF PALESTINE'S ECONOMIC POLICY AND FOREIGN TRADE REGIME

Draft Memorandum for application for Observer Status at the WTO

I. INTRODUCTION

A. Geography and population

Palestine lies on the western edge of the Asian continent and on the eastern extremity of the Mediterranean Sea. Its territory comprises two parts - the West Bank, a landlocked area bordered by Israel and Jordan, and the Gaza Strip, bordered by Israel, Egypt and the Mediterranean Sea. It covers an approximate area of 6,165 km2 (5,800 km2 in the West Bank and 365 km2 in the Gaza Strip).

The population of Palestine was put at 2,895,683 in the 1997 census, with 1,873,476 living in the West Bank and 1,022,207 in the Gaza Strip. The population has been growing at an annual rate of 5% in recent years. This extremely rapid growth rate reflects both high fertility rates and the return of Palestinians to their homeland. The literacy rate of 86% ranks amongst the highest in the Arab world. Arabic is the official language, although English and Hebrew are widely used.

More Palestinians live outside the territory of Palestine than within it. Estimates in 1997 put the numbers at 5,120,000 of which nearly half were refugees; at end 1998 a total of 2,225,094 were registered with the United Nations Refugee and Works Agency (UNRWA) in Jordan, Lebanon and Syria. There is also a still large refugee community within Palestine, numbering 1,348,288 at the same date.

B. Economy

Although it has undergone a significant process of modernisation over the last five years, the Palestinian economy is characterised by profound structural imbalances and high external dependence. This owes much to the lengthy period of Israeli occupation from 1967, which blocked export markets (other than Israel) and deterred investment in production capacity. With the scope for domestic employment generation thus severely curtailed, a large proportion of the Palestinian labour force had to find work in Israel. The ratio has varied with the security situation, with border closures by Israel repeatedly interrupting the flow of workers. It has fallen since the Oslo peace accords in 1993, but Palestinian employment in Israel and the Jewish settlements in West Bank and Gaza represented a fifth of the total work force in 1998. The economy is thus highly dependent on the earnings from this group, and also from inflows of funds from the Palestinian diaspora. Since much of the latter is not recorded, its exact size can only be estimated. The IMF has put the value of transfers at upwards of $1bn a year in mid-1990s – or around double the level of Palestine's export earnings. The labour surplus in Palestine and the capital resources of the expatriate community represent two significant reservoirs to feed economic growth.

The still limited capacity of the Palestinian economy has meant that it is highly dependent on imports and has a chronic trade deficit. In 1995-98 imports of goods and services were equivalent to, on average, 69% of GDP. Exports, by contrast, were equivalent to only around 18%. Israel remains overwhelmingly the dominant trade partner, accounting for 90% of

Palestinian imports and 88% of exports in 1996 – both marginally up on the ratios at the beginning of the decade.

Its vulnerability to external factors has meant that the economy's performance has fluctuated widely. Expanding employment opportunities for Palestinians in Israel and the Gulf brought a period of strong GDP growth in the 1970s, with an average estimated at 8-9% a year. The deteriorating external environment - with the onset of the *intifada* in 1989 and in the aftermath of the Gulf War, when Palestinians were expelled from Kuwait and Gulf countries – caused a decline in GDP in 1987-89 and again in 1991. The wide variation in growth has continued since, with a surge to 11.8% growth in GDP in 1994 in the wake of the Oslo accords followed by two years of decline, and a recovery in 1997-99, when the annual rise was running at around the 2-4% rate. These results, combined with the surge in population numbers, mean that GDP per head has risen in only one year – 1994 – while GDP per head in 1999 will have been about one eighth below its level in 1993.

Major economic indicators

	1994	1995	1996	1997	1998
GDP ($m at current prices)	3,210	3,361	3,333	3,439	3,511
Real GDP growth (%)	11.8	-3.8	-4.3	2.4	4.1
GDP per head ($)	1,448	1,431	1,354	1,343	1,321
Real GDP per head growth (%)	5.4	-9.1	-8.7	-1.6	0.2
Employment ('000)					
in West Bank & Gaza	324	342	342	364	387
in Israel & settlements	71	66	55	77	107
Unemployment ('000)	70	91	127	108	84
Exports of goods & services ($m)	366	550	582	632	693
Imports of goods & services ($m)	1,433	2,012	2,368	2,497	2,532
Current account transfers ($m)	601	561	581	534	394
Donor financing ($m)	665	795	735	716	549

Source: IMF, drawing on Palestinian and Israeli official statistics.

Economic growth since 1993 has been underpinned by substantial inflows of foreign aid, designed to meet immediate problems and requirements and to lay the foundation for longer-term economic growth. In 1994-98 Palestine received total aid of $3.46bn, of which $2.6bn was in support of the development plan. Inflows of donor funds were equivalent to an annual average of 21% of GDP during this period, and played a significant role in supporting the PA until it could build up its own revenue base.

C. Main sectors of the Palestinian economy

Agriculture

The contribution of agriculture to the economy varies from year to year, fluctuating with the two-yearly cycle of olive production (which contributes about a quarter of income in this sector), climate and the conditions of access to the Israeli market. Its share of GDP averaged 27% in 1992-96. The variety of climate allows cultivation of a wide range of crops, but production is constrained by Israeli restrictions on land and water. In mid-1996 around 70% of land in the West Bank and 50% in Gaza had been expropriated or closed for military reasons. The diversion of water for use in Israel or the settlements has reduced the already small area of land under irrigation (about a quarter of the total). In addition, while the Paris protocol of 1994 (which set the terms for economic relations between Palestine and Israel) permits unrestricted access to Israel for Palestinian agricultural exports (except for quotas on poultry, eggs, potatoes, cucumbers, tomatoes and melons until 1998), closures have prevented the Palestinians fully utilising this market opportunity.

Industry

The contribution to GDP of the industry sector (mining, manufacturing, construction and utilities) is slightly under that of agriculture. While long established, manufacturing makes a relatively minor contribution (around 10%) because investment in its development has been depressed by the complexity of regulations, inadequate financial infrastructure and the restrictions imposed under Israeli occupation. Small, owner-operated enterprises characterise this sector. Only 5% of enterprises employ more than 50 workers while nearly 90% employ less than five workers. There are approximately 11,500 establishments evenly spread over the various regions. The principal activities are food processing and the manufacture of plastics, soap, pharmaceuticals, clothing and shoes, and building materials.

Construction received a boost from the 1993 peace accord and the donor assistance that flowed in thereafter, and in every year since its share of GDP has exceeded that of manufacturing.

Services

The compression of opportunities for the production sectors has meant that the services sector is unusually large, accounting for 50% of GDP on average in 1992-96. Wholesale and retail trade has always been significant, particularly as a source of employment (together with transport and tourism it accounted for about one quarter of jobs in Palestine in 1997-98). The contribution of services to GDP has been underpinned in recent years by the doubling in employment in the public sector since the establishment of the PA, in part the reflection of the expansion in its operations and functions. In addition self-rule has stimulated the re-emergence of the banking sector. Whereas at the end of 1993 there were only four banks operating in the West Bank and Gaza, with just 16 branches, by the end of 1998 there were 22 banks, with 102 branches. Of the 22 banks, 13 were branches of foreign banks.

The telecommunication infrastructure is currently being improved under the supervision of the Palestinian Telecommunication Company. One sector which has not yet realised its very significant growth potential, given the wealth of religious and archaeological sites, is tourism. Its expansion has been hampered by the political situation, but important investments have been made in the hotel, travel agency, tourism-related transport and restaurant sectors in recent years.

Composition of imports and exports
(%)

	Imports 1996	Exports 1996	Imports 1997	Exports 1997
Food & live animals	21.0	14.3	22.2	15.0
Beverages & tobacco	5.3	4.5	3.3	5.2
Crude materials, excl. fuel	3.4	6.9	3.5	4.5
Mineral fuels, lubricants, & related materials	19.1	2.4	15.2	1.6
Animal & vegetable oils, fats, & waxes	1.1	2.6	1.1	2.1
Chemicals & rel. products	7.8	7.0	7.8	6.0
Manufactured goods	23.0	40.7	26.7	43.5
Machinery & transport equipment	12.5	6.0	12.7	5.7
Miscellaneous manu-factured articles	6.6	15.3	6.9	15.0
Commodities not classified elsewhere	0.2	0.3	0.6	1.4

Source: IMF, drawing on Palestinian official statistics

II. ECONOMIC POLICY AND OVERALL DEVELOPMENT STRATEGY

The remedying of structural imbalances and laying the foundations of sustainable economic development have been the economic policy priorities of the Palestinian Authority (PA) since it took over the management of the economy in 1994. The PA was established under the terms of the Declaration of Principles (known as the Oslo accords) signed in September 1993 by Israel and the Palestine Liberation Organisation (PLO), providing for an interim period of limited self-rule in the West Bank and Gaza. The rules and procedures governing economic relations between the two parties during this interim period were set out in the Protocol on Economic Relations between the Government of Israel and the PLO representing the Palestinian people (known as the Paris Protocol) signed in April 1994. This protocol defines the four areas of «interim self-government» for the Palestinian Authority in the economic field: fiscal competence; monetary competence; labour relations; and trade and trade-related questions.

A. Palestinian Development Plan

The Palestinian Development Plan (PDP) embodies the medium-term economic development strategy. It is a rolling programme, updated on a year-by-year basis, which sets the goals and strategies and establishes the general framework within which PA ministries and institutions can allocate resources. The PDP was first introduced in 1997, following on from: the Emergency Assistance Programme for 1994 which focused on the rehabilitation of infrastructure; the Core Investment Programme for 1996, which identified the most urgent investment and technical assistance needs for physical infrastructure, housing and the social sector, private sector support and institutional development; and the Public Investment Programme for 1997. The latest PDP covers the period 1999-2003.

The objectives of the PDP and the policies to achieve these are defined as:

a) The establishment of a legal and institutional framework that will contribute to the development of a market-based economy driven by the private sector.
b) The maintenance of an open economy, which will permit the reduction of dependence on the economy of Israel, raise the productivity of economic operators in the West Bank and the Gaza Strip, and gain access to foreign markets.
c) The development of human resources through creating more employment opportunities, reducing dependence on external labour markets, and adopting sectoral strategies, specifically in services and information technology.
d) The promotion of the tourism industry through the exploitation of the region's unique geographical and historical assets.
e) Progressive integration in regional and multilateral trade agreements.
f) Promotion of the economy's competitiveness through developing new technologies to comply with international standards.

B. Fiscal policy

In taking over the functions of the Israeli Civil Administration in 1994, a priority task for the PA was to secure a solid revenue base and provide basic public services. The PA has managed to triple its tax take, from $268m (8% of GDP) in 1994 to $863m (25% of GDP) in 1998, through modernising collection procedures and, after some initial problems, the smooth operation of the revenue clearance system operated with Israel. Higher tax revenue allowed a rise in current budget spending, which was necessitated by the expanded responsibilities of the PA and the duplication of some functions because of restricted movement between the West Bank and Gaza. Despite the very rapid rise in the public sector payroll in 1996 and 1997, the deficit on the current budget was eliminated in 1998, when the balance (on a cash basis) was a positive $60.5m (equivalent to 1.7% of GDP). After allowing for accumulated arrears of $63m the budget was virtually balanced – representing a major achievement for the PA. The following year saw a slight deterioration in the balance, owing to a rise in spending that was not matched on the revenue side, after personal and corporate taxes were cut so as to boost levels of consumption and investment. Capital spending meanwhile continued to be covered by foreign aid.

Customs procedures and administration have been closely reviewed with the assistance of the European Union and the German Government in order to comply with international standards.

C. Investment promotion

A major legacy of the Israeli occupation was the very low level of investment. While public investment has been rising steadily since 1994, underpinned by donor funding, there was no sign of an increase in private investment, other than in housing. To remedy this situation the PA is implementing measures to stimulate investment, both domestic and foreign, in production sectors. These have taken three main forms:

i) Investment incentives

The 1998 Law for the Encouragement of Investment, superseding the 1995 measure, offers a series of incentives based on the capital invested and the labour force employed. It fully exempts investors from income tax according to the amount and the length of the investment, for a variable number of years, and permits free transfer of foreign currency and repatriation of income generated in the West Bank and Gaza Strip. The law applies uniformly to all investors, irrespective of their nationality.

ii) Industrial estates and free zones

The Law on Industrial Estates and Industrial Free Zones, enacted in November 1997, creates free zones for export activities geared to regional and international markets. An independent and autonomous body was set up to oversee these zones. The first such estate, the Gaza Industrial Estate, was opened in late 1998 on a 50-hectare site on the border with Israel. It will be developed in three phases and should eventually generate 20,000 jobs directly and another 30,000 indirectly.

iii) Investment guarantees

At the request of the PA the Multilateral Investment Guarantee Agency (MIGA) has set up the West Bank and Gaza Investment Guarantee Trust Fund. This provides eligible private investors with guarantees against political risks (expropriation, war and civil disturbance), up to a limit at present of $5m per project.

III: FOREIGN TRADE REGIME

The framework within which the Palestinian foreign trade regime operates is set out in the Protocol on Economic Relations between the Government of Israel and the PLO representing the Palestinian People, signed on April 29, 1994 (the Paris Protocol). This protocol was appended to the Israeli-Palestinian Interim Agreement on the West Bank and Gaza Strip of September 1995 (the Washington agreement). This instrument governs the economic relations between the two parties during the interim period, i.e. until a permanent final status agreement enters into force. Negotiations for the final status are in process. The present regime inherently links Palestine to a large extent to the foreign trade regime of Israel and thus to its rights and obligations under the WTO. Imports into, and exports from, Palestine to third countries are largely bound by these rules, except where the Paris Protocol exceptionally offers room for autonomous foreign trade policies of the PA.

A. The foreign trade clauses of the Paris Protocol

The Paris Protocol lays the foundations of a de facto customs union between Israel and the West Bank/Gaza Strip. It provides for the free movement for both agricultural and industrial products, subject to each side’s legislation. No certificates of origin are required. In respect of imports from third parties, the two parties apply the import policy of Israel.

However, the Paris Protocol and the Washington agreement introduce exceptions which deviate from a strict customs union, in relation to mutual trade and imports from third parties. Thus, the free movement of goods between the two sides is:

- limited by quotas for the mutual exchange of six agricultural products (to be removed by 1998);
- dependent on each side's legislation, mainly in the fields of phytosanitary, veterinary and quality controls, labelling and environmental protection;
- subject to special rules for petroleum and motor vehicles as a consequence of the rights the PA can exercise in respect of their import;
- constrained by the special modalities agreed upon in respect of the direct import into Palestine of products enumerated in Lists A1, A2 and B, annexed to the protocol. (List A1 relates to goods produced in Arab countries, List A2 to food items and cotton from Arab, Islamic or other countries, and List B to goods for the Palestinian economic development programme.)

In addition there are exceptions to the implementation of Israel's import policy:

- the PLO/PA may decide on any upward change in import rates on all products not specified in Lists A1, A2 and B and with respect to quantities exceeding these agreed upon with regard to products in Lists A1 and A2.

- it may autonomously set its own tariffs, if necessary at a lower level, on goods in Lists A1, A2 and B, in agreed quantities. To date the PA has not introduced any changes to the prevailing customs duties.

A Joint Economic Committee was established under the protocol to monitor specific aspects of the agreement and to resolve any problems that arise.

B. Agreements and Arrangements with other trading partners

To reduce its high dependence on Israel as both export market and import source, the PA has signed a number of agreements governing autonomous relations with other trading partners or has benefited from reciprocal measures in its favour:

- The Technical and Economic Cooperation Accord between the Arab Republic of Egypt and the PLO of January 25, 1994, eases border restrictions and provides for the creation of free-transit areas and the use of Egyptian ports, airports and land borders.
- The Trade Agreement between the Government of the Hashemite Kingdom of Jordan and the Palestinian National Authority of January 26, 1995, provides for the duty-free import by the other party of 77 products originating in Jordan and 60 products originating in the West Bank and Gaza.
- The US Presidential Proclamation of November 13, 1996, grants duty-free treatment to products of the West Bank and Gaza entering the US market. The PA reciprocated unilaterally and grants US products duty-free treatment upon entering the West Bank and Gaza.
- The Euro-Mediterranean Interim Association Agreement on Trade and Co-operation between the European Communities and the PLO for the Benefit of the Palestinian

Authority of the West Bank and Gaza Strip of February 24, 1997, formally brings Palestine into the emerging Euro-Med area and endorses the PA's status as a full partner in the Barcelona process. It confirms concessions granted by the EU to the Palestinians since 1986 (duty-free access to the EU for Palestinian products subject to some agricultural quotas) and provides for financial and economic co-operation.

- The Interim Agreement between the EFTA states and the PLO for the Benefit of the Palestinian Authority of November 30, 1997, grants duty-free access to the EFTA markets for products from the West Bank and the Gaza Strip.
- The Joint Canadian Palestinian Framework for Economic Co-operation and Trade of February 27, 1999, provides for duty-free access for a number of Palestinian goods and services to the Canadian market.

C. Non-tariff measures

As Palestine still applies almost the same trade regime as Israel, imports and exports from World Trade Organisation (WTO) members to Palestinian territories particularly through Israeli ports and facilities are subject to the rules and disciplines of the WTO with respect to non-tariff measures. Moreover, existing agreements binding Palestine on more than one occasion implicitly or explicitly refer to WTO rules and thereby affect the framework of Palestinian trade policy.

D. Trade in services

The Paris Protocol deals in some detail with services-related issues such as banking and financial services, tourism, insurance, electricity, postal services, telecommunications, transport, etc. In the tourism sector, for example, the following powers have been entrusted with the PA :

a) Regulating, licensing, classifying and supervising tourist services, sites and industries;
b) Promoting foreign and domestic tourism and developing the Palestinian tourist resources and sites;
c) Supervising the marketing, promotion and information activities related to foreign and domestic tourism.

With respect to insurance, Article XI of the Paris Protocol transfers to the PA the authorities, powers and responsibilities including inter alia the licensing of insurers, insurance agents and the supervision of their activities.

Nothing in the Paris Protocol, however, deals specifically with the liberalisation of trade in services. However, since Israel is a member of the WTO, imports and exports from other WTO members not only to the State of Israel, but also to the Palestinian territories are subject to the rules and disciplines of the WTO. This is also true for trade in services. Therefore, the commitments agreed by Israel in its list of specific commitments under the WTO General Agreement on Trade in Services (GATS) on crossborder trade also de facto apply in the Gaza Strip and the West Bank.

E.Trade-related aspects of intellectual property rights

Under the Paris Protocol and the Washington agreement, legislation and enforcement of intellectual property rights were transferred to the PA with the proviso that they should be consistent with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs). The prevailing laws in Palestine predate 1954. The PA is therefore drawing up legislation to conform to international standards with technical assistance from the World Intellectual Property Rights Organisation (WIPO).

IV. CONCLUDING REMARKS

Palestine has adopted a policy to bring about trading relations which are fully compatible with principles, rules and obligations of the WTO. Relations with its neighbouring countries and WTO members around the World should be firmly based on the law of the WTO. Under the 1994 Paris Protocol, Palestine is largely bound by these rules even without being a member in its own right. WTO members, exporting to, and importing from, Palestine are equally and indirectly bound in their relations by this body of law. However, Palestine does not have the possibility, at this stage, either to follow discussions and negotiations within the World Trade Organisation, or to express its views and specific interests in this multilateral forum. In view of its aspiration to pursue WTO-compatible policies within the region and given the current partial autonomy it enjoys combined with the existing legal and de facto implications of WTO law, the Palestinian Authority respectfully submits this memorandum with a view to obtain the status as an observer and, subsequently, of a Member, for consideration to the Member States of the World Trade Organisation.