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## Mending Walls: The Economic Aspects of Israeli-Palestinian Peace

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# MENDING WALLS: THE ECONOMIC ASPECTS OF ISRAELI-PALESTINIAN PEACE

OREN GROSS\*

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*"[T]he key to maintaining an equitable and safe regional system is in politics and in economics . . . . Politics should pave the way from pure military strategy to an enriched political and economic repertoire."*

Shimon Peres<sup>1</sup>

*"I was elected telling people I am going to physically separate us and the Palestinians in order to encourage cooperation, mutual respect and trust . . . . I quoted Robert Frost about how good fences make good neighbors."*

Ehud Barak<sup>2</sup>

*"Spring is the mischief in me, and I wonder  
If I could put a notion in his head:  
'Why do they make good neighbors?' . . .  
Before I built a wall I'd ask to know  
What I was walling in or walling out,  
And to whom I was like to give offense . . . ."*

Robert Frost, *Mending Wall*<sup>3</sup>

## INTRODUCTION

Economic issues as part of a political solution in the Middle East are nothing new. It is common knowledge that the United Nations General Assembly Resolution 181 of November 29, 1947, stands for a partition plan of mandatory Palestine.<sup>4</sup> Fewer people know, how-

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1. SHIMON PERES, *THE NEW MIDDLE EAST* 34-35 (1993).
2. Lally Weymouth, *The Peace of the Brave*, NEWSWEEK, Nov. 8, 1999, at 46 (interview with Prime Minister Barak).
3. ROBERT FROST, *Mending Wall*, in COMPLETE POEMS OF ROBERT FROST 47, 48 (1949).
4. See *Resolution on the Future Government of Palestine (Partition Resolu-*

ever, that the plan recommended by the General Assembly for adoption and implementation with regard to the future government of Palestine was a "Plan of Partition *with Economic Union*."<sup>5</sup> Economic cooperation was included among the principles agreed upon by Israel and the Palestine Liberation Organization ("PLO") in the framework of the Declaration of Principles, signed on September 13, 1993.<sup>6</sup> The significance of the link between economic welfare and stable peaceful relations among nations was also formally acknowledged by the drafters of the 1994 Protocol on Economic Relations, annexed to the Israeli-Palestinian Interim Agreement on the West Bank and the Gaza Strip ("Paris Protocol").<sup>7</sup> The preamble to the Paris Protocol states: "[t]he two parties view the economic domain as one of the cornerstones in their mutual relations with a view to enhance their interest in the achievement of a just, lasting and comprehensive peace."<sup>8</sup> Similarly, a declaration issued at the conclusion of the first

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*tion*), G.A. Res. 181 (II), U.N. GAOR, 2d Sess., at 31, U.N. Doc. A/64 (1947), reprinted in *THE ISRAEL-ARAB READER—A DOCUMENTARY HISTORY OF THE MIDDLE EAST CONFLICT 95-103* (Walter Laqueur & Barry Rubin eds., 5th rev. ed. 1995) (providing selections from General Assembly Resolution 181).

5. *Id.* (emphasis added). Indeed, in the Declaration of the Establishment of the State of Israel, it is explicitly stated that: "The State of Israel is prepared to cooperate with the agencies and representatives of the United Nations in implementing the resolution of the General Assembly of the 29th November, 1947, and will take steps to bring about the economic union of the whole of Eretz-Israel." See *The Declaration of the Establishment of the State of Israel*, 1 OFFICIAL GAZETTE 1 (May 14, 1948).

6. Israel-Palestine Liberation Organization: Declaration of Principles on Interim Self-Government Arrangements, Sept. 13, 1993, 32 I.L.M. 1525 (1993) [hereinafter DOP]. See *id.* Article XI (the establishment of an Israeli-Palestinian Economic Cooperation Committee), Annex III (detailing the areas on which the Economic Cooperation Committee will focus), and Annex IV (regional development program).

7. The Paris Protocol was signed on April 29, 1994. It was included as an annex to the Israel-Palestine Liberation Organization Agreement on the Gaza Strip and the Jericho Area, May 4, 1994, 33 I.L.M. 622 (1994) (known as "the Cairo Agreement"). The Protocol was later partially incorporated and expanded upon in the Agreement on Preparatory Transfer of Powers and Responsibilities, Aug. 29, 1994, 34 I.L.M. 455 (1995). Finally, it was included as Annex V of the Israel-Palestinian Liberation Organization Interim Agreement on the West Bank and the Gaza Strip, Sept. 28, 1995, 36 I.L.M. 551 (1997).

8. Paris Protocol, *supra* note 7, preamble. See generally PERES, *supra* note 1, at 98 ("We do not view the agreement that was signed by us as a commercial one,

Middle East/North Africa economic summit, convened in Casablanca, Morocco on October 31-November 1, 1994, noted the participants' agreement that "the progresses made in the peace process should go along with a serious consideration of the socio-economic disparities in the Region."<sup>9</sup> The summit participants considered enjoyment of the economic dividends of peace crucial to establishing and maintaining peaceful relations in the region.<sup>10</sup>

As part of the Interim Agreement between Israel and the Palestinian Liberation Organization, the Paris Protocol sought to regulate the interim economic arrangement between Israel and the Palestinians pending the formation of a permanent agreement between them. It set up a concrete framework concerning the integration of the Israeli and Palestinian economies, which was based primarily on the model of a customs union. This framework established a single customs envelope, covering both Israel and the areas put under the control of the Palestinian Authority, based on the Israeli customs regime and im-

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but as a historic commitment with an economic lining. This will be the political significance of the passage from an economy of confrontation to an economy of peace . . .").

9. *Casablanca Declaration, Middle East/North Africa Economic Summit, Oct. 31-Nov. 1, 1994*, para. 8 (visited May 8, 2000) <[www.Israel-mfa.gov.il/mfa/go.asp?mfah00pj0](http://www.Israel-mfa.gov.il/mfa/go.asp?mfah00pj0)> (providing the text of the Casablanca Declaration).

10. See *Address by Prime Minister Yitzhak Rabin to the Middle East/North Africa Economic Summit, Casablanca, Oct. 30-Nov. 1, 1994* (visited May 8, 2000) <[www.Israel-mfa.gov.il/mfa/go.asp?mfah00r00](http://www.Israel-mfa.gov.il/mfa/go.asp?mfah00r00)> [hereinafter *Rabin Address*] (emphasizing that for peace in the Middle East to be of substance, each country seeking peace must realize the economic benefits such that "the man in the street will sense, will feel, that as a result of the peace, he has got better chances for economic and social development"); see also Ofira Seliktar, *The Peace Dividend: The Economy of Israel and the Peace Process*, in *THE MIDDLE EAST PEACE PROCESS: INTERDISCIPLINARY PERSPECTIVES* 223-24 (Ilan Peleg ed. 1998) (asserting that by spreading the economic benefits of peace to the general population, government leaders can encourage and increase public support for the peace process); Daniel Lubetzky, *Incentives for Peace and Profits: Federal Legislation to Encourage U.S. Enterprises to Invest in Arab-Israeli Joint Ventures*, 15 MICH. J. INT'L L. 405, 409-10 (1994) (arguing that nations who interact economically have an interest in preserving peace and stability between them); Philip Shenon, *U.S. and Other Nations Plan More Aid for Palestinians*, N.Y. TIMES, Dec. 1, 1998, at A6 (quoting President Clinton saying: "For too long, too many young people have turned to terrorism and old hatreds partly because they had nothing better to do. We must give them a different future to believe in.").

port policy.<sup>11</sup>

Since 1994, however, there has been growing public support in Israel for a physical separation between Israelis and Palestinians. The idea of physical separation, which had gained much support among Israelis during the Palestinian uprising, the “*Intifada*,” established its position as the preferred political solution to the Israeli-Palestinian conflict for most of the Israeli public as a result of recurrent periods of terrorist attacks carried out by Palestinians in Israel. These attacks, which included blowing up buses, placing bombs in crowded places, and attacking civilians with knives, unnerved the Israeli public.<sup>12</sup> Significantly, the current Israeli Prime Minister, Ehud Barak, publicly expressed his preference for what is known colloquially as the “border fence option.”<sup>13</sup>

This Article revisits the issue of the economic framework for a permanent peace settlement between Israel and the Palestinians. It takes as a starting point the linkage between economic development

11. See *infra* notes 55-56 and accompanying text (providing excerpts of decisions and treaties describing the Israeli customs regime and its application to the Palestinian Authority).

12. See Israel Ministry of Foreign Affairs, *Fatal Terrorist Attacks in Israel Since the Declaration of Principles* (visited May 11, 2000) <[www.israel-mfa.gov.il/mfa/go.asp?mfah0cc40](http://www.israel-mfa.gov.il/mfa/go.asp?mfah0cc40)> (noting that from September 13, 1993 to September 2, 1999, 256 civilians and soldiers were killed in terrorist attacks in Israel). Public opinion polls conducted by the Tel Aviv University’s Tami Steinmetz Center for Peace Studies demonstrate that since early 1995 between three-quarters and four-fifths of Israelis support a physical separation between Israelis and Palestinians in the framework of a permanent peace settlement.

13. See Ora Koren, *The Permanent Status Economic Arrangement Preferred by Israel: A Free Trade Agreement with the Authority*, HA’ARETZ, June 16, 2000; Daniel Klaidman & Matt Rees, *A Separate Peace?*, NEWSWEEK, Nov. 15, 1999, at 39 (stating that despite Barak’s willingness to accept a Palestinian state, he also wants to separate Israel and the Palestinian Authority both economically and physically). In a recent interview, Barak explained his thoughts on the matter of separation as follows:

I was elected telling people I am going to physically separate us and the Palestinians in order to encourage cooperation, mutual respect and trust. And in order to encourage the development of the Palestinian Authority. I quoted Robert Frost about how good fences make good neighbors. I think [a fence] is needed for personal security and security of property. It is needed to give the Palestinian infrastructure and economy a chance to stand on its own feet.

Weymouth, *supra* note 2, at 46.

and welfare and the attainment of a just and long-lasting peace in the Middle East. For peace to last among the former bitter enemies in the Middle East, ensuring that the different parties have vested interests and stakes in the success of the process is a crucial and necessary step.<sup>14</sup> The economic dividends of peace can bolster political compromises and agreements, both on the individual and the communal-national level.<sup>15</sup> More specifically, the Article suggests that raising the standard of living of the Palestinian people is critical to the strengthening of peace between Israelis and Palestinians. As such, it is as much an Israeli interest as it is a Palestinian one. In addition, peace also holds the potential for an accelerated economic growth for the region. This is so, in part, due to the lowering of defense expenditures, coupled with the reallocation of resources currently used for military needs, attraction of foreign investment, enhanced economic efficiency based on regional trade, improvement of the regional infrastructure and human capital, and higher productivity.

The Article goes on to argue that economic growth and prosperity will be better served by some sort of economic integration between the Israeli and Palestinian economies than by separating the two. Moreover, it argues that a deeper degree of integration is more likely to be beneficial in this respect than lower level integration. Thus, it suggests that, from a purely economic standpoint, a customs union model is preferable to a free trade area model.

Focusing on the economic perspective, to the exclusion of other considerations, leads, however, into the a trap of utopianism and irrelevance. In the Middle East, political, social, and cultural considerations overshadow economic arguments and calculations. In order to construct long-term meaningful structures for the economic rela-

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14. See RUTH ARAD ET AL., *THE ECONOMICS OF PEACEMAKING – FOCUS ON THE EGYPTIAN ISRAELI SITUATION* 47-50 (1983) (discussing the concept of “vested interest in peace” as referring to the welfare of interest groups which enjoy political clout). I use the term “vested interests” here in a looser meaning than that.

15. See, e.g., Stanley Fischer & Thomas C. Schelling, *Summary and Conclusions*, in *SECURING PEACE IN THE MIDDLE EAST* 1 (Stanley Fischer et al. eds., 1994) (“Peace in the Middle East will be secured only when it takes root in the everyday lives of the people of the region. That will happen if the peace brings open economic relations and economic development to the peoples and countries of the region . . .”).

tions between Israelis and Palestinians, one must understand the tension between economics and politics in this region. It is precisely such competing considerations that may lead to the conclusion that separation between Israelis and Palestinians, or at least a relatively low degree of economic integration between them, is to be preferred to a deeper form of economic integration in the region. Thus, a tension is evident between the economic and political spheres.

The traditional discourse concerning economic integration, in general, and in the Middle Eastern context, in particular, is not nuanced sufficiently to strike a viable balance between these competing interests and goals. It is here that this Article seeks to offer an alternative by proposing a new, more finely tuned model for economic integration in the region that will combine national and regional economic welfare and development with the political interests of sovereignty, national independence, and security. Thus, it seeks to reconcile the political and economic meaning of borders within the framework of transforming age old animosities into a long-lasting and just peace in the region.

Part I of the Article discusses the separation-integration debate concerning the relations between Israel and the Palestinians in its historic and economic context. It also reviews the relevant political positions and economic realities since the end of the Six-Day War. Part II focuses on the tension between economic and political considerations in structuring a viable economic model as part of a permanent peace agreement between Israelis and Palestinians. This part starts with an exposition of the conflict between economic integration and interdependence and political particularism and national sovereignty as it plays out in the Israeli-Palestinian context. It goes on to analyze in detail the considerations influencing the selection between complete separation and economic integration in the region. This part of the Article also addresses specifically one of the major concerns often expressed in opposition to economic integration in the Middle East, namely the vast differences in size between the Israeli and Palestinian economies. Bringing experience accumulated in other regional trade arrangements, the Article demonstrates that, while meriting heightened sensitivity to the needs of the economically weaker party, such economic differences should not bar a process of regional integration. This part of the Article concludes that



some degree of economic integration between the two parties is desirable in order to maintain long-term peaceful relations in the region.

Part III of the Article analyzes the potential implementation in the Israeli-Palestinian context of the traditional models of economic integration with a particular focus on the models of a free trade area ("FTA") and customs union. Scrutinizing the strengths and weaknesses of the traditional models of economic integration, the Article concludes that, while a deeper level of integration is economically more efficient, it is politically problematic.

Thus, in Part IV, this Article puts forward an alternative model for structuring the economic relations between the two parties. Based on a concept of flexible, permeable borders, this alternative model promotes bounded functional cooperation and integration between Israel and the Palestinians. This model facilitates cooperation and integration while, at the same time, taking account of national aspirations and political desires. While not necessarily a first-best model, this model may well offer the best practical chances of achieving a successful accommodation of the relevant economic and political considerations.

In light of the foregoing, there are several parameters by which the following discussion is framed. First, within the Middle Eastern setting, the Article focuses on the economic prospects for a peaceful settlement between Israelis and Palestinians. It does not address the possibilities of more expansive regional trade arrangements that include additional countries in the region. A fundamental assumption underlying this Article is that the establishment of an independent Palestinian state is inevitable and the issues discussed should therefore be thought of in the framework of country-to-country (*i.e.*, Israel-to-Palestine) relations. Second, this Article concentrates on the issue of the appropriate trade regime to be implemented between the two parties with respect to the movement of goods, services, and labor. It does not discuss fiscal and monetary issues and the movement of capital.<sup>16</sup> Finally, the analysis proposed below focuses, for the

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16. See Arie Arnon & Jimmy Weinblatt, *Sovereignty and Economic Development: From an Interim Agreement to a Permanent Settlement between the Israelis and the Palestinians*, 47 *ECON. Q.* 33, 43 (2000) (noting that issues of monetary or

most part, on the national level of analysis, *i.e.*, on the state-to-state level, rather than on a more systemic level or on the level of domestic decision-making and politics.<sup>17</sup> Thus, for example, the Article does not analyze the internal workings of different domestic interest groups operating within each of the relevant actors and their effect on the makings of national policies.<sup>18</sup> Although clearly the influence of such groups has played a significant role in shaping the economic and political relations between the relevant actors, and probably will continue to play such a role in the future,<sup>19</sup> analyzing the contours of that influence and its workings is a matter for separate research.

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fiscal policy are not dependent on, nor do they impact, the existence of economic borders between Israel and Palestine).

17. The distinction between the various levels of analysis is well developed in international relations literature. *See, e.g.*, KENNETH N. WALTZ, *MAN, THE STATE, AND WAR: A THEORETICAL ANALYSIS* (1959) (distinguishing between three levels of analysis: the international system; the nature of the state; and human nature); ARNOLD WOLFERS, *DISCORD AND COLLABORATION: ESSAYS ON INTERNATIONAL POLITICS* (1962) (describing two levels of analysis: internal and external); ROBERT JERVIS, *PERCEPTION AND MISPERCEPTION IN INTERNATIONAL POLITICS* (1976) (exploring four levels of analysis: external environment, *i.e.*, the international system; domestic sources; bureaucratic politics; and decision making).

18. *See* Federation of Israeli Chambers of Commerce, Israel and the Palestinian Authority – Towards Economic Permanent Status Arrangements, July 25, 1999 (on file with the author) (rejecting the continuation of a customs envelope covering both Israel and the areas under the control of the Palestinian Authority, and expressing preference for monetary, fiscal and tariff separation between Israel and Palestine based on a physical border, on the one hand, and a free trade area regime, on the other hand). There is a wealth of literature on the role of domestic interest groups in shaping national trade policy. *See, e.g.*, Enrico Colombatto & Jonathan R. Macey, *A Public Choice Model of International Economic Cooperation and the Decline of the Nation State*, 18 *CARDOZO L. REV.* 925 (1996) (explaining the public choice theory of international regulatory competition and coordination and applying the public choice theory to international banking and securities law); Paul B. Stephan III, *Barbarians Inside the Gate: Public Choice Theory and International Economic Law*, 10 *AM. U. J. INT'L L. & POL'Y* 745 (1995) (examining public choice theory and its relevance to international economic law).

19. *See, e.g.*, J.W. Wright, Jr., *Competing Trade Agendas in the Arab-Israeli Peace Process – A Case Studies Approach*, in *THE POLITICAL ECONOMY OF MIDDLE EAST PEACE – THE IMPACT OF COMPETING TRADE AGENDAS* 40 (J.W. Wright, Jr. ed., 1999); Jonathan Nitzan & Shimshon Bichler, *The Impermanent War Economy? Peace Dividends and Capital Accumulation in Israel*, in *THE POLITICAL ECONOMY OF MIDDLE EAST PEACE: THE IMPACT OF COMPETING TRADE AGENDAS* 73, 96-98 (J.W. Wright, Jr. ed., 1999) (analyzing the causes for the mobilization of Israel's conglomerates for purposes of regional reconciliation).

# I. INTEGRATION AND SEPARATION IN THE ISRAELI-PALESTINIAN CONTEXT – HISTORICAL PERSPECTIVES

## A. THE ROOTS OF THE DEBATE

The magnitude of the military defeat of the Arab forces in 1967 and the speed by which their collapse was brought about, as well as Israel's ability to gain control of the Sinai, the Golan Heights, East Jerusalem, the Gaza Strip and the West Bank,<sup>20</sup> came as a shock to the Arab nations and their allies. They also surprised Israel itself.<sup>21</sup> One important outcome of that surprise was the lack of a coherent policy and comprehensive planning concerning the future of the Territories and their relationship to Israel.<sup>22</sup>

Soon after the end of the 1967 war, two competing views developed in the Israeli government regarding the nature of the desired economic relations between Israel and the Territories. Moshe Dayan, the powerful Minister of Defense, advocated the integration of the two economies into a single economic unit and argued for the free movement of not only goods and services, but also labor and capital. Dayan also supported the integration and linkage of the infrastructure

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20. In the rest of this Article, reference shall be made exclusively to the West Bank and the Gaza Strip (collectively, "the Territories").

21. See CHAIM HERZOG, *THE ARAB-ISRAELI WARS: WAR AND PEACE IN THE MIDDLE EAST 189* (1982) (characterizing victory in the Six Day War as "astounding and unexpected.").

22. See SHLOMO GAZIT, *PETAIM BE-MALKODET [TRAPPED]* 27-32 (1999) (noting the lack of planning prior to the 1967 war, concerning the possibility of having to establish a military government in areas outside the Israeli territory, the absence of political planning, after the war has ended, as to the political future of the territories, and the "shock of victory" within the Israeli public after the war).

This section of the Article focuses on the debate within Israel for two reasons. First, no similar debate took place within the Palestinian population in the Territories until relatively recently. Second, since the development of the Palestinian economy was mostly influenced by its links to the Israeli economy, and since those links have been controlled and shaped almost exclusively by Israel, it is Israeli views and opinions on the issue at hand that mattered most, at least in the past. See ARIE ARNON ET AL., *THE PALESTINIAN ECONOMY – BETWEEN IMPOSED INTEGRATION AND VOLUNTARY SEPARATION* 6 (1997) (discussing how the "links between the two economies were decided in Israel.").

of the Territories with Israel's.<sup>23</sup> His major opponent was the equally powerful Minister of Finance, Pinhas Sapir, who opposed the elimination of an economic border between the two economies with respect to the movement of labor.<sup>24</sup>

Economic realities proved stronger than governmental decisions and ministerial positions.<sup>25</sup> The end of the war witnessed high unemployment rates in the Territories. On the one hand, there were no substantial investments made in the Territories. At the same time, Israeli manufacturers were not permitted to establish factories and plants in those areas.<sup>26</sup> It appeared that the Israeli government adopted a protectionist stance against the industrialization of the Territories for fear of competition with Israeli manufacturers.<sup>27</sup> The economic boom of the Israeli economy in the years following the 1967 war, on the other hand, resulted in an urgent need for working hands, especially in such sectors as construction and agriculture. As a result,

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23. See SHLOMO GAZIT, HA-MAKEL VEHA-GEZER: HAMIMSHAL HAYI'SRE'ELI BIYEHUDAH VESHOMRON [THE CARROT AND THE STICK - ISRAEL'S POLICY IN JUDEA AND SAMARIA] 141, 147-50 (1985).

24. See SHABTAI TEVETH, KILELAT HA-BERAKHAH [THE CURSED BLESSING: THE STORY OF ISRAEL'S OCCUPATION OF THE WEST BANK] 283-92 (2d ed. 1973) (detailing the debate between Dayan and Sapir).

25. See GAZIT, *supra* note 23, at 254 (noting that employment of the Palestinian residents of the Territories was not an Israeli governmental initiative, but rather sprang from the "reality of life," and further noting that prior to 1973, the Israeli government had engaged in an ongoing struggle to thwart the employment of Palestinian laborers in Israel); GAZIT, *supra* note 22, at 155-57.

26. See GAZIT, *supra* note 23, at 150 (positing that the failure of the Israeli government to permit and encourage Israeli investment to develop industry in the Territories was a primary cause of the continuing chasm between the Israeli and Palestinian economies).

27. See, e.g., SARA ROY, THE GAZA STRIP: THE POLITICAL ECONOMY OF DEVELOPMENT 4 (1995) (arguing that Israel deliberately prevented economic development of the Territories in order to keep the Palestinians economically and politically subservient and documenting the "impact of Israeli occupation policy on economic development in the Gaza Strip"). *But see* ARNON, *supra* note 22, at 9-10 (claiming that existing data is insufficient to conclude that there was a calculated long-term protectionist policy as opposed to responses to immediate needs and pressures); GAZIT, *supra* note 23, at 179 (noting Israel's goal to prevent its control over the Territories from becoming economically burdensome on the Israeli economy as a major reason behind Israel's failure to positively act to develop the Territories).

thousands of Palestinians chose to take advantage of the geographic proximity to the Israeli market in order to seek employment in Israel, albeit illegally at first. The vast differences in income of those Palestinians as compared with their neighbors who continued to be employed in the Territories, combined with the other factors noted above, soon made the movement of Palestinian workers into Israel an established feature of the economic relations between Israel and the Palestinians.<sup>28</sup> Noting these trends, in October 1970 the Israeli Cabinet decided that Palestinians holding work permits were entitled to work in Israel for wages equal to those earned by Israeli workers in similar positions.<sup>29</sup> By 1972, economic integration between Israel and the Territories was "almost complete."<sup>30</sup> Rather than limiting the free movement of Palestinian workers into Israel, a policy of "open bridges," not only between the Territories and Jordan, but also between the Territories and Israel, came to life.<sup>31</sup> Palestinian labor could move freely into Israel, and Israeli goods could be exported freely to the Territories. Likewise, Palestinian goods could be sold in Israel, although Israel imposed various trade barriers for protectionist reasons, especially with respect to agricultural goods.<sup>32</sup> This was of great significance in light of the special place of agriculture in the Palestinian economy.<sup>33</sup>

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28. See GAZIT, *supra* note 23, at 252-58.

29. See Guy Mundlak, *Power Breaking or Power-Entrenching Law: The Regulation of Palestinian Workers in Israel*, COMP. LABOR L. & POL'Y J. (forthcoming fall 2000) (on file with the author).

30. See ARNON, *supra* note 22, at 5.

31. See generally GAZIT, *supra* note 23, at 204-22 (noting that while originally the policy of "open bridges" referred solely to the decision to allow movement from the West Bank to Jordan via the bridges crossing the Jordan River, the "open bridges" policy became a prong in a greater political program designed to eliminate barriers and integrate the Palestinian and Israeli economies); see also GAZIT, *supra* note 22, at 68-69.

32. See ARNON, *supra* note 22, at 5 (arguing that Israel imposed various trade barriers on Palestinian agricultural products designed to make it harder for Palestinian growers to market their produce in Israel and further noting that those barriers were later replaced by a manufacture and growing quotas regime implemented in the Territories themselves by the Israeli military government).

33. See *id.* at 18-19 (noting the Palestinian economy traditionally relied heavily on the agricultural sector); Raymond Vernon et al., *Agriculture, Industry, Services, and Trade*, in SECURING PEACE IN THE MIDDLE EAST 45, 53-54 (Stanley Fischer et

## B. ECONOMIC REALITIES

A cursory view of the economic relations between Israel and the Palestinians prior to 1994 reveals two striking features. First, the shaping of such relations was almost entirely a matter for Israel. The Palestinians had not played a significant role in that context and did not have a say in any decision-making processes in these matters. Second, the huge economic gaps between the two peoples were marked by a one-sided dependence of the Palestinian economy on Israel. The economic relations between Israel and the Palestinians have been traditionally characterized as constituting "asymmetric trade relations."<sup>34</sup> Furthermore, these relations were not based on a voluntary arrangement between two parties of relatively equal bargaining power and leverage; instead, Israel unilaterally shaped their contours.<sup>35</sup>

Israel is an economic giant compared with the Palestinian economy and the economies of all of its neighbors.<sup>36</sup> In 1998, the gross national product ("GNP") per capita in Israel stood at a level of \$16,180.<sup>37</sup> At the same time, the figures for the Territories, Egypt, Jordan, and Syria stood at \$1,560, \$1,290, \$1,150, and \$1,020, respectively.<sup>38</sup> In GNP and gross domestic product ("GDP") terms, the

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al eds., 1994) (noting that the Palestinian economy resembles low-income economies in its reliance on the agricultural sector).

34. INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT, WORLD BANK, 2 DEVELOPING THE OCCUPIED TERRITORIES: AN INVESTMENT IN PEACE, *The Economy* 45 (1993).

35. ARNON, *supra* note 22, at 88 (describing the trade regime that existed between Israel and the Palestinian economy since 1967 as "an *involuntary, one-sided, impure, customs union*"). The authors note that "[s]ince there was no Palestinian (economic) authority and Palestinians did not participate in policy-making, all decisions were made by the Israeli authorities." *Id.*

36. See, e.g., Patrick Clawson, *Mideast Economies After the Israel-PLO Handshake*, 48 J. INT'L AFF. 141, 159 (1994) ("In many areas in which functional cooperation has been proposed, Israel is the giant that, no matter how well-intentioned, has the potential to overwhelm its neighbors.").

37. WORLD BANK, WORLD DEVELOPMENT INDICATORS 2000 (2000) (providing national development statistics). Country data is also available online at <<http://www.worldbank.org/data/countrydata/countrydata.html>> [hereinafter WDI 2000].

38. See *id.*

combined economies of the Gaza Strip and the West Bank are about 4.5 percent and 3.6 percent the size of the Israeli economy, respectively.<sup>39</sup> In fact, Israel's GDP – \$100.5 billion in 1998 – exceeds the combined GDP of Egypt (\$82.7 billion), Jordan (\$7.4 billion), and the Territories (\$3.6 billion).<sup>40</sup> There are substantial economic differences between the relative sizes of the Israeli and Palestinian economies, and between the relevant economies' level of development and the structure of the domestic markets.<sup>41</sup> Whereas Israel is a developed country specializing increasingly in the production of high technology products, its neighbors' comparative advantages lie in the production of low-tech, labor-intensive products.

Since 1967, Israel constituted the lion's share of Palestinian trade. Up to ninety percent of all imports to the Territories came from or through Israel while eighty-five percent of all Palestinian exports went to or through Israel.<sup>42</sup> Export of labor services to Israel formed a particularly significant portion of the Palestinian GNP.<sup>43</sup> In 1992, for example, Israeli employers employed over one third of the Palestinian work force, or almost 116,000 people.<sup>44</sup> Most of these Palestini-

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39. See ARNON, *supra* note 22, at 12-13 (noting that the economic gap is more pronounced when measured in GDP terms since there is a substantial difference between the Territories' GNP and GDP, with the former exceeding the latter, due, primarily, to the Palestinian economy's heavy reliance on the export of labor services to Israel and private remittances from abroad); Vernon, *supra* note 33, at 47.

40. See WDI 2000, *supra* note 37 (comparing Israel's economy with its neighbors').

41. See *id.* at Table 5.11 (noting that there were 187.41 internet hosts per 10,000 people in Israel in July 1999, compared to 0, 0.28, 1.17, and 0 internet hosts per 10,000 people in the Territories, Egypt, Jordan and Syria, respectively).

42. See ARNON, *supra* note 22, at 34-37 (noting the Palestinian dependence on Israel in as much as trade is concerned); ISHAC DIWAN & RADWAN A. SHABAN (EDS.), DEVELOPMENT UNDER ADVERSITY – THE PALESTINIAN ECONOMY IN TRANSITION 6 (1999), also available online at <[www.palecon.org/wbdocs/Development\\_Under\\_Adversity.pdf](http://www.palecon.org/wbdocs/Development_Under_Adversity.pdf)>.

43. See Sharif S. Elmusa & Mahmud El-Jaafari, *Power and Trade: The Israeli-Palestinian Economic Protocol*, 24(2) J. PALESTINE STUD. 14, 28 (1995) (describing Palestinian labor in Israel as a "necessary evil" for both sides, particularly for the Palestinians). See generally MICHAEL SHALEV, LABOR AND THE POLITICAL ECONOMY IN ISRAEL (1992); LEV L. GRINBERG, THE HISTADRUT ABOVE ALL 162-205 (1993).

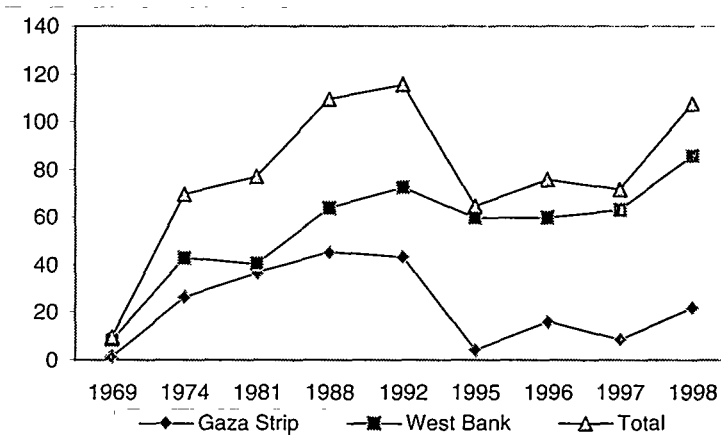
44. See *infra* note 46 and the accompanying graph.

ans were employed in low-skill, manual labor jobs in construction, agriculture and services. The income from Palestinian employment in Israel contributed directly to about twenty-five percent of the Territories' GNP and added to it indirectly by increasing demand for locally produced goods, thus further contributing to the GDP.<sup>45</sup> While the exact figures have fluctuated throughout the period of Israel's rule over the Territories, as shown in the graph on the next page, the overall picture of a one-sided economic dependence remained largely intact and unchanged.

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45. See Oren Gross & Eli Sagi, *The Israeli-Palestinian Economic Permanent Status Agreement and Trade Regime*, 47 *ECON. Q.* 50, 57 (2000) (discussing the multiplier effect); ARNON, *supra* note 22, at 19 (suggesting that the share of Palestinian workers' remittances in the overall Palestinian GNP "is probably the highest level in the world.").



PALESTINIAN WORKERS EMPLOYED IN ISRAEL (THOUSANDS)<sup>16</sup>

To complete the picture, it is important to note that even under such conditions (and, it may be argued, precisely because of them) the Palestinian economy's rate of growth far outpaced that of Is-

46. See Israel Central Bureau of Statistics, National Accounts of the Judea, Samaria and the Gaza Area 1968-1993, Special Report, No. 1012 (1996). There are significant difficulties in ascertaining the actual numbers of Palestinians working in Israel since 1994. With the implementation of the closure policy by the Israeli government, for example, a significant discrepancy appeared between reports accounting only for permit-holding Palestinian workers employed in Israel, and those reports that attempt also to estimate the number of informal workers, *i.e.*, Palestinians who work in Israel without a permit. As these latter figures are based on estimates, variances are inevitable. In fact, the number of Palestinians working without a permit has exceeded the number of permit-holders at any given period. In the absence of clear measurement criteria and effective monitoring system, each side "chose" its own data. For the years 1995-98 the graph in the text is based on the total numbers of permit holders as well as on estimates of non-permit-holding workers who actually worked in Israel. See generally ARNON, *supra* note 22, at 75 (listing employment data from the ICBS for Gaza Strip and West Bank residents working in Israel and locally); B'Tselem, *Poalei Zion - Human Rights Violations of Palestinians from the Occupied Territories Working in Israel and the Settlements* 12 (1999) (providing a historic overview of entry of Palestinian workers in Israel, their place and numbers in the Israeli economy, restrictions on their movement, and interactions with Israeli security forces); World Bank Group, *West Bank and Gaza Updates* (visited June 8, 2000) <<http://wbln0018.worldbank.org/mna/mena/nsf>> (reporting quarterly on recent economic developments and World Bank activities in the Territories).

rael's, at least until the early 1980s.<sup>47</sup> In that respect, the forced economic integration with the Israeli market greatly contributed to the rise in the individual Palestinian's standard of living as well as the growth of the economy.<sup>48</sup>

The (forced) economic integration between Israel and the Territories was at its peak from 1967 to 1987. The outbreak of the the *Intifada* in December 1987 led to a counter-movement toward greater separation between the two markets. This resulted in a subsequent decrease in the number of Palestinian workers employed in the Israeli labor market, a decline in the total weekly hours worked by Palestinian workers in Israel,<sup>49</sup> a widening wage differential between the two markets,<sup>50</sup> and a decrease in Palestinian exports and imports.<sup>51</sup>

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47. See Barbara Kotschwar, *Small Countries and the Free Trade Area of the Americas*, in TRADE RULES IN THE MAKING - CHALLENGES IN REGIONAL AND MULTILATERAL NEGOTIATIONS 134, 135-36 (Miguel Rodriguez Mendoza et al. eds., 1999) (explaining the economic theory concerning regional trade arrangements, which forecasts that under a liberalized free trade regime between economies of differing sizes, the smaller economy stands to benefit more than its larger counterpart from liberalization and the lifting of trade restrictions, due to gains of efficiency and economies of scale).

48. See ARNON, *supra* note 22, at 21 (noting the average annual rates of GDP growth in 1968-90 were 5.4 percent for the Gaza Strip and 7.4 percent for the West Bank, compared with 4.5 percent in Israel). Economic data clearly demonstrates the significant rise in disposable income in the Territories following 1967 (affected, primarily, by the access opportunities to the Israeli labor market and its affect on the domestic Palestinian market) and the concomitant rapid growth in consumption per capita. *Id.* at 23; see also Ephraim Kleiman, *The Economic Provisions of the Agreement Between Israel and the PLO*, 28 ISRAEL L. REV. 347, 350 (1994) (commenting that GNP per capita in the Territories almost quadrupled in 1969-92, whereas in Israel it hardly doubled). *But see* MARK TESSLER, A HISTORY OF THE ISRAELI-PALESTINIAN CONFLICT 525-28 (1994) (revealing the Palestinian view that forced economic integration did not result in an improved standard of living for Palestinians as evidenced by substandard housing, education, etc., and that the export of labor was not a signal of economic development, but rather a signal of deepening dependence of the territories on Israel).

49. See ARNON, *supra* note 22, at 77 (determining that although more Palestinian workers worked in Israel in 1992 than in 1987, the total number of hours worked by such workers in 1987 was larger than the equivalent figure for 1992).

50. See *id.* (arguing that the widening gap means that a higher premium was attached to working in Israel and indicates a degree of separation between the Israeli and Palestinian labor markets).

51. *Id.* at 35, 93, 99 (illustrating the dramatic fall in trade after 1987 graphically

There is a clear, yet often overlooked, link between the outbreak of the *Intifada* and negative trends that developed with respect to the economy of the Territories and its relationship with the Israeli economy. The Israeli economy slowed down during the late 1970s and 1980s, real wages eroded as a result of high inflation rates in Israel, unemployment levels rose in the Territories during the 1980s, and the economies of the Gulf states, where many Palestinians were employed, contracted, affecting the jobs available in these countries for Palestinians and the amount of remittances from such employment entering the Territories. Privation, therefore, is closely linked to the turn to violence as a political measure of desperation.<sup>52</sup>

The September 13, 1993 signing of the Declaration of Principles on the White House lawn and the conclusion of the Paris Protocol in April 1994, were to signify the dawn of an old-new era. This era was "old" in the sense of return to the format of economic integration, but "new" insofar as that integration was based on a consensual, rather

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and with a series of trade data from 1968 to 1993).

52. See, e.g., BARUCH KIMMERLING & JOEL S. MIGDAL, *PALESTINIANS – THE MAKING OF A PEOPLE* 259-61 (1993) (linking the economic downturn in Israel with the *Intifada*). The authors note that:

[t]he bleakness of national prospects thus combined with despair over individual and family prospects. Added to this dismal brew were the personal experiences of routine harassment, occasional beatings, arrests without formal charges, and humiliating searches by security forces at roadblocks and checkpoints. Young Palestinians increasingly felt there was little to lose if they broke the rules of the game . . . .

*Id.*; see also ZE'EV SCHIFF & EHUD YAARI, *INTIFADA* 71 (1990) (in Hebrew). A chapter entitled, "The Raging Proletariat," describes the *Intifada*'s breakout as "rebellion of the poor, an awesome outburst by the forsaken and the bottom at the bottom of the social scale." Schiff and Yaari argue that:

[u]ndoubtedly, in the beginning the uprising grew out of the conditions of hardship under which the [Palestinian] refugees continued to live under the Israeli rule – and not out of the desires planted in their hearts by the PLO. The daily hardship greased the wheels of momentum – not the expectations of a better political future.

*Id.* at 72 (translated by the author). See also Gad G. Gilbar, *Demographic and Economic Developments as Causes for the Intifada*, in *AT THE CORE OF THE CONFLICT: THE INTIFADA* 20 (Gad G. Gilbar & Asher Susser eds., 1992) (analyzing the link between economic deprivation and the outbreak of the *Intifada*).

than unilateral, understanding.<sup>53</sup> The Paris Protocol, based on the model of a customs union,<sup>54</sup> established a single customs envelope covering both Israel and the areas put under the control of the Palestinian Authority.<sup>55</sup> This customs envelope, which was based on the Israeli customs regime and import policy, sought to harmonize tariff rates, purchase tax and value added tax rates, import procedures, price evaluations and product classifications for customs purposes, and technical requirements and standards.<sup>56</sup> However, in recognition

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53. See ARNON, *supra* note 22, at 7 (“As regards the economic arrangements, the most dramatic change was the mutual recognition that there were two legitimate parties to every economic decision affecting the Palestinian economy.”).

54. See Kleiman, *supra* note 48, at 370 (explaining that the Paris Protocol does not mention the term “customs union” because the Palestinians rejected this concept in order to emphasize their separateness from Israel).

55. PCA 2736/98 Habboub Bros. Co. and Others v. Nike International Ltd. and Others (decision of the Israeli Supreme Court, March 6, 2000), at § 11 (“Israel and the Palestinian Authority are included in one customs envelope ...[which means that] the importation of goods to Israel, for purposes of sale, marketing, or for any other commercial purpose, in the territory of the Palestinian Authority, will be regarded as importation of goods into Israel itself.”) (translated by the author); See also Meir Kapota, *Taxation and Trade Arrangements between Israel and the Palestinian Authority*, 13(4) MISSIM A9 (Part i) & 13(5) MISSIM A17 (Part ii) (1999), at Part ii, at A18 (describing the Paris Protocol as creating a customs union between Israel and the Palestinian Authority); David P. Fidler, *Peace Through Trade? Developments in Palestinian Trade Law During the Peace Process*, 38 VA. J. INT’L L. 155, 161-62 (1998) (describing the Paris Protocol arrangement as a compromise, which provided for free movement of goods between Israel and the Territories while establishing a customs union); Joel Singer, *The Israeli-Palestinian Interim Agreement on Self-Government Arrangements in the West Bank and the Gaza Strip – Some Legal Aspects*, 27 MISHPATIM 605, 626 (1997) (stating that the basic principle underlying the Paris Protocol was the establishment of a customs union); Yoram Gabai, *Agreement on Tariffs and Trade between Israel and the Palestinians*, 8(3) MISSIM A1, A5 (1994).

56. See Paris Protocol, *supra* note 7. Article III(5) of the Paris Protocol states the following:

a. . . . the Israeli rates of customs, purchase tax, levies, excises and other charges, prevailing at the date of signing of the Agreement, as changed from time to time, shall serve as the minimum basis for the Palestinian Authority. The Palestinian Authority may decide on any upward changes in the rates on these goods and exceeding quantities when imported by the Palestinians to the Areas.

b. . . . Israel and the Palestinian Authority will employ for all imports the same system of importation . . . including inter alia standards, licensing,

of the special links between the Palestinians and the neighboring Arab countries, and the need for independence in setting Palestinian trade policy, the Paris Protocol grants the Palestinian Authority the power (albeit limited to goods agreed upon by the parties and by quotas) to set its own trade policy with respect to imports from Arab countries.<sup>57</sup> Of course, within the customs envelope, goods were to move freely between Israel and the Territories.<sup>58</sup> Finally, Article

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country of origin, valuation for customs purposes etc.

Article III(10) of the Protocol adds:

Except for the goods on Lists A1 and A2 and their quantities . . . both sides will maintain the same import policy (except for rates of import taxes and other charges for goods in List B) and regulations including classification, valuation and other customs procedures, which are based on the principles governing international codes, and the same policies of import licensing and of standards for imported goods, all as applied by Israel with respect to its importation. Israel may from time to time introduce changes in any of the above, provided that changes in standard requirements will not constitute a non-tariff-barrier and will be based on considerations of health, safety and the protection of the environment . . . .

*Id.*

57. See Elmusa & El-Jaafari, *supra* note 43, at 20-23 (outlining rules governing imports and exports under the Paris Protocol). Lists A1 and A2 include food and agricultural products (with the exception of fresh fruits and vegetables), basic construction materials, fertilizers, and household electric appliances. List B includes capital goods for economic development, such as agricultural equipment, heavy construction equipment, and factory and household textile machinery and tools. Goods included in List B are not subject to any tariff, rules of origin, or quantity restrictions under the Paris Protocol, although their import is subject to other aspects of Israel's import policy (*e.g.*, standards), whereas goods included in the A1 or A2 lists are subject to quotas and rules of origin. In addition, special arrangements are structured under the Paris Protocol with respect to petroleum and petroleum products and cars. See *id.*; see also Kleiman, *supra* note 48, at 358-60 (commenting that the purpose of the exemption from the Israeli import regime for the items on lists A1 and A2 was to permit Palestinians to import from countries with which Israel did not trade at the time of the agreement). The exemptions included in Lists A1, A2 and B may also be seen "as an alternative to power sharing" between Israel and the Palestinians with respect to imports into the customs envelope. See *id.* at 371. See also Gabai, *supra* note 55, at A6-A7; Kapota Part ii, *supra* note 55, at A19-A24; Nu'man Kanafani, *Trade Relations Between Palestine and Israel: Free Trade Area or Customs Union?* 20-23 (1996).

58. See Paris Protocol, *supra* note 7, Art. IX(1) (stating that "[t]here will be free movement of industrial goods free of any restrictions including customs and import taxes between the two sides, subject to each side's legislation."). While a similar provision deals with the free movement of agricultural produce between the

VII(1) of the Paris Protocol states that “[b]oth sides will attempt to maintain the normality of movement of labor between them, subject to each side’s right to determine from time to time the extent and conditions of the labor movement into its area.”<sup>59</sup>

Reality proved to be much more fickle, however, and it soon undermined much of the hard-fought-for agreement. Responding to an increase in Palestinian terrorist activity, aimed primarily at Israel’s civilian population,<sup>60</sup> the Israeli government applied a relatively strict closure policy to the Territories, periodically sealing them off from Israel and preventing movement between the Gaza Strip and the West Bank.<sup>61</sup> As a result, the economic crisis, which plagued the Pal-

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two parties, such movement is subject to several exceptions and arrangements specified concerning, primarily, veterinary and plant protection needs.

59. *Id.* at Article VII(1).

60. *See supra* note 12 and accompanying text (discussing terrorist attacks that led to the closure response).

61. *See UNSCO, Closure on the West Bank and Gaza, Fact Sheet* (Aug.-Sept. 1997) (visited May 8, 2000) <[www.arts.mcgill.ca/mepp/unsco/closure001097.html](http://www.arts.mcgill.ca/mepp/unsco/closure001097.html)> [hereinafter UNSCO, *Closure*] (reporting on the number of closure days, income and trade losses, and short and the long-term impact of closures). Under the closure policy, movement from the Territories to Israel was only allowed to Palestinians holding special permits of limited duration issued for that purpose by Israel. The criteria developed for the purpose of determining who would receive a permit were designed to prevent terrorists from legally entering Israel. Thus, for example, to be eligible for a worker’s permit, an individual ought to be married and over a certain age. The idea is, of course, that young, unmarried men, are more likely to engage in acts of terrorism (and especially in acts of suicide-bombing) than older, married men. In addition, Israel has also imposed “total closures” on the Territories, usually after particularly serious terrorist attacks that had been carried out in Israel proper. Under such circumstances, all Palestinians were barred from entering Israel. *See id.*; *see also* Serge Schmemmann, *Gazans’ Plea to Netanyahu: Stop Closing Us Out of Jobs*, N.Y. TIMES, July 9, 1996, at A1 (describing economic hardships on Palestinians as a result of “closures” and the effect on Gaza, which is more dependent on jobs in Israel); *West Bank and Gaza. The Banging Door*, THE ECONOMIST, Aug. 3, 1996, at 39; Kleiman, *supra* note 48, at 372-73 (noting that as early as 1994, warnings were made that “frequent closures can play havoc with the economic logic underlying the whole [Paris Protocol]. Furthermore, the more security precautions take the form of physical borders, the louder and more numerous will be the voices clamouring on both sides for economic borders as well . . .”). For a critique of the lack of clear, transparent rules governing the issuance of permits *see* Fatemeh Ziai, *Human Rights Violations as an Obstacle to Economic Development: Restrictions on Movement in the West Bank and the Gaza Strip*, in THE POLITICAL ECONOMY OF MIDDLE EAST PEACE –

estonian economy throughout the years of the *Intifada*, worsened. Both real GNP and real GNP per capita significantly declined.<sup>62</sup> The relative weight of international trade demonstrated a similar pattern, with merchandise exports from the Territories falling from eleven percent to six percent of GDP between 1992 and 1995, and imports falling from forty-six percent to thirty-eight percent of GDP during the same period.<sup>63</sup> Estimates are that between 1994 and 1996 the level of standard of living in the Territories declined by some twenty-five percent.<sup>64</sup> The heightened state of security led to more stringent inspection of Palestinian goods moving into Israel and further encumbered the movement of Palestinian goods and persons, resulting in increased costs of Palestinian trade.<sup>65</sup> Various estimates put the cost to the Palestinian economy of each day of closure at around

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THE IMPACT OF COMPETING TRADE AGENDAS 128, 135-36 (J.W. Wright, Jr. Ed., 1999).

62. As reliable economic data relating to the relevant period is difficult to get by, different figures may be quoted by different sources which are not always compatible with each other. Some of the figures are based on estimates and should be interpreted cautiously. UNSCO, *Economic and Social Conditions in the West Bank and Gaza Strip, Quarterly Report, April 1997* (visited May 8, 2000) <[www.arts.mcgill.ca/MEPP/unsco/qr2/qr2.html](http://www.arts.mcgill.ca/MEPP/unsco/qr2/qr2.html)> [hereinafter UNSCO April 1997] (reporting that between 1992 and 1996 there was a decline in the Palestinian GNP and GNP per capita of 18.4 percent and 36.1 percent, respectively); UNSCO, *Economic and Social Conditions in the West Bank and Gaza Strip, Quarterly Report, October 1997* (visited May 8, 2000) <[www.arts.mcgill.ca/MEPP/unsco/qr3/qr3.html](http://www.arts.mcgill.ca/MEPP/unsco/qr3/qr3.html)> [hereinafter UNSCO October 1997] (reporting that in 1996 GNP and GNP per capita declined by 3 percent and 8.6 percent, respectively); UNSCO, *Report on Social and Economic Conditions in the West Bank and Gaza Strip, October 1998* (visited May 8, 2000) <[www.arts.mcgill.ca/programs/polisci/faculty/rexb/unsco98/section1.html](http://www.arts.mcgill.ca/programs/polisci/faculty/rexb/unsco98/section1.html)> [hereinafter UNSCO October 1998] (reporting that in 1997, real GNP per capita continued to decline 3 to 4 percent while real GNP grew by 2 percent).

63. See World Bank Group, *The West Bank and Gaza: Country Overview* (visited May 11, 2000) <[www.worldbank.org/html/extdr/offrep/mena/wb&g.htm](http://www.worldbank.org/html/extdr/offrep/mena/wb&g.htm)> (summarizing the current economic trends in the Territories).

64. The decline was more pronounced in the Gaza Strip than in the West Bank. This is due, among other things, to the fact that it is much easier to seal-off the Gaza Strip than it is to do the same with respect to the West Bank.

65. See Fidler, *supra* note 55, at 164-66 (noting that closures resulted in the breakdown of the free trade area and undermined economic development in Palestine).

\$4.4 million.<sup>66</sup>

Further costs were added as a result of a cobweb of export and import licensing requirements.<sup>67</sup> Due to potential security risks and closures, which made showing up to work on a regular basis far from guaranteed, Israeli employers considered Palestinian workers less reliable. Israeli employers, therefore, began replacing Palestinian workers with foreign workers imported from East Europe, the Far East, and Africa.<sup>68</sup> These foreign workers filled the vacancies in manual labor sectors such as the construction industry and agriculture. In 1992, more than a third of the Palestinian work force was employed in Israel contributing about twenty-five percent of the GNP, but in 1996, only seven percent of the Palestinian work force was similarly employed contributing no more than six percent to the GNP.<sup>69</sup> Many of the Palestinians previously employed in Israel could not find alternative sources of income and the rate of unemployment in the Territories soared to an annual average rate of thirty percent,<sup>70</sup> while per capita income plummeted twenty percent between 1993 and 1996.<sup>71</sup>

Several additional factors must be mentioned in order to complete the picture. First, foreign investors are reluctant to invest in the Ter-

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66. See UNSCO April 1997, *supra* note 62 (claiming that closures have cost the Palestinian economy approximately \$6.5 billion during the period 1993 to 1996); DIWAN & SHABAN, *supra* note 42, at 51 (suggesting that \$2.8 billion was the cost of the permit system and border closures for the same period); Zia, *supra* note 61, at 140-41 (arguing that closures resulted in Palestine's loss of trade competitiveness with the rest of the world).

67. See Fidler, *supra* note 55, at 170 (describing various actors who must issue import licenses for particular areas).

68. See DIWAN & SHABAN, *supra* note 42, at 5 (explaining that Palestinian workers were permanently displaced by importation of foreign labor for jobs in Israel).

69. See *id.* at 45-65 (analyzing the detrimental effect of the closure policy on the Palestinian economy with particular reference to short term economic losses, impact on the labor market, and damaging the growth prospects of the economy).

70. STEVEN BARNETT ET AL., THE ECONOMY OF THE WEST BANK AND GAZA STRIP – RECENT EXPERIENCE, PROSPECTS, AND CHALLENGES TO PRIVATE SECTOR DEVELOPMENT 3 (1998). Also significant were the substantial fluctuations in unemployment levels in the Territories.

71. *Id.* at 3.



ritories under conditions of political uncertainty and instability.”<sup>72</sup> Second, the closure of the Israeli seaports and airports to Palestinians further damaged Palestinian exporters who could no longer use these convenient venues for exporting their products abroad.<sup>73</sup> Third, widespread institutional and individual corruption in the Palestinian Authority, linked, *inter alia*, to the creation of import monopolies headed by senior officials of the Authority or their relatives, further undermined the economic welfare of the local population.<sup>74</sup> Fourth,

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72. See Keith C. Molkner, *Legal and Structural Hurdles to Achieving Political Stability and Economic Development in the Palestinian Territories*, 19 FORDHAM INT'L L.J. 1419, 1429-49 (1996) (describing legal hurdles to development in the Territories in the areas of investment, banking and tax law); see also Mel Levine, *Palestinian Economic Progress under the Oslo Agreements*, 19 FORDHAM INT'L L.J. 1393, 1405-06 (1996); Jack I. Garvey, *Regional Free Trade Dispute Resolution as Means for Securing the Middle East Peace Process*, 47 AM. J. COMP. L. 147, 155-58 (1999); Fidler, *supra* note 55, at 181-86 (pointing to inadequate legal infrastructure, trade monopolies, corruption, and human rights abuses as impediments to development of Palestinian trade). Foreign investors also have been deterred by periodic closures. See *id.* at 165-66. See generally David P. Fidler, *Foreign Investment in Palestine: An Analysis of the Law on the Encouragement of Investment in Palestine*, 19 FORDHAM INT'L L.J. 529 (1995) (explaining the effect of the Palestinian investment law on foreign investment in the context of the overall search for peace).

73. See Fidler, *supra* note 55, at 164-65 (arguing that Palestinian trade would be subject to Israeli security measures until the Palestinians have their own points of entry). In addition, as the Gaza Strip and the West Bank are separated by Israeli territory, closures also meant a significant disruption of trade between the two regions. See *id.*; see also Ziai, *supra* note 61, at 141-44 (finding that the arbitrary denial and restrictions on permits, closures, and the lack of an international airport or port facility significantly increases the costs of trade).

74. See, e.g., Daniel Klaidman & Matt Rees, *Something Rotten in Palestine*, NEWSWEEK, May 29, 2000 (reporting that “[a] Newsweek investigation reveals abuses at almost every level of the Palestinian Authority and quoting a West Bank resident as saying that “[t]he Authority is like the 40 thieves and Arafat is Ali Baba”); Ronnen Bergman, *The Man who Swallowed Gaza*, HA'ARETZ (Mussaf), April 4, 1997, at 18 (reporting on monopolies governed by senior Palestinian officials and their cronies); Dani Rubinstein, *Festivities in the Palestinian Authority on the Sources of Corruption*, HA'ARETZ, Nov. 3, 1999; Amira Hess, *Corruption under the Aegis of the Process*, HA'ARETZ, Oct. 13, 1999; David Hirst, *Shameless in Gaza*, THE GUARDIAN, April 21, 1997, at T8 (describing rampant corruption within the Palestinian National Authority since the organization took control after the Oslo Accords); Dani Rubinstein, *Corruption and Other Malfunctions: The Growth of Public Criticism over Arafat's Rule*, HA'ARETZ, September 16, 1996; Peter Hirschberg, *Playing Monopoly*, JERUSALEM REPORT, Feb. 22, 1996, at 14.

the Palestinian Authority designed a series of measures to limit the scope of operations of Israeli firms and manufacturers in the Territories – such as limits on registration, rules requiring marketing through a single authorized (Palestinian) dealer, and local ownership requirements with respect to joint ventures – which have undermined further the idea of a customs union between the parties to the Paris Protocol.<sup>75</sup> Finally, various difficulties concerning the operation of the mechanism for clearance of revenues between Israel and the Palestinian Authority caused significant losses to the Palestinian Authority.<sup>76</sup> This mechanism also has been used by the Israeli government to pressure the Palestinian Authority into cracking down harder on Islamic terrorism.<sup>77</sup> The combination of all of these factors has led to the prolongation and intensification of the economic crisis in the Territories. The promised dividends of peace were nowhere to be seen.

## II. SEPARATION VERSUS INTEGRATION: IT'S NOT ONLY THE ECONOMY, STUPID!

Economic considerations have always played an important role in shaping the relations between Israelis and Palestinians.<sup>78</sup> Yet, in the Middle East, political, social, and cultural considerations overshadow economic arguments and calculations. As Seev Hirsch so poignantly notes, “[e]conomic constraints may limit the capacity of the parties

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*See also* Talia Einhorn, *The Customs Union between Israel and the Palestinian Authority: A Critical Analysis*, 14 BAR-ILAN L. STUD. 439, 444–47 (1998) (arguing for the need to establish competition rules to counter anticompetitive behavior on the part of the Palestinian Authority); Fidler, *supra* note 55, at 183–85 (discussing the corruption of the Palestinian Authority and its attempts to monopolize sectors of the economy).

75. Federation of Israeli Chambers of Commerce, *supra* note 18, at 2.

76. *See infra* notes 242–258 and the accompanying text (discussing the issue of revenue clearance in the years following the signing of the Paris Protocol).

77. *See, e.g.*, UNSCO, *Closure*, *supra* note 61 (describing the Israeli government’s decision, following a series of terrorist attacks in 1997, to unilaterally stop all revenue transfers to the Palestinian Authority until the Authority pursued stricter measures against Palestinian terrorists).

78. *See, e.g.*, YUVAL ELIZUR, LOHAMAH KALKALIT : MEAH SHENOT IMUT KALKALI BEN YEHUDIM LE-ARVIM [ECONOMIC WARFARE: THE HUNDRED-YEAR ECONOMIC CONFRONTATION BETWEEN JEWS AND ARABS] (1997).

to wage war against each other; they are unlikely to move them towards peace.”<sup>79</sup> Thus, the choice among the variety of possible economic scenarios to be implemented in the framework of a political permanent peace agreement between Israel and the Palestinians is not purely, nor even mainly, one shaped by economic considerations.<sup>80</sup> Political, social, cultural, and security considerations are predominant in national decision-makers’ calculi over economic considerations. At the same time, economics should be considered and the economic implications of going down one route or another must be openly and boldly recognized and addressed.

Neo-classical international trade theory promotes the view that the freer is the international trade, the greater is the economic welfare of all trading partners.<sup>81</sup> Yet, in practice, not a single country exercises a trade policy fully committed to a pure form of free, uninterrupted trade. This gap between trade theory and political reality is, of course, well known and analyzed. To a certain extent, such a dissonance results from an inherent tension between the economic benefits accruing to countries exercising free trade and the costs inflicted upon them, measured, *inter alia*, in the currency of “sovereignty” and “independence.” The argument waged between those who promote the cause of economic integration in the Middle East and the proponents of economic separation between Israelis and Palestinians reflects, to a large extent, this duality. Whereas most of the arguments in favor of separation are couched in political terms and evoke issues of national sovereignty and independence, advocates of integration resort, first and foremost, to economic arguments based on the perceived advantages derived from trade liberalization. The main

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79. See Hirsch, *Trade Regimes in the Middle East*, in *ECONOMIC COOPERATION IN THE MIDDLE EAST* 269 (Gideon Fishelson ed., 1989) (describing the difficulties involved in analyzing trade regimes and stating that political conditions take precedence over economic considerations).

80. See, e.g., ARNON, *supra* note 22, at 3 (quoting the report of the Bruno Committee of 1967, which states that “[e]ven an economist who approves of [complete integration of the administered territories into the Israeli economy] in the long run, on economic grounds—and these are not obvious—will admit that the economic considerations are secondary in this context.”); Hirsch, *supra* note 79, at 269.

81. See *infra* notes 108-110 and accompanying text (discussing the economic benefits of free trade).

problem in finding the point of equilibrium results from the different levels on which the two conversations are conducted. Searching for a common ground on which to evaluate the different arguments and balance the relevant competing interests is, therefore, one of the crucial tasks for peace brokers and negotiators.

This part of the Article seeks to explore the tension between economic and political considerations in structuring a viable economic model as part of a permanent peace agreement between Israelis and Palestinians. Particularly, it analyzes the considerations influencing the selection between complete separation and a model of economic integration and shows that an integrationist model is preferable to complete separation.

## A. INTEGRATION SEEMS TO BE THE HARDEST WORD

### 1. *Separate and Equal: A View from Palestine*

Sovereignty and independence arguments carry particular force in the context of the Israeli-Palestinian conflict, where one party struggles to obtain its political independence from the rule of, and military occupation by, the other. Under such circumstances, it is not surprising that the Palestinians are willing to pay a high premium for the right to emphasize and exercise their independence from Israel. Tangible expressions of such independence, such as a flag, national anthem, stamps, passports, an airport and seaport, and a physical border, are of special significance. Giving any of them up is not to be taken lightly, even for the sake of a potential long-term increase in economic welfare.<sup>82</sup> This is particularly true in light of the fact that the Palestinians do not have their own independent state, but rather a state-to-be. Symbols tend to be infused with special meaning and

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82. See ELIAS T. GHANTUS, ARAB INDUSTRIAL INTEGRATION 19-20 (1982) (noting that the "national consciousness [of developing countries] is high and economic development to them is a post-independence endeavor"). See also Nathan Sussman, *Trade Agreement as a Part of Peace Agreements: A Historical Perspective*, 41 *ECON. Q.* 630, 635-49 (1994) (discussing the economic costs incurred by the Republic of Ireland from the isolationist trade policy it adopted until the early 1960s resulting, among other things, from desire to minimize trade relations with the United Kingdom, its former occupying power).

significance at such a formative stage of the national ethos.<sup>83</sup> Denial of such symbols is almost certain to be rejected and opposed. When the reason for such denial is perceived to be the recent foreign occupying power, resistance will likely intensify.

In addition, one cannot be oblivious to the Palestinian fear of replacing Israeli military imperialism with an economic form of subjugation and domination given the vast differences in economic power, development level, structure, and size between the two economies.<sup>84</sup> To paraphrase Von Clausewitz's famous comment on the relationship between war and politics, economic integration may be considered as the continuation of military occupation and rule by other means.<sup>85</sup> Indeed, it has been argued that economic interdependence has increased the power of economically powerful, industrial nations. Economic interdependence, it is argued, enables powerful countries to expand the scope of state regulation and extend it far beyond their territorial boundaries, thus increasing their regional and global influence.<sup>86</sup> The vast economic differences between the Israeli and Pales-

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83. GHANTUS, *supra* note 82, at 19-20 (explaining the importance of national symbols in the formative states of national development). *See also* Lee Hockstader, *Palestinians Open Gaza Airport; A Proud Sign of Sovereignty, Despite Israeli Presence*, WASH. POST, Nov. 25, 1998, at A1 (quoting a Palestinian Airlines ground attendant as saying "[f]inally we have our airport, and this is the most important day in our hopes to be a state"); Kleiman, *supra* note 48, at 351 (noting, with respect to the Paris Protocol, that: "precisely because the DOP stopped short of holding out a promise of a sovereign state . . . the Palestinians were eager for even the slightest tokens of sovereignty, and for any expression of the separateness of their new entity from Israel.").

84. *See, e.g.*, Laura Drake, *Arab-Israeli Relations in a New Middle East Order – The politics of economic cooperation*, in *THE POLITICAL ECONOMY OF MIDDLE EAST PEACE – THE IMPACT OF COMPETING TRADE AGENDAS* 11, 17 (J.W. Wright, Jr. ed., 1999) (quoting Egyptian president Hosni Mubarak, who stated the following in a 1995: "[e]xplain to me, what is a new Middle East? If it's peace and cooperation, that's OK. But people say Israel wants to be the strongest state in the region and control the economy. Talk like this makes all the countries in the region afraid."). *See also* Eliyahu Kanovsky, *Marketing the New Middle East*, COMMENTARY, Apr. 1, 1997, at 55, 57; Kleiman, *supra* note 48, at 351.

85. *See* Drake, *supra* note 84, at 22 (suggesting that the asymmetries in levels of economic development between Israel and its neighbors "are likely to result not in interdependence but in dependence.").

86. *See, e.g.*, HARRY G. GELBER, *SOVEREIGNTY THROUGH INTERDEPENDENCE* (1997).

tinian economies, as well as the divergent level of realization of national aspirations between Israelis and Palestinians, cast doubts as to the viability of economic integration in the Middle Eastern context.

Such political arguments favoring economic separation between Israelis and Palestinians are further buttressed by certain economic claims, such as the protection of infant industries, the argument concerning the relationship of exporting labor services to Israel and foreign investment in the Territories, and the socio-economic costs of polarization and unbalanced distribution of benefits resulting from integration between Israel and the Palestinian state. Even if one conceded that some degree of economic integration between Israel and Palestine is desirable, it might still be advisable to start the two parties off on a separation track that will converge at some point in the future.<sup>87</sup> The wide rift between the two economies, especially regarding their industrial sectors, may necessitate an initial substantial degree of separation between them, designed to protect the fledgling Palestinian industry from being trampled by its far advanced Israeli counterpart. This protection is necessary, according to this line of argument, if the local industry is to be able to realize its potential and take advantage of its unique comparative advantages. The fact that the low level of industrialization in the Territories is deemed the result not merely of inadequate local incentives, but also of an intentional Israeli policy to keep the Palestinians under-industrialized, is often mentioned as a further historical support for this argument.<sup>88</sup>

Indeed, even (the Treaty of) Rome was not built in a day. The European Union, being the most advanced model of economic integration to date, resulted from evolutionary growth rather than revolutionary cusps.<sup>89</sup> On the political side, the “separation first” argu-

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87. See, e.g., Arnon & Weinblatt, *supra* note 16, at 43-44.

88. See *supra* notes 26-27 and the accompanying text (arguing that the Israeli government adopted protectionist policies to protect Israeli industry from Palestinian competition).

89. *A New Idea for Europe: The Schuman Declaration* (visited May 9, 2000) <[http://europa.eu.int/comm/dg10/publications/brochures/docw50ans/decl\\_en.html#declaration](http://europa.eu.int/comm/dg10/publications/brochures/docw50ans/decl_en.html#declaration)> (text of the declaration made by the French Foreign Minister Robert Schuman on May 9, 1950, expressing the fundamental vision underlying the move towards gradual economic integration in post-World War II Europe and suggesting that “Europe will not be made all at once, or according to a single, general plan. It

ment distinguishes between economic arrangements struck between Israel and Palestine and those struck between the two parties prior to Palestine gaining independence. Advocates of this approach note the following: first, it is unlikely that pre-negotiated economic arrangements constraining the Palestinians' sovereignty would be able to hold sway against the winds of nationalism, sovereignty and independence in the newly created state. Violations by the Palestinians of such pre-set arrangements, which are quite certain to occur, will only add friction and conflict with Israel. Such arrangements will also be used by internal domestic opposition to challenge the Palestinian government as "selling out" to Israel.<sup>90</sup> Second, structuring the economic relations between Israelis and Palestinians in the stage preceding the creation of an independent Palestinian state would lead to Israel and the peace process taking blame for any socio-economic difficulties that may occur after independence is declared.<sup>91</sup>

Another economic rationale opposing economic integration points out the "deleterious effect on investment in the Palestinian territories and on their economic development" of the employment of Palestinian workers in Israel.<sup>92</sup> The level of domestic wages in the Territories rises as a result of the availability of high-paying jobs in the Israeli market. As foreign investments are attracted by, *inter alia*, low wages, this phenomenon should deter investment and hamper further economic development in the Territories.<sup>93</sup> Indeed, the promise of free movement of Palestinian workers into Israel in the context of an economic integration between the two countries is seen by some to be a double-edged sword. On the one hand, there are the short-term

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will be built through concrete achievements, which first create a de facto solidarity.").

90. Yoram Meshar, *On the Desirability of Proper Borders between Israel and the Palestinian Entity: Economic and Politics Overshadowed by Sociology and Demographics*, 41 *ECON. Q.* 656, 665 (1994); DAN SCHUEFTAN, KORAH HA-HAFRADAH : YISRAEL VEHA-YESHUT HA-PALESTINIT [DISENGAGEMENT - ISRAEL AND THE PALESTINIAN ENTITY] 110-16 (1999).

91. Meshar, *supra* note 90, at 665.

92. ARNON, *supra* note 22, at 20.

93. *See id.* at 19-20 (commenting that the Territories are underdeveloped and obtain little foreign investment because the high number of job opportunities abroad decreases the number of workers in the Territories, thereby raising the wages of workers and decreasing potential profits for foreign investors).

benefits to the Palestinian economy of continued export of labor services to Israel. At the same time there is the fear of the continued dependency effect that such heavy reliance on work in Israel creates for the Palestinian economy. Palestinian work in Israel is considered a tool that Israel can utilize to advance its political and economic policies at the expense of the Palestinians.<sup>94</sup> Even if it is not used by Israel in this way, the fact that most Palestinians working in Israel are employed in volatile sectors such as agriculture and construction makes this significant source of Palestinian GNP particularly problematic.<sup>95</sup> In addition, it is also necessary to address the possibility of entrenching asymmetrical patterns of development of the two neighboring markets, *i.e.*, the fear that economic integration between Israelis and Palestinians would lead Israel to take advantage of cheap Palestinian labor without facilitating any significant technological advancement of the Palestinian economy.<sup>96</sup>

Finally, there are also the arguments concerning the distribution of benefits between the parties to an integration arrangement. First, while all countries involved may gain economic benefits, measured on an aggregate basis, initial economic differences may not be minimized as a result of integration, but rather may be enhanced and accentuated. For example, some domestic regions may feel the brunt of integration as industries and businesses may prefer other sites. Furthermore, industries and businesses already established in those areas may choose to relocate elsewhere. It is also quite likely that regions already economically disadvantaged prior to the integration will be

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94. See *Developing the Palestinian Economy, an Interview with George T. Abed*, 23(4) J. PALESTINE STUD. 41, 43 (1994) (encouraging Palestinian leaders to implement developmental programs for jobs rather than telling Palestinians to go to Israel for jobs); Elmusa & El-Jaafari, *supra* note 43, at 29.

95. See, *e.g.*, Kleiman, *supra* note 48, at 351 (concluding that the nature of the Palestinian economy makes it dependant on a highly volatile industry that is out of its control); Ephraim Kleiman, *A Propos the Israel-PLO Economic Agreement*, 41 ECON. Q. 678, 680-81 (1994).

96. See, *e.g.*, Sara Roy, *Separation or Integration: Closure and the Economic Future of the Gaza Strip Revisited*, 48 MIDDLE EAST J. 11 (1994) (arguing that through closure of the Territories and a variety of new economic measures designed to mitigate the effects of a decaying economy, Israel's government has not tried to institutionalize a separation of the Territories and Israel, but rather has pursued a restructured form of integration); Drake, *supra* note 84, at 24-25.



the ones most hurt by that economic move.<sup>97</sup> Consequently, these economically disadvantaged regions may experience further non-linear adverse social and economic effects such as higher crime levels, negative immigration, and so forth. Second, economic integration between an economically strong party and a much weaker one may result in the weaker party substituting imports from third countries with goods imported from the wealthier party to that arrangement, thus resulting in loss of much-needed tariff and import duty revenues.<sup>98</sup>

## 2. "Good Fences Make Good Neighbors":<sup>99</sup> A View from Israel

From the Israeli perspective, economic considerations also play a secondary role in deciding the nature of future relations with the Palestinians. The leading role is played by ideological considerations concerning the political future of the Territories, as well as by national and personal security considerations. Gaining momentum during the turbulent years of the *Intifada*, and spreading rapidly as a result of the post-Oslo Palestinian terrorist campaign, the idea of physical separation became the preferred political option for the vast majority of the Israeli public.<sup>100</sup> A catchy slogan used by the Barak campaign during the 1999 Israeli elections stated simply "*Anakhnu*

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97. See PETER ROBSON, *THE ECONOMICS OF INTERNATIONAL INTEGRATION* 239-42 (4th ed. 1998) (illustrating the phenomenon of perpetuation of initial economic differences among regions as a result of the free flow of trade and factors of production, known as polarization or backwash).

98. However, the weight of this argument is limited due to the fact that at present most goods imported into the Territories come from Israel. See *supra* note 42 and accompanying text.

99. FROST, *supra* note 3, at 48. The adage "good fences make good neighbors" is often quoted by Prime Minister Barak. See Weymouth, *supra* note 2.

100. See *supra* note 12 and the accompanying text (discussing the *Intifada* and the terrorist activities associated with it). The view that separation was crucial to their personal security has thus become widely shared among Israelis. See SHLOMO BEN AMI, MAKOM LE-KHULAM [A PLACE FOR EVERYONE] 106-10 (1998); SCHUEFTAN, *supra* note 90, at 54-58. But see *West Bank and Gaza. The Banging Door*, *ECONOMIST*, Aug. 3, 1996, at 39 (noting the Likud party's opposition to "separation" and its disbelief that restricting border access constitutes an effective security measure).

*Kan, Hem Sham,*” or “Us Here, Them There.”<sup>101</sup> At minimum, it was argued, eradicating the long-standing hostility and animosity between Israelis and Palestinians could not be accomplished overnight. Hence, a preliminary stage of separating the former enemies and reducing potential frictions is needed before any further step towards integration can be taken.<sup>102</sup>

From the economic perspective, the substantial size differentials between the Israeli and the Palestinian economies, the differences in their level of development, and the relatively negligible exports to, and imports from, the Territories, minimize the implications for the Israeli economy of economic separation or integration with the Palestinians.<sup>103</sup> The purchasing power of the small Palestinian economy

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101. See Matt Rees, *Israel's Stance Becomes Clear as Barak Calls for Separation*, THE SCOTSMAN, Aug. 19, 1999, at 12 (discussing Barak's belief that peace can only be achieved through a separatist approach).

102. See, e.g., Meshar, *supra* note 90, at 666.

103. See Eli Sagi & Yaacov Sheinin, *The Chances for Trade with the Arab Countries*, 41 ECON. Q. 15, 21 (1994). Palestinian exports to Israel constitute less than 1 percent of the aggregate Israeli import market. At first glance it seems that the Palestinian market constitutes an important target market for Israeli exports, second in importance only to the American and European markets. However, several factors modify this picture. First, one should discount the indirect importation by residents of the Territories, i.e., import of goods from third countries via the Israeli seaports and airports. The value added to the Israeli economy with respect to such goods in transit is relatively small. Second, another portion of Israeli exports to the Territories is comprised of the sale of used durable goods by Israelis to Palestinians. Third, a significant portion of Israeli exports to the Territories involves subcontracting activities in the Territories for Israeli plants and factories. Such factories would send materials and unfinished inputs to the Territories where the final product is manufactured for the Israeli manufacturer. Fourth, the data includes Palestinian consumption in Israel proper, such as the purchase of cigarettes and food by Palestinian workers employed in Israel. Finally, while Israel has maintained a trade surplus in its relations with the Territories, this trade is, in fact, internal, as it has been carried out in Israeli currency, thus not much improving Israel's foreign trade balance. See *id.* In the discussion above I have specifically avoided adding into the economic calculation the thorny question of management of the scant water resources in the region and the arrangements concerning the sharing and use of these water resources, albeit a significant potential trade issue upon Israel's withdrawal from the Territories. See, e.g., Eyal Benvenisti, *Collective Action in the Utilization of Shared Freshwater: The Challenges of International Water Resources Law*, 90 AM. J. INT'L L. 384 (1996) (exploring the relationship and contributions of international law to water resources issues, and the problems associated with management of those resources); Eyal Benvenisti & Haim Gvirtz-

and the nature of Israel's technologically advanced market, which specializes in producing and exporting products for high-income consumers in developed countries, reduce further the economic significance of the Palestinian market for the Israeli manufacturers.<sup>104</sup>

The political case against economic integration is often buttressed by economic arguments raised by powerful interest groups, such as the agricultural sector, that in the past enjoyed varying degrees of protection against Palestinian competition, and that fear exposure to such competition in the future.<sup>105</sup> Other economic considerations take into account the potential use of the Territories to circumvent Israel's import regime and trade and environmental policies, as well as the use of the Palestinian state to provide tax shelters for Israeli citizens and nationals.<sup>106</sup> There are also fears that integration will permit the

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man, *Harnessing International Law to Determine Israeli-Palestinian Water Rights*, 33 NAT. RESOURCES J. 543 (1993) (discussing the peace talks with relation to the conflict over the region's scarce water resources and noting that a peace agreement will have to include an arrangement concerning the utilization and conservation of water).

104. See *Israel and the Arab World, Little Becomes Even Less*, THE ECONOMIST, Apr. 5, 1997, at 42 (estimating that "growth in regional trade would not add more than 1 percent to Israel's overall export volume"); MARK A. HELLER, A PALESTINIAN STATE – THE IMPLICATIONS FOR ISRAEL 127 (1983) (arguing that closing trade with the Territories would have little effect on Israeli markets because Israel has a trade surplus with them and because trade was carried out in Israeli currency); Sagi & Sheinin, *supra* note 103 (arguing that direct trade relations between Israel and Arab nations are not likely to be economically significant due to the small addition of the Arab markets to existing target markets for Israeli exports as well as the fact that the Arab countries are relatively poor and their import patterns and needs do not meet Israeli exports and comparative advantage. The authors arrive at similar conclusions with respect to imports to Israel).

105. See Kleiman, *supra* note 48, at 352 (claiming that competition between Israeli and Palestinian farmers could cause economic hardship within the Israeli agricultural sector); see also *infra* note 134 and the accompanying text (noting that Palestinians are generally employed in low-skilled, low-paid, manual labor jobs); HELLER, *supra* note 104, at 127 (noting that less sophisticated Israeli industries may suffer some losses from competition with Palestinian producers). *But see id.* at 126-31 (emphasizing that the relatively small weight of Palestinian trade in the overall Israeli international trade, as well as the fact that the Israeli and Palestinian economies are, by and large, complementary rather than competing, weaken the impact of such arguments as far as the Israeli economy *as a whole* is concerned).

106. See Kleiman, *supra* note 48, at 352; Ora Koren, *Supervision over the Transfer of Goods from the Territories into Israel to be Tightened*, HA'ARETZ, Feb.

use of the Territories to bypass Israel's immigration policy and Israel's ability to monitor those who wish to enter its borders.<sup>107</sup>

## B. SEPARATION ANXIETY

In as much as regional economic integration is thought of in terms of trade liberalization among the trading partners and a potential for international trade playing an enhanced role in the local economy, the benefits resulting from such integration are explained, primarily, in economic terms. These derive from neo-classical, liberal theories of international trade rooted in the Ricardian notion of comparative advantage,<sup>108</sup> which explains that free trade leads to specialization in production coupled with the exchange of goods and services. Each country ought to specialize in the production of those goods and services that it most efficiently produces, *i.e.*, with respect to which it enjoys a comparative advantage to other countries. International trade allows countries to so specialize and then exchange goods and services, rather than produce everything at home, thus resulting in a more efficient allocation of resources, and creating a rise in global welfare.<sup>109</sup> Free trade encourages economic growth and the creation of greater wealth for all the countries involved. It increases the

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24, 2000 (reporting a decision by the Israeli government's Ministerial Committee on Intellectual Property to tighten the supervision over the transfer of goods from the Territories into Israel, in order to minimize the smuggling into Israel of counterfeit goods).

107. Einat Fishbein, *Police: Thousands of Illegal Workers from Various Countries enter Israel through the Palestinian Authority's controlled areas*, HA'ARETZ, Feb. 24, 2000.

108. See, e.g., PETER H. LINDERT & THOMAS A. PUGEL, *INTERNATIONAL ECONOMICS* 33-36 (10th ed. 1996) (illustrating the concept of comparative advantage); see also Alan O. Sykes, *Comparative Advantage and the Normative Economics of International Trade Policy*, 1 J. INT'L ECON. L. 49 (1998) (examining comparative advantage as the "engine of trade").

109. See LINDERT & PUGEL, *supra* note 108, at 28 (quoting ADAM SMITH, *THE WEALTH OF NATIONS* (1776)). Smith stated that:

What is prudence in the conduct of every private family, can scarcely be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the product of our own industry.

*Id.*

amount and variety of goods and services available to consumers world-wide and accelerates the diffusion of knowledge and innovation.<sup>110</sup> Its economic advantages are dynamic as well as static.

Furthermore, a link is often argued to exist between international trade, economic development, and democracy.<sup>111</sup> Economic growth and development are considered linked to liberalization of trade and participation in the global markets.<sup>112</sup> At the same time, it is frequently argued that higher levels of economic development and economic growth are closely linked to the democratic nature of the relevant polity.<sup>113</sup> This perceived link is of particular significance in the

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110. See, e.g., Jagdish Bhagwati, *Is Free Trade Passé After All?*, 125 WELTWIRTSCHAFTLICHES ARCHIV 17 (1989), reprinted in POLITICAL ECONOMY AND INTERNATIONAL ECONOMICS 3 (Jagdish Bhagwati & Douglas A. Irwin eds., 1991) (discussing the doctrine of free trade and several theories that challenge the system).

111. See, e.g., Alberto Costi, *The Use of Free Trade Instruments in the Transition Process of Central and Eastern Europe: Success or Failure?* (forthcoming 2000).

112. See, e.g., Dan Ben-David et al., *Trade, Income Disparity and Poverty* 32-36 (WTO Special Studies 5, June 2000) (discussing the relationship between trade openness and economic growth).

113. See, e.g., Boutros Boutros-Ghali, *Maintaining International Peace and Security: The United Nations as Forum and Focal Point*, 16 LOY. L.A. INT'L & COMP. L.J. 1, 2 (1993) ("Promotion of peace and security, economic and social development, and democracy are one and the same."); Donald K. Emmerson, *Americanizing Asia?*, FOREIGN AFF., May/June 1998, at 46 (discussing the debate concerning the existence of a link between democratic governance and robust economic growth); Alan S. Greenspan, *Thoughts About the Transitioning Market Economies of Eastern Europe and the Former Soviet Union*, 6 DEPAUL BUS. L.J. 1, 13-14 (1993) (discussing that free markets support the growth of democracy); Adam Przeworski et al., *What Makes Democracies Endure?*, 7 J. DEMOCRACY 39 (1996) (analyzing different countries between 1950 and 1990 and concluding that the level of economic development directly affects the survival chances of democracies, and that among moderate-income and poor countries, democracy has a much higher chance of surviving if there is a strong economic growth); Seymour Martin Lipset, *Some Social Requisites of Democracy: Economic Development and Political Legitimacy*, 52 AM. POL. SCI. REV. 69 (1959) (suggesting that "the more well-to-do a nation, the greater the chances that it will sustain democracy"); Seymour Martin Lipset, *The Social Requisites of Democracy Revisited*, 59 AM. SOC. REV. 1 (1994). This approach is not shared by all. See, e.g., Fareed Zakaria, *Democratic Tyranny*, 25 PROSPECT 20 (1997) (emergence of "illiberal democracies" in developing countries where political leaders argue for the need for sweeping, "illiberal" governmental powers in order to ensure economic liberalization.).

context of conflict resolution and international reconciliation for two main reasons. First, there is the long recognized inherent relationship between trade and peace. In his *To Perpetual Peace*, Immanuel Kant argues that “the spirit of trade cannot coexist with war.”<sup>114</sup> Those believing in the existence of a close link between free trade and democracy may seek to buttress this argument by adding observations about “democratic peace,” *i.e.*, that democratic regimes have a low propensity to go to war (or, according to some, do not at all go to war)

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114. Immanuel Kant, *To Perpetual Peace: A Philosophical Sketch*, in PERPETUAL PEACE AND OTHER ESSAYS 107, 125 (Ted Humphrey trans., 1983) (1795). Kant proceeds to state that “sooner or later this spirit dominates every people. For among all those powers (or means) that belong to a nation, financial power may be the most reliable in forcing nations to pursue the noble cause of peace . . .” *Id.* See also Michael W. Doyle, *Kant, Liberal Legacies, and Foreign Affairs*, 12 PHIL. & PUB. AFF. 205 and 323 (1983) (arguing that liberal economies tend less to wage wars compared with non-liberal economies); CHARLES COVELL, KANT AND THE LAW OF PEACE – A STUDY IN THE PHILOSOPHY OF INTERNATIONAL LAW AND INTERNATIONAL RELATIONS 160-61 (1998) (discussing Kant’s identification of cosmopolitan law, the law of peace, with law “pertaining to trade and commerce”); ROBERT GILPIN, THE POLITICAL ECONOMY OF INTERNATIONAL RELATIONS 56 (1987) (“[Liberals take the view that] the mutual benefits of trade and the expanding web of interdependence among national economies tend to foster cooperative relations ... Trade and economic interdependence create bonds of mutual interest and a vested interest in international peace and thus have a moderating influence on international relations.”); JOHN STUART MILL, *Principles of Political Economy*, in 3 COLLECTED WORKS OF JOHN STUART MILL 594 (John M. Robson ed., 1965) (noting that trade is “the principal guarantee of the peace of the world”); CHARLES LOUIS MONTESQUIEU, THE SPIRIT OF THE LAWS 338 (A. Cohler et al. trans., 1989) (“The natural effect of commerce is to lead to peace.”); Philip M. Nichols, *Regulating Transnational Bribery in Times of Globalization and Fragmentation*, 24 YALE J. INT’L L. 257, 263 (1999). *But see* Mark Duffield, *Geography and the Boundaries of Confidence: Globalization and War Economies: Promoting Order or the Return of History?*, 23 FLETCHER F. WORLD AFF. 21 (1999) (noting the “paradox of globalization”). Duffield explains that “despite the predominance of neo-liberal assumptions that market reform will promote growth and order, we are daily confronted with setbacks and evidence of instability.” *Id.* at 21. He argues that “rather than promoting stability, globalization has helped illiberal and quasi-feudal forms of political economy to expand.” *Id.* Against the liberal interpretation of globalization he poses the “durable disorder” interpretation of globalization, namely “the forces of globalization often produce unexpected and unwanted outcomes as they encounter other social systems. Rather than the anticipated virtuous circles of growth and prosperity that lead to orderliness, globalization tends to encourage new and durable forms of division, inequality and instability.” *Id.* at 22.

against each other.<sup>115</sup> Following this line of argumentation, trade and growth stand in an inverse relationship to war.<sup>116</sup> Empirical studies, which show that growth in direct trade between countries stands in inverse relation to their propensity to fight each other, establish an even more direct link between trade and peace. The more that particular countries trade with each other, the less likely they are to conduct armed hostile acts against each other.<sup>117</sup> To the extent that economic integration is seen to be trade enhancing between the countries taking part in such integration, it lowers the risk of the eruption of violence in the relevant region.<sup>118</sup>

A second, another important link frequently made in the context of the Arab-Israeli conflict is the inverse relation perceived to exist between rising standards of living and the turn to religious fundamentalism.<sup>119</sup> Economic prosperity is considered an important

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115. See, e.g., PATHS TO PEACE: IS DEMOCRACY THE ANSWER? (Miriam F. Elman ed., 1997) (providing case studies of the democratic peace hypothesis); BRUCE RUSSETT, GRASPING THE DEMOCRATIC PEACE: PRINCIPLES FOR A POST-COLD WAR WORLD (1993) (establishing the democratic peace theory); Anne-Marie Slaughter et al., *International Law and International Relations Theory: A New Generation of Interdisciplinary Scholarship*, 92 AM. J. INT'L L. 367, 382-83 (1998) (providing context for the democratic peace theory in liberal international relations theory). See generally THOMAS L. FRIEDMAN, THE LEXUS AND THE OLIVE TREE 195-98 (1999) (referring to a globalized "McDonald's" world with a "Golden Arches Theory of Conflict Avoidance").

116. See, e.g., EDWARD D. MANSFIELD, POWER, TRADE, AND WAR 233 (1994) (discussing the inverse relationship between economic growth and conflict); WILLIAM H. MOTT IV, THE ECONOMIC BASIS OF PEACE - LINKAGES BETWEEN ECONOMIC GROWTH AND INTERNATIONAL CONFLICT 193-229 (1997) (arguing that whereas static economic growth, which is based on accumulation of existing resources, favors conflict, economic dynamic growth, which is based on knowledge and innovation, inhibits conflict).

117. See, e.g., Solomon W. Polachek, *Conflict and Trade*, 24 J. CONFLICT RESOL. 55 (1980) (analyzing data for 30 countries between 1958 and 1967, showing that doubling the volume of trade between two countries results in a 20 percent decline in the incidence and frequency of armed hostilities between them).

118. See, e.g., WILLEM MOLLE, THE ECONOMICS OF EUROPEAN INTEGRATION: THEORY, PRACTICE, POLICY 8 (3d ed. 1997) ("Economic integration is not an *objective* in itself, but serves higher objectives, both of an economic and of a political nature . . . . When countries become dependent upon each other as a result of economic integration this reduces the chance of armed conflicts between them.").

119. See JOHN KENNETH GALBRAITH, ECONOMICS, PEACE, AND LAUGHTER 3-4

weapon in the fight against terrorist organizations, such as the Hamas movement, that cultivate support for their actions and recruit active cadre on the basis of the appeal of religious fundamentalism to the socially and economically disenfranchised.<sup>120</sup>

The economic hardships that are likely to plague the Palestinian economy – should it separate from its Israeli counterpart – and the destructive effects that such economic decline may have on the maintenance of long-lasting peace in the region are the main arguments marshaled by opponents of economic separation.<sup>121</sup> The equation of higher standards of living with lower levels of violence is the battle cry of those supporting ongoing integration.<sup>122</sup> Given the Territories' substantial economic reliance on exporting labor services to Israel since 1967,<sup>123</sup> it is argued that complete separation will have disastrous implications for the Palestinian economy, due to the in-

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(1971) (noting that “among the poor, only religion, with its promise of a later munificence for those who endure privation with patience, has been competitive with economic circumstance in shaping social attitudes”); *see also* Kleiman, *supra* note 48, at 352 (arguing that a rise in the standard of living in the Gaza Strip and the West Bank is a means to combat the rise of Islamic fundamentalism); PERES, *supra* note 1, at 72 (characterizing poverty as “[t]he father of fundamentalism”); *Rabin Address*, *supra* note 10 (“Israel is interested that the Palestinians in Gaza will entertain better economic and social conditions, because poverty is a fertile ground for the growth of the HAMAS and the Islamic Jihad.”).

120. *See* SCHIFF & YAARI, *supra* note 52, at 222–45 (1990) (“when all the doors are shut, the doors of *Allah* open”) (quoting Sheikh Ahmad Yassin of Gaza, the powerful spiritual leader of the Hamas movement. *Id.* at 229).

121. Whereas the arguments discussed in this section of the Article focus primarily on the macro-economic level, others have tried to support the cause of free trade between Israelis and Palestinians also on the basis of micro-economic analysis. *See* Ezra Sadan, *Free Trade between Israel and the Palestinian Export Industries*, 41 *ECON. Q.* 5, 9–13 (1994).

122. Recently, that equation is garnering some support also among the Palestinians. *See* Klaidman & Rees, *supra* note 13 (quoting a Palestinian legislator who stated that “[s]eparation is very bad for us . . . . Separation will force the people to revolution again.”); *see also* Danna Harman, *Separation has downside, Berger tells Ben-Ami*, *THE JERUSALEM POST*, Oct. 31, 1999, at 3 (quoting Yasser Abed Rabbo, the Palestinian Information Minister and head of the Palestinian final-status agreement negotiating team, as saying that “I am against separation. We want open borders.”).

123. *See supra* notes 43–46 and accompanying text (noting that there are a significant number of Palestinian laborers in Israel, both permit holders and non-permit holders).



ability of Palestinians to export labor services to Israel.<sup>124</sup> As witnessed during the *Intifada*, and under the Israeli government's closure policy in the years immediately following the signing of the Paris Protocol and the Interim Agreement, separating Palestinian workers from the Israeli workplace has dealt a critical blow to the Palestinian economy.<sup>125</sup> In fact, Gazans were far worse off than the residents of the West Bank because sealing off the Gaza Strip was an easier task to perform than blocking entry into Israel from the West Bank.<sup>126</sup> The rapid economic decline in Gaza is therefore quite telling when economic separation is considered. Palestinians previously employed in Israel were unable to replace their lost positions either in the local labor market or in other countries in the region. This state of affairs is unlikely to change in the near future,<sup>127</sup> given the small size of the regional economies<sup>128</sup> and political concerns, such as fear of destabilizing the fragile power structure in Jordan. There are also grudges and mistrust going back to the Gulf War, during which the Palestinians enthusiastically supported the Iraqi regime.<sup>129</sup> High unemployment rates and a decline in the standard of living in the Territories came to represent aspects of the resulting economic stagnation and depression that hit a population already suffering a

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124. *But see* ARNON, *supra* note 22, at 45 (asserting that "long-run considerations call for a gradual decrease of Palestinian employment in Israel . . . We may therefore expect the peace era to generate a mechanism that produces a gradual phasing out of Palestinian labor activity in the Israeli economy").

125. *See supra* notes 49-50, 68-70 and accompanying text (remarking that after December 1987, movement towards separation between the Palestinian and Israeli markets led to a decline in Palestinian laborers employed in Israel).

126. *See, e.g., supra* note 46 and accompanying graph. Pre the 1994 closures, the percentage of Palestinians working in Israel out of the overall Palestinian workforce was higher for the Gaza Strip than for the West Bank. With the imposition of closures, this trend has reversed. *See* Arnon & Weinblatt, *supra* note 16, at 40 (noting this trend reversal).

127. GAZIT, *supra* note 22, at 270.

128. Richard B. Freeman et al., *Palestinian-Israeli-Jordanian Labor Mobility: The Current Situation and Issues for a Peaceful Future*, in *SECURING PEACE IN THE MIDDLE EAST* 69 (Stanley Fischer et al. eds., 1994).

129. DIWAN & SHABAN, *supra* note 42, at 4 (discussing the elimination of Jordan and the Gulf market as potential sources for demand for Palestinian labor). *See also* Wright, *supra* note 19, at 52-53 (noting the localization of the labor forces in the Gulf states as a response to the fast growth rate of their labor forces).

substantial economic hardship.<sup>130</sup> As experience clearly demonstrates, the burden of such labor dislocation fell disproportionately on the shoulders of unskilled and semi-skilled Palestinian laborers who, by and large, constituted the major portion of workers employed in the Israeli market.<sup>131</sup> The potential disruption of class relations within the Palestinian society may well have substantial ramifications not only as far as domestic politics in the Palestinian state is concerned, but also vis-à-vis that state's continued peaceful relations with Israel.<sup>132</sup>

From an Israeli perspective, the barring of Palestinian workers from entering Israel and working there is also not cost-free. The number of Palestinians working in Israel has always been small compared with the overall size of the Israeli workforce. At its highest, the number of Palestinian workers in Israel did not exceed seven percent of the Israeli workforce.<sup>133</sup> However, since 1967 certain sectors utilizing low skilled, low paid, manual labor, such as the construction industry and agriculture, came to rely heavily on Palestinian labor.<sup>134</sup> Israeli employers, pressured to find replacements for Pales-

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130. See Gross & Sagi, *supra* note 45, at 58 (arguing that although the level of unemployment in both the Gaza Strip and the West bank has stabilized in recent years, a major factor in this context is the explosion in the number of jobs created in the civil service and public sector of the Territories, and suggesting that this trend is coming to an end); see also DIWAN & SHABAN, *supra* note 42, at 117-18 (noting the rapid expansion in public sector employment under the Palestinian Authority and expressing concern that: "extra recruitment has already met the level needed to fulfill public sector functions under a market economy blue-print ... Continued recruitment at the same pace as in recent past could threaten medium-term fiscal stability. It could compromise the PA's ability to provide adequate ... service ...").

131. See, e.g., DIWAN & SHABAN, *supra* note 42, at 4 (discussing in general "the rapid drop in demand for existing unskilled Palestinians workers in Israel ... which have affected various segments of the labor market differently").

132. See HELLER, *supra* note 104, at 86-87 (analyzing economic problems that could arise out of the establishment of the Palestinian state).

133. See ARNON, *supra* note 22, at 83 (noting further that Palestinian laborers in Israel are "concentrated in a small number of industries").

134. See *id.* (noting that in 1991, close to 68,000 Palestinians were employed in the construction industry in Israel compared to approximately 96,000 Israelis). A similar trend was noted in the agricultural sector. As a result, "[Israeli c]ontractors and farmers ... became a lobby for maintaining the employment of Palestinian workers in the face of security problems." *Id.* See also B'Tselem, *supra* note 46, at 11-13.

tinian workers, turned to importing foreign workers from low-wage countries. Within two years, starting in February 1994, the number of foreign workers employed in Israel jumped from around 10,000 to some 200,000.<sup>135</sup> Unlike Palestinian workers who live with their families in the Territories and commute to work in Israel on a daily basis, foreign workers reside within Israel, frequently bringing family members with them.<sup>136</sup> This has caused severe social problems, including the lack of adequate legal and social protection for such workers and their families. This led, in turn, to exploitation and a concomitant moral corruption of the Israeli society.

Market access of Palestinian goods and services to Israel constitutes another important factor favoring economic integration. As emphasized above, since 1967, trade relations between Israel and the Territories have been far from balanced, with the Palestinian economy dependent on the Israeli market both for its exports and imports.<sup>137</sup> The Israeli market remains the natural target market for Palestinian exports and the obvious source for imports into the Territories.<sup>138</sup> This is due to the physical proximity of the two markets, the de facto integration of their infrastructure, and the wide economic difference between them. Physical proximity is especially

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135. See ARNON, *supra* note 22, at 8 (stating that one of the factors making it easier for the Israeli economy to remain strong during 1994, when it closed its borders to the Territories, was the substantial migration of foreign workers to Israel). See also Kav La'Oved, *Newsletter*, May 2000 (on file with the author) (Kav La'Oved (Workers' Hotline), an Israeli non-profit organization focusing on the protection of the rights of workers in Israel, estimates that as of May 2000 there were some 211,000 foreign, non-Palestinian, workers employed in Israel of which 141,000 were without working permits).

136. See Ruth Ben Israel, *On Social Human Rights for Workers of the Administered Areas*, 12 ISRAEL Y.B. HUM. RTS. 141, 141 (1982) (noting the distinction between the situation of an ordinary migrant worker and that of a Palestinian worker).

137. See *supra* Part I.B. (commenting that the Territories rely heavily on Israel both for exports and imports).

138. See Oren Gross & Eli Sagi, *Regional Trade Arrangements in the Service of Peace in the Middle East*, in REGIONAL COOPERATION IN A GLOBAL CONTEXT (R. Bar-El et al eds., forthcoming 2000) (on file with the author); Amir H. Khoury, *International Trade and Commerce: A Bridge for the Israeli-Palestinian Peace*, 7 CARDOZO J. INT'L & COMP. L. 11, 27-28 (1999) (listing several reasons why the Israeli market is the target of Palestinian trade).

crucial for trade in fresh agricultural produce, and is responsible for much of the subcontracting activities that developed in the Territories since 1967.<sup>139</sup> Both are staples of the economy in the Territories.<sup>140</sup> Proximity also means relatively low, if not negligible, transportation costs. Shared infrastructure, including roads, electrical power grids, and water supplies, emphasizes the nature of the Israeli-Palestinian economic relationship even further.

The vast economic differences between the Israeli and Palestinian markets present significant opportunity for Palestinian manufacturers. Enjoying comparative advantage in the production of low-technology, labor-intensive products, they can produce and supply goods and services aimed at the relatively large market of lower income Israeli households.<sup>141</sup> The same advantages do not hold true for Palestinian manufacturers and service suppliers seeking to compete in other regional markets.

First, they will compete against local manufacturers and service suppliers who frequently enjoy lower costs of production and require

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139. See Elmusa & El-Jaafari, *supra* note 43, at 27 (noting the disadvantaged position of Palestinian produce in regional markets due to higher production costs); see also Hisham Awartani & Ephraim Kleiman, *Economic Interactions Among Participants in the Middle East Peace Process*, 51 MIDDLE EAST J. 215, 217, 222 (1997) (suggesting that although trade patterns of Arab states show a weak tendency for intra-regional trade among themselves, the geographical proximity of the Israeli, Palestinian, and Jordanian markets presents the potential for substantial border-type trade, as well as joint ventures); see also Arie Arnon & Jimmy Weinblatt, *Potential Trade Flows between Israel, Jordan, and the Palestinian Economy*, 41 ECON. Q. 574 (1994); Nadav Halevi, *Trade Relations between Israel and Jordan in Light of the Agreement between Israel and the Palestinians*, 41 ECON. Q. 611 (1994). But see Sagi & Sheinin, *supra* note 103, at 20-23.

140. See Antoine Mansour & B. Destremau, *Palestine and Israel: Subcontracting Relations in the Garment Industry* 41 (1997) (discussing the relative importance of sub-contracting activity in the Territories, mainly in the context of clothing manufacturing); GAZIT, *supra* note 23, at 252 (the development of sub-contracting activity in the Territories, mainly in the context of clothes manufacturing); see also Vernon, *supra* note 33, at 60-61; *Clothes 'Made in Israel' sewn in West Bank*, THE TORONTO STAR, May 18, 1992, at B4.

141. See, e.g., Haggai Atkes, *Separation is Dead. Long Live Trade*, GLOBES, Feb. 17-18, 2000, at 60 (describing the thriving Palestinian markets which operate close to the Green Line catering to Israeli consumers).

little additional transportation costs.<sup>142</sup> Second, the local population in such alternative markets is substantially poorer than that of Israel, thereby minimizing the size of the potential target market for Palestinian products.<sup>143</sup> Finally, the Palestinian economy and those of the Arab countries in the region are far more competitive than complementary. Indeed, available data clearly demonstrates that the level of intra-regional trade among the Arab countries is negligible.<sup>144</sup> This is much less the case with respect to the Israeli economy.<sup>145</sup> If the Palestinians wish to compete in the European or North American markets, they would have to contend with an interim period during which they would face difficulties penetrating those markets.<sup>146</sup> In that interim period, Israel would remain without substitute as the major trading market for Palestinian goods and services and a source

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142. See Elmusa & El-Jaafari, *supra* note 43, at 25. These authors note that:

[the West Bank and Gaza's] production costs, greatly influenced by the Israeli cost structure, are higher than in the non-oil-producing [Arab] states. It would also be more difficult for the Palestinians to find the least costly materials because of the import restrictions. In order to compete, Palestinian producers would have to become highly efficient, not an easy task considering the general state of underdevelopment in the [occupied Palestinian territories].

*Id.*

143. See *supra* notes 36-40 and accompanying text (noting the significant difference between the Israeli economy and the economies of the neighboring Arab states).

144. See Elmusa & El-Jaafari, *supra* note 43, at 25 (observing that “[i]nter-Arab trade usually comprises less than five percent of the overall value of Arab trade . . . largely because of the region’s lack of complementarity in production and diversified industrial structure, although inter-Arab political quarrels also take their toll”); see also Riad Ajami, *A Middle Eastern Free Trade Agreement (MEFTA): Prospects and Possibilities*, in 2 PRACTICAL PEACEMAKING IN THE MIDDLE EAST 371, 375 (Steven L. Spiegel & David J. Pervin eds., 1995) (asserting that “less than 10% of all Middle Eastern trade is with other Middle Eastern countries.”); Awartani & Kleiman, *supra* note 139, at 221 (stating that there is a “low level of economic integration” between Middle Eastern countries because trade between the countries is unnatural).

145. See, e.g., Awartani & Kleiman, *supra* note 139, at 222 (declaring that in the absence of trade barriers, trade between Israel and the Territories can substantially expand and be further enhanced by the complementary economies of both regions).

146. See *infra* note 155 and accompanying text (arguing that Israeli-Palestinian cooperation may assist in overcoming difficulties in penetrating Western markets).

for imports. Separating the two markets, therefore, would impede the growth prospects of the Palestinian economy.

Economic integration between the Israeli and Palestinian economies also holds the promise of benefits accruing to the latter from economies of scale. First, a major obstacle to rapid development of the local economy is the lack of adequate infrastructure. Israel's policy concerning the Territories in the past thirty years has certainly a lot to do with this. Yet, regardless of the past, the size of the local economy does not justify the installation of expensive facilities and infrastructure, such as power stations, that are designed to service only the Palestinian population. Despite the political appeal of "symbolic modernization,"<sup>147</sup> especially in the context of a newly independent state, investing in such projects may significantly retard economic welfare and well being for the individual Palestinian and create a substantial balance of payments deficit.<sup>148</sup> A more efficient use of the scarce resources available to the Palestinians would be the joint use of existing Israeli infrastructure. Joint Israeli-Palestinian ownership or operation of certain facilities may create an equilibrium between the Palestinian need for national symbols and the economic risks resulting from substantial investments in such independent projects.<sup>149</sup> Indeed, even if going its own way is the preferred choice for Palestine, it could use existing infrastructure and facilities in the transition period. This choice further weakens the force of the "sovereignty" argument.

Second, the small size of the Palestinian economy substantially limits the scope and nature of competitive industry that can develop there.<sup>150</sup> An integrationist model involving Palestine and Israel would

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147. GALBRAITH, *supra* note 119, at 204-05 (describing "symbolic modernization" as a tool used by politicians to reinforce national sentiments as well as the notion that their country is prosperous).

148. *See id.* (explaining how symbolic modernization actually hinders economic growth of a country paying for such investment).

149. *See* Awartani & Kleiman, *supra* note 139, at 227-28 (noting that investment in common infrastructure projects and, more generally, in joint business ventures, is an important ingredient of regional integration); Gross & Sagi, *supra* note 45, at 61.

150. At the same time, the small size of the local economy practically rules out the possibility of adopting an import-substitution strategy. Hence, a policy geared

vastly increase the size of the market opened to Palestinian goods and services.<sup>151</sup> Finally, economic development is also connected to the creation of clusters of interdependent and complementary industries as well as commercial and business centers. Such clusters and centers tend to form in specific areas where a critical mass of industries and other businesses is located.<sup>152</sup> Silicon Valley is the paradigm of such cluster formation.<sup>153</sup> On a smaller scale, another typical example of such formations is the concentration of high tech related industries near Hertzelia, Israel. Industries and businesses that are part of such a cluster can receive technological, logistical, and financial support by specialized firms and supporting industries, supply goods and services required by other industries and businesses in that region, and enjoy access to information. Thus, the costs to manufacturers are reduced and available resources are more efficiently allocated. The Palestinian industrial and business sectors are neither sizeable nor concentrated enough to form the necessary critical mass. Yet, their geographical proximity to the Israeli business and industrial centers would enable local businesses and industries to resort to existing Israeli support structures, making necessary adjustments in order to make those more amenable to their specific needs and demands.<sup>154</sup>

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towards encouraging exports and international trade is, for all practical purposes, an economic necessity.

151. See *Economic Transition in the Occupied Territories, an Interview with Stanley Fischer*, 23(4) J. PALESTINE STUD. 52, 58 (1994) (stating that free trade with regional partners is extremely important in the world economy). Stanley Fischer suggested that:

[h]ow important is free trade with their neighbors for the Palestinians? It is very important, because the economy is so small. If Palestinian industry is to reach any reasonable size, it can only be on the basis of becoming an export economy. The largest neighboring market is Israel, and that would be a natural place to export to.

*Id.*

152. See MICHAEL E. PORTER, *THE COMPETITIVE ADVANTAGE OF NATIONS* (1990) (explaining the formation of clusters of industries and their effect on the economic growth of countries).

153. See *id.* at 151 (commenting on the Silicon Valley cluster formation).

154. Gross & Sagi, *supra* note 45, at 62 (discussing the advantages to Palestinian manufacturers and businesses from proximity to Israeli industrial and commercial clusters).

Israeli-Palestinian cooperation may open up important new markets for Palestinian goods. Penetrating the European or North-American markets may prove a difficult task for Palestinian producers. Reasons for these difficulties include fierce competition characterizing these markets, the markets' high level of technical requirements and standards, the Palestinian's lack of sophisticated technological know-how, and the absence of appropriate marketing mechanisms. Israeli-Palestinian cooperation may remove some of these obstacles.<sup>155</sup> At the same time, eliminating trade barriers between the two neighbors will facilitate a higher degree of transfer and spillover of technology, as well as administrative, managerial and organizational knowledge, from the developed Israeli market to the developing Palestinian market. With strong incentives to produce goods that meet the higher demands of the Israeli customers, the human capital in Palestine and the quality of locally manufactured goods and services supplied will further improve.<sup>156</sup> Given the available market's larger size, new possibilities opened to investors, and the potential extension to Palestine of preferential trade arrangements entered into by Israel with third party trading partners, there will be increased attraction for private foreign investment. This holds the promise of a rapid and robust economic growth in Palestine.

On the other hand, a complete separation between Israel and Palestine would perpetuate the economic inferiority of the new Palestinian state and could lead to the domestic destabilization of its political regime at a time when stability and calm are precious commodities.<sup>157</sup> Such effects may also endanger the maintenance of

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155. Sadan, *supra* note 121, at 6.

156. Gross & Sagi, *supra* note 45, at 62; Kanafani, *supra* note 57, at 39.

157. See GALBRAITH, *supra* note 119, at 222-23, noting that:

In Europe in the last several decades, governments have been stable and secure because their people have been contented and secure. International cooperation, and most notably the creation of the Common Market, has been possible for the same reason . . . . As well-being is a solvent for tensions, so poverty is a principal cause. The poor countries are the focus of internal disturbance, insecurity, interracial friction and international conflict because these are intimately a part of the politics of privation.

*Id.*



peaceful relations with Israel.<sup>158</sup> Israel stands to gain a great deal from an enhanced economic welfare on the Palestinian side, if only for the fact that economic prosperity is a strong disincentive to violence.<sup>159</sup> Raising the standard of living of the Palestinian people, conferring upon them the economic dividends of peace, and putting them in a position of having something to lose,<sup>160</sup> is critical to the strengthening of peace between the two states.<sup>161</sup> As such, it is as much an Israeli interest as it is a Palestinian one.<sup>162</sup> Although the static economic gains accruing to the Israeli economy from an economic integration with the Palestinian economy seem relatively

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158. See, e.g., Fidler, *supra* note 72, at 531 (noting that “Palestinians who see no improvement in their standard of living or find no economic opportunities as a result of the peace process will question the wisdom of making deals with Israel and perhaps support forces that oppose the peace process.”); see also Drake, *supra* note 84, at 27 (noting that “at the level of the ordinary Arab citizen, the phenomenon of unfulfilled expectations, generated by an unwarranted *a priori* belief in a Middle Eastern version of the trickle-down theory, provides a second layer of anti-normalization sentiment.”); HELLER, *supra* note 104, at 79 (“[I]f the [Palestinian] state’s inability to satisfy the economic needs of its subjects were so pronounced as to threaten a government’s position, that government might feel compelled to renew the confrontation with Israel . . .”). Following the signing of the DOP, public opinion polls in the Territories found that about two-thirds of Palestinians had expectations of rapid economic growth.

159. See, e.g., *Address by Minister for Foreign Affairs Shimon Peres to the Middle East/North Africa Economic Summit, Casablanca, Oct. 31-Nov. 1, 1994* (visited May 8, 2000) <[www.Israel-mfa.gov.il/mfa/go.asp?mfah00r10](http://www.Israel-mfa.gov.il/mfa/go.asp?mfah00r10)> (noting that “today’s source of violence is principally the menace from within: poverty breeding despair. Our aim is to address ourselves to a Middle East, where its people will have a higher standard of living and a lower standard of violence.”).

160. GAZIT, *supra* note 23, at 207 (“‘Let them have something to lose.’ This slogan became a fundamental tenet of the Israeli policy in the Territories . . . The military government was constrained in the effective punitive measures it could take, and the substitute found was the system of ‘revoking privileges and rights.’”) (translated by the author); see also *id.* at 278-79.

161. GALBRAITH, *supra* note 119, at 22-23 (stating that a country’s economic well-being promotes international peace and cooperation).

162. See, e.g., GAZIT, *supra* note 23, at 182 (describing guidelines set by the Israeli Minister of Defense, Moshe Dayan, on November 17, 1967, concerning the activities of the Israeli military government in the Territories). Dayan ruled that raising the standard of living of the local inhabitants was crucial, among other things, as a necessary component in fighting terrorism. In his view, the most effective war on terrorism was possible when individuals had something to lose if peace and calm were replaced by acts of terror. *Id.*

small, the dynamic gains, both economically and politically, are significant.<sup>163</sup> Accelerated economic growth under conditions of peace and economic integration may be attributable to the lowering of defense expenditures, coupled with the reallocation of resources currently used for military needs, attraction of foreign investment, enhanced economic efficiency based on regional trade, improvement of the regional infrastructure and human capital, and higher productivity.<sup>164</sup>

### C. A BULL IN A CHINA SHOP: INTEGRATION UNDER CONDITIONS OF SUBSTANTIAL ECONOMIC INEQUALITY

As noted above, there exists Palestinian apprehension of economic integration becoming a means of replacing the military occupation by Israeli economic control over the Territories. This fear is all the more pronounced when considering the substantial disparity between the two economies insofar as their respective sizes, levels of development and sophistication, openness, and structure are concerned. The anticipated asymmetrical interdependence between the Israeli and the Palestinian economies is certainly a cause for alarm among Palestinians.<sup>165</sup> Israel may use such asymmetry in the future, as it has done in the past, to coerce the Palestinian state into making additional political and economic concessions.<sup>166</sup> Yet, seen from the perspective of neo-classical trade theory, economic integration under

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163. See, e.g., ROBERT Z. LAWRENCE ET AL., TOWARDS FREE TRADE IN THE MIDDLE EAST: THE TRIAD AND BEYOND 7 (1995) (explaining that static gains from economic integration refer, by and large, to the effects on welfare through specialization based on comparative advantages, whereas dynamic gains derive from, *inter alia*, increased level of competition, technology transfer, and market expansion). It is noteworthy that in the late 1980s Ben-Shahar estimated that within ten years of peace, Israel's GNP could be about twenty-two percent higher than in the absence of peace. Haim Ben-Shahar, *Economic Cooperation in the Middle East: From Dream to Reality*, in ECONOMIC COOPERATION IN THE MIDDLE EAST 1, 5 (Gideon Fishelson ed., 1989).

164. See generally Ben-Shahar, *supra* note 163, at 5-6 (discussing the costs of war).

165. See ROBERT O. KEOHANE & JOSEPH S. NYE, POWER AND INDEPENDENCE: WORLD POLITICS IN TRANSITION 11 (2d ed. 1989) (discussing the possibility of asymmetrical interdependencies as a source of power).

166. See, e.g., Arnon & Weinblatt, *supra* note 16, at 41.

conditions of economic size asymmetries is expected to confer greater benefits on the smaller, rather than the larger, economy.<sup>167</sup>

Economic integration among nations whose size of domestic economies vary greatly from each other is not unique to the Israeli-Palestinian experience. Several regional trade arrangements involving economies of substantially different sizes exist in the world today. Their experiences, while not necessarily fully applicable to the Middle Eastern context, may well be of use and interest to policy-makers in that region. An instructive example in this context is the North American arrangement and the economic relations it established between Canada, the United States, and Mexico in the framework of the North American Free Trade Agreement ("NAFTA").<sup>168</sup> Although the colonial subtext is absent in this context, and there is no issue of entrenched animosities between the trading partners, much can be gleaned from the experience accumulated in the six years since this agreement came into force on January 1, 1994.

The differences in size of the relevant economies are similar in the Israeli-Palestinian and the U.S.-Mexican contexts. Measured in total GNP terms, the Palestinian economy is about 4.5 percent of the size of the Israeli economy,<sup>169</sup> whereas the Mexican economy is about 4.6 percent the size of the United States.<sup>170</sup> Substantial differences also exist with respect to the GNP per capita indicator.<sup>171</sup> Over eighty percent of all Mexican exports are exported to the United States mar-

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167. See, e.g., LAWRENCE, *supra* note 163, at 9 (explaining the effects of economic integration); see also, Sussman, *supra* note 82 (contrasting the experience of the expansion of the European Economic Community to include the relatively smaller economies of Portugal, Greece, and Ireland, with the isolationist trade policy adopted by the Republic of Ireland until the early 1960s).

168. North American Free Trade Agreement, Dec. 17, 1992, 32 I.L.M. 605 (1993). See Ephraim Kleiman, *Peace and Trade with Neighbors*, 41 ECON. Q. 32, 37-40 (1994); Garvey, *supra* note 72, at 163 (suggesting that NAFTA and its dispute resolution processes present "the most revealing parallels for addressing fundamental problems of political and economic development in the Middle East.").

169. See *supra* note 39 and accompanying text (detailing the differences in disparity between the Palestinian and Israeli economies).

170. See WDI 2000, *supra* note 37 (in 1998 Mexico's GNP was \$368 billion, whereas the United States' GNP was \$7,903 billion).

171. *Id.* (reporting that GNP per capita levels stood at \$29,240 for the United States, \$19,170 for Canada, and \$3,840 for Mexico).

ket.<sup>172</sup> The phenomenon of export of labor services from one country to another, playing a prominent role in the Israeli-Palestinian context, is also prevalent in the economic relations between Mexico and the United States.<sup>173</sup>

Evaluating the economic success of NAFTA is not a straightforward matter in light of the peso crisis that hit Mexico in 1994, which had substantial impact on imports to, and exports from, Mexico. However, available data indicates an increase in the volume of bilateral trade between Mexico and the United States between 1994 and 1996, with a 2.3 percent increase in the market share of Mexican goods in overall imports to the United States, and a 6.2 percent increase in the market share of American goods in overall imports to Mexico during the same period.<sup>174</sup> NAFTA, and the easy access it afforded Mexican goods to the large American and Canadian markets, had a positive effect on Mexico's relative rapid emergence from the crisis. Whereas five years were needed for Mexico to overcome a 1982 peso crisis, only two years were required to return to its pre-crisis level after the 1994 crisis.<sup>175</sup> Exporting was the main cause of

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172. See, e.g., World Trade Organization, Trade Policy Review: Mexico, October 1997, Press/TPRB/63, Oct. 2, 1997 (noting that: "[r]eflecting their growing bilateral trade relationship, the share of Mexico's merchandise trade with the United States rose from 75 per cent in 1992 to 80 per cent in 1996.").

173. See, e.g., AT THE CROSSROADS: MEXICO AND U.S. IMMIGRATION POLICY (Frank D. Bean et al eds., 1997); see also FREDERICK M. ABBOTT, LAW AND POLICY OF REGIONAL INTEGRATION: THE NAFTA AND WESTERN HEMISPHERIC INTEGRATION IN THE WORLD TRADE ORGANIZATION SYSTEM 17-18 (1995) (arguing that an important goal of the United States in concluding the NAFTA was "to stem the tide of illegal immigration from Mexico").

174. See U.S. Executive Branch, *Study on the Operation and Effect of the North American Free Trade Agreement (NAFTA)*, at iv-vi, 35-36 (visited May 14, 2000) <<http://www.ustr.gov/reports/index/html>> [hereinafter U.S. Executive Branch NAFTA Study] (noting a 17.2 percent rise in the market share of American textile products imported to Mexico and a 19.2 percent rise in the market share of transport equipment originating in Mexico and imported to the United States); see also Nora C. Lustig, *NAFTA: Setting the Record Straight*, in THE WORLD ECONOMY - GLOBAL TRADE POLICY 1997 89 (Sven Arndt & Chris Milner eds., 1998) (evaluating the effects of NAFTA on Mexico's economy).

175. Frederick M. Abbott, *The North American Integration Regime and Its Implications for the World Trading System* 42 (Jean Monnet Papers, No. 2/99, Harvard Law School) (1999) (noting that Mexican manufacturing returned to its pre-

this rapid economic recovery. In 1995 alone, Mexico's volume of non-oil exports rose by 47.5 percent compared with the previous year.<sup>176</sup> More significantly, after 1994, the annual average growth rate of Mexican exports to the United States was more than ten percent higher than the equivalent figure for the period of 1991 through 1993.<sup>177</sup> Similarly, the Mexican government made public its opinion that NAFTA had been a crucial factor in Mexico's ability to maintain relative stability during the 1997-98 currency crisis that hit so many other economies around the world, including several Latin and South American countries.<sup>178</sup>

Much of the opposition to NAFTA in the United States focused on the fear of losing American jobs, especially those in vulnerable sectors such as the automotive industry, to Mexico due to lower wages. This fear was described as the "giant sucking sound" of jobs "going south."<sup>179</sup> Today, Israeli opponents of an economic integration with Palestine also fear losing jobs as a result of integration with the Palestinians, especially in already hard-hit sectors such as textile manufacturing. Many textile factories are located in major unemployment centers in Israel, and are the largest employer for those lucky enough to find a job. The loss of additional jobs, or even the closing down of these factories, would disproportionately hit these already disadvantaged areas. Not only will they not be better off as a result of integration, but actually their economic condition will deteriorate further. In turn, opponents conclude, this will have repercussions in the so-

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crisis level by 1996); see Lustig, *supra* note 174, at 91 (arguing that NAFTA contributed to Mexican recovery from the peso crisis).

176. See Lustig, *supra* note 174, at 91.

177. See *id.* (indicating that Mexican exports to the United States increased as a result of NAFTA).

178. See Abbott, *supra* note 175, at 44-45.

179. See, e.g., Peter Behr, *Fears of Job Exodus Emerge as Chief Hurdle for Free Trade Pact*, WASH. POST, Mar. 18, 1993, at C15 (quoting Ross Perot) (predicting NAFTA would create "a giant sucking sound" as U.S. firms relocated to Mexico); see also Lance Compa, *International Labor Rights and the Sovereignty Question: NAFTA and Guatemala, Two Case Studies*, 9 AM. U. J. INT'L L. & POL'Y 117 (1993); Jorge F. Perez-Lopez & Eric Griego, *The Labor Dimension of the NAFTA: Reflections on the First Year*, 12 ARIZ. J. INT'L & COMP. L. 473 (1995).

cial, political, and economic structures of Israel.<sup>180</sup>

The experience under NAFTA, however, does not support this grim outlook. For example, in the first nine months of 1996, the number of American employees displaced due to NAFTA constituted a mere 0.01 percent of the total number of American employees who were displaced in that same period.<sup>181</sup> In other words, even if NAFTA caused some individuals to lose their jobs, their number was negligible in the context of the overall trend in the American labor market. Furthermore, taking into account not only the number of jobs lost due to the agreement, but also the number of new jobs created as a result of its operation and implementation, initial data indicates that NAFTA had an overall positive aggregate effect on the American labor market.<sup>182</sup> We can predict that similar consequences will result from an Israeli-Palestinian agreement on economic integration. A further indication that Palestinian workers employed in Israel do not, by and large, take jobs away from Israelis, is seen in the fact that most of the jobs previously occupied by Palestinian workers and made available as a result of the *Intifada* and the Israeli government closure policy were not filled by Israeli workers, but rather by importing foreign workers from East Europe, Africa, and the Far East. Furthermore, the complementary structures of the two markets also minimize the risks of job losses and the concomitant adjustments.

Certainly this comes as no consolation to those who lose their jobs. For them general statistics are of no interest.<sup>183</sup> It is important to note that these considerations are not, however, unique to the Israeli-Palestinian context. "Pauper labor" arguments are perennial in the on-going debate concerning the desirability of free trade and trade

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180. See, e.g., MICHAEL J. TREBILCOCK & ROBERT HOWSE, *THE REGULATION OF INTERNATIONAL TRADE* 242-43 (2d ed., 1999).

181. See Lustig, *supra* note 174, at 93.

182. See *id.* at 96; U.S. Executive Branch NAFTA Study, *supra* note 174, at i (estimating that exports to Canada and Mexico supported 2.3 million jobs in the United States in 1996).

183. It falls to their country to ensure that such individuals can find alternative employment by operating adequate adjustment assistance programs. See TREBILCOCK & HOWSE, *supra* note 180, at 240-45 (discussing labor market adjustment policies to counter the dislocation effects of trade liberalization).

liberalization.<sup>184</sup>

Finally, NAFTA was also challenged on environmental grounds. Opponents argued the agreement would have an adverse effect on the environment in the United States, particularly in the border areas between the United States and Mexico, due to arguably lower standards of environmental protection in Mexico. To ease this fear, the NAFTA signatories added a side agreement dealing specifically with the protection of the environment.<sup>185</sup> Given the geographical proximity of Israel and Palestine and the small size of the two, detrimental environmental effects in one country will not be substantially determined by the existence or absence of an economic integration between the two parties. The real issue, therefore, is not finding ways to confine environmental degradation to the territory of another country, but rather cooperating in order to prevent such degradation or minimize its scope and effects in the region as a whole. Furthermore, even within the framework of free trade arrangements, participating nations may have the option to intervene, under appropriate circumstances, in the free flow of goods, services, labor and capital for protection of legitimate interests such as public health and environmental protection.

There are other examples of economic integration carried out on a regional or sub-regional basis between parties of substantially different economic sizes. Indeed, there are even examples of deeper economic integration between such parties, going beyond the FTA model adopted under NAFTA. Under the umbrella of the Southern Cone Common Market ("Mercosur"), Argentina, Brazil, Paraguay, and Uruguay pursue the goal of establishing a common market.<sup>186</sup>

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184. See, e.g., JOHN H. JACKSON ET AL., *LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS* 18 (3d ed. 1995) (illustrating popular arguments for trade restrictions).

185. See North American Agreement on Environmental Cooperation, 32 I.L.M. 1480 (entered into force on Jan. 1, 1994); see also 19 U.S.C. § 1311(b) (1994) (enacting NAFTA's side environmental agreement into law). See also Richard H. Steinberg, *Trade-Environment Negotiations in the EU, NAFTA, and WTO: Regional Trajectories of Rule Development*, 91 AM. J. INT'L L. 231, 245-53 (1997); TREBILCOCK & HOWSE, *supra* note 180, at 432-40.

186. See Treaty Establishing a Common Market Between the Argentine Republic, the Federal Republic of Brazil, the Republic of Paraguay and the Republic of

Mercosur is a sub-regional trade arrangement that includes countries whose GNP is as small as 1.2 percent of the GNP of other members.<sup>187</sup> Also, the history of the evolution of the European Economic Community (“Community”) and its expansion to include within its scope the relatively smaller and structurally different economies of Ireland, Greece, Spain, and Portugal, is a success story, both for the Community at large and for those individual countries in particular, notwithstanding fears of integrating these economies.<sup>188</sup>

Coming back once again to the context of the Israeli-Palestinian relations, the history of involuntary, one-sided economic integration of the Territories’ and the Israeli economies, actually facilitates the move towards future consensual economic integration between them since they have already incurred some of the expected adjustment and transition costs into a free trade regime. Thus, future costs may be lower in comparison with situations of integrating “from scratch.”<sup>189</sup>

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Uruguay, Mar. 26, 1991, 30 I.L.M. 1041 (establishing Mercosur – Mercado Común del Sur). In 1996, Chile and Bolivia joined Mercosur as associate members. See generally Lisa Anderson, Comment, *The Future of Hemispheric Free Trade: Towards a Unified Hemisphere?*, 20 HOUSTON J. INT’L L. 635, 654-56 (1998). Negotiations for further widening and deepening Mercosur are currently under way. *Id.* at 656-59. For analysis of Mercosur’s economic achievements see, e.g., Danny M. Leipziger et al., *Mercosur: Integration and Industrial Policy*, in THE WORLD ECONOMY – GLOBAL TRADE POLICY 1997 69, 76-79 (Sven Arndt & Chris Milner eds., 1998); Félix Peña, *Some Lessons from the Mercosur Initial Experience*, in REGIONALISM AND MULTILATERALISM AFTER THE URUGUAY ROUND – CONVERGENCE, DIVERGENCE AND INTERACTION 161, 167-70 (Paul Demaret et al eds., 1997).

187. See WDI 2000, *supra* note 37 (listing economic data for countries and economies). Brazil’s GNP stands at a level of \$767.6 billion and Argentina’s at \$290.6 billion, whereas Paraguay’s is \$9.2 billion and Uruguay’s \$20 billion. In GNP per capita terms, Argentina (\$8,030), Uruguay (\$6,070) and Brazil (\$4,630) are significantly ahead of Paraguay (\$1,760). *Id.* In fact, with Bolivia joining as an associate member, the economic disparities indicated above deepened further as Bolivia’s GNP (\$8 billion) and GNP per capita (\$1,010) are the lowest of all member countries. *Id.*

188. See, e.g., Sussman, *supra* note 82, at 633-35.

189. See, e.g., Kotschwar, *supra* note 47, at 137-39 (noting the costs to countries with small economies that enter into trade and integration arrangements); LAWRENCE, *supra* note 163, at 16 (noting that, due to the fact that the Territories have been exposed to Israeli competition and are without an extensive import-competing industry, maintaining open trade with Israel will pose few adjustment



### III. LEVELS OF ECONOMIC INTEGRATION: FREE TRADE AREA OR CUSTOMS UNION?

The arguments discussed in Part II point to the desirability of some sort of integration between the Israeli and Palestinian economies. Yet, saying that economic integration is preferable to complete separation between the Israeli and Palestinian economies does not convey a commitment to any specific model of integration. The question of which model of economic integration is most suitable for the permanent status agreement between Israel and the Palestinians is not confined to evaluating economic considerations. It is a question of balancing conflicting economic, political, cultural, and social interests. For proponents of integration, finding modes of accommodating those counter-arguments is a major challenge on the road to building a structure for a just and long-lasting peace between Israelis and Palestinians.

#### A. MODELS OF ECONOMIC INTEGRATION

The term "economic integration" connotes the process by which the economies of several sovereign states are combined and the economic borders between them are gradually removed.<sup>190</sup> More specifically, it refers to arrangements aimed primarily at the elimination of barriers to free movement of goods and services (and potentially also factors of production) within the integrated area. While the reasons underlying a state's decision to pursue a policy of economic integration need not be confined to the economic sphere,<sup>191</sup> the gains in terms of economic welfare of such integration are clearly of great importance for the member states.<sup>192</sup>

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difficulties. However, such difficulties may occur with respect to firms that expanded as a result of Palestinian self-sufficiency strategy during the *Intifada*.

190. See MOLLE, *supra* note 118, at 8 (defining economic integration as the gradual elimination of economic frontiers between independent states, resulting in the economies of several states functioning as one).

191. See, e.g., John Whalley, *Why Do Countries Seek Regional Trade Agreements?*, in THE REGIONALIZATION OF THE WORLD ECONOMY 63 (Jeffrey A. Frankel ed., 1998) (formulating reasons for negotiating regional trade agreements).

192. For the economic theory underlying the creation of regional trade arrangements see generally ROBSON, *supra* note 97; JACOB VINER, THE CUSTOMS UNION ISSUE (1950).

The classical discourse concerning regional trade arrangements identifies several models of economic integration, distinguished from each other according to the depth and breadth of integration among the parties involved.<sup>193</sup> For the purposes of this discussion, three basic models ought to be mentioned. The lowest level of integration is an FTA. An FTA refers to the elimination among the states parties of all, or substantially all, barriers to free movement of goods and services, while allowing each party to retain an independent trade policy vis-à-vis third countries outside the integrated area. The different treatment accorded to goods and services originating from within the integrated area and goods and services originating in third countries necessitates the existence of rules of origin and of border mechanisms, such as customs stations, to verify the origin and to monitor cross-border movement of imported goods in order to prevent trade deflection.<sup>194</sup>

A closer economic integration results under the customs union model. As in the case of the FTA, the goal is the elimination of all barriers to the free and uninterrupted movement of goods and services among the member states. In addition, the member states adopt a single external trade policy towards third countries by establishing a single external customs regime.

A common market is the next stage of economic integration. Sharing the features of the customs union, it adds the element of free movement of factors of production. This requires a higher degree of harmonization on issues such as immigration policies and taxation.

Economic integration, which is, in essence, a mutual preferential treatment arrangement among the member states, does not comport with a fundamental principle of the modern multilateral trade system, *i.e.*, the most favored nation principle ("MFN") enshrined in the

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193. See BELA A. BALASSA, *THE THEORY OF ECONOMIC INTEGRATION* 1-17 (1961) (introducing the concept and forms of integration); MOLLE, *supra* note 118, at 10-12.

194. See ROBSON, *supra* note 97, at 28 (explaining that trade deflection occurs when goods are imported into the member country with the lowest tariff and then redirected to another member of the FTA, thus bypassing the latter country's higher tariff and exploiting the tariff differential). In the Israeli-Palestinian context, trade deflection may take place even with small tariff differentials between Israel and Palestine due to low transportation costs.

General Agreement on Tariffs and Trade ("GATT").<sup>195</sup> However, GATT Article XXIV recognizes the need to allow for some exceptions to the MFN principle, as far as regional trade arrangements are concerned.<sup>196</sup> Article XXIV deals with FTAs and customs unions and exempts their member states from the dictates of the MFN provision inasmuch as such member states are not required to extend to non-member states the same trade concessions accorded to other states that are members of the relevant FTA or customs union. Thus, Article XXIV accommodates preferential trade regimes within the framework of the multilateral trade system.

Article XXIV sets a number of conditions for a specific regional trade arrangement to be acceptable under the GATT, which are meant to prevent the possibility of easy manipulation of Article XXIV by members of the World Trade Organization ("WTO") to avoid their obligations under the MFN principle.<sup>197</sup> The major substantive condition is the "all or nothing" requirement.<sup>198</sup> A regional trade arrangement is considered compatible with the GATT only if the member states have committed to liberalize "substantially all" trade between them.<sup>199</sup> The underlying rationale for this requirement is that, by doing so, the member states demonstrate their sincerity and seriousness about eliminating trade barriers among them on a broad basis. It also shows that they do not intend to use Article XXIV merely as a mechanism to discriminate against third countries

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195. See General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194, 196 [hereinafter GATT].

196. See, e.g., R. H. Snape, *History and Economics of GATT's Article XXIV*, in REGIONAL INTEGRATION AND THE GLOBAL TRADING SYSTEM 273 (Kym Anderson & Richard Blackhurst eds., 1993) (explaining the reasoning behind Article XXIV); JOHN H. JACKSON, WORLD TRADE AND THE LAW OF GATT 576-77 (1969).

197. See BERNARD HOEKMAN & MICHEL KOSTECKI, THE POLITICAL ECONOMY OF THE WORLD TRADING SYSTEM 218 (1995); JOHN H. JACKSON, THE WORLD TRADING SYSTEM - LAW AND POLICY OF INTERNATIONAL ECONOMIC RELATIONS 165-66 (2d ed., 1997) (stating the requirements necessary to satisfy Article XXIV of the GATT).

198. JACKSON, *supra* note 197, at 165.

199. See GATT, *supra* note 195, Article XXIV:8 (imposing requirements on customs unions so that they are compatible with GATT obligations); 2 WORLD TRADE ORGANIZATION, ANALYTICAL INDEX: GUIDE TO GATT LAW AND PRACTICE 824-27 (6th ed. 1995).

or to bypass selectively the MFN rule with respect to specific goods.<sup>200</sup> Thus, to be GATT-compatible,<sup>201</sup> any arrangement for economic integration among WTO member states must be comprehensive and not merely content itself with liberalizing trade in a limited number of goods or in particular sectors.<sup>202</sup> Insofar as the relevant actors in the Middle East are WTO members, these provisions set the international legal framework for constructing regional trade relations among them.<sup>203</sup>

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200. See J. M. Finger, *GATT's Influence on Regional Agreements*, in *NEW DIMENSIONS IN REGIONAL INTEGRATION* 134 (Jaime de Melo & Arvind Panagariya eds., 1993) (explaining the rationale of Article XXIV's requirements).

201. See, e.g., HOEKMAN & KOSTECKI, *supra* note 197, at 218-19 (concluding that the monitoring of the compatibility of FTAs and customs unions arrangements with the GATT is ineffective); David R. Karasik, *Securing the Peace Dividend in the Middle East: Amending GATT Article XXIV to Allow Sectoral Preferences in Free Trade Areas*, 18 *MICH. J. INT'L L.* 527, 541-44 (1997) (questioning the continued utility of Article XXIV because it is seldom complied with and does not adequately serve international economic purposes). See also Serge Devos, *The Multilateral Rules and the New Dimension of Regional Integration: Weaknesses, Need and Scope for more Disciplines*, in *REGIONALISM AND MULTILATERALISM AFTER THE URUGUAY ROUND – CONVERGENCE, DIVERGENCE AND INTERACTION* 725, 737-44 (Paul Demaret et al. eds., 1997).

202. But see Karasik, *supra* note 201, at 549-55 (advocating the establishment of a "sectoral trade area" in the Middle East, *i.e.*, a free trade area that will reduce trade barriers only for those economic sectors in which the relevant actors enjoy complementary production structures such as textile, chemicals, energy, and transportation). Karasik puts forward a proposal to amend Article XXIV of the GATT so as to accommodate such a model of economic integration. See *id.* at 555-56, 561-63. Alternatively he argues that such an arrangement may be facilitated by other venues made possible under already existing GATT provisions. See *id.* at 556-61.

203. See WTO Home Page, *Members* (visited May 11, 2000) <<http://www.wto.org/wto/about/organsn6.htm>> (listing the following Middle Eastern/North Africa countries as WTO members: Bahrain, Egypt, Israel, Jordan, Kuwait, Morocco, Qatar, Tunisia, and the United Arab Emirates). Algeria, Oman, and Saudi Arabia are being reviewed by WTO accession working parties. The Palestinian Authority is not a member of the WTO. It is interesting to note that Article I:3 of the GATT provides an exemption from the MFN rules with respect to "preferences between countries formerly a part of the Ottoman Empire and detached from it on July 24, 1923," provided that a waiver is given to that effect by Ministerial Conference. See GATT, *supra* note 195, Art. I:3; Kleiman, *supra* note 168, at 33.

## B. FREE TRADE AREA OR CUSTOMS UNION?

Between 1967 and 1994, trade relations between Israel and the Territories could only be characterized as a unilaterally imposed customs union.<sup>204</sup> The Paris Protocol put forward, for the first time,<sup>205</sup> a consensual economic agreement between the parties. The arrangement agreed upon was, in principle, that of a customs union between Israel and the Palestinian Authority, based on the Israeli customs regime and import policy.<sup>206</sup>

In the negotiations leading to the conclusion of the Paris Protocol, the Palestinians insisted on the implementation of an FTA-type economic arrangement between the Palestinian Authority and Israel, while their Israeli counterparts pushed for a customs union regime.<sup>207</sup> For their part, the Palestinian negotiators sought to maximize the symbols of sovereignty and political independence of the Palestinian Authority *en route* to an independent Palestinian state. An FTA arrangement would require the demarcation of economic borders between the parties, which, in the context of the Israeli-Palestinian conflict, would likely serve as precursors for the final political borders

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204. See ARNON, *supra* note 22, at 88 (describing the trade regime that existed between Israel and the Palestinian economy since 1967 as “an *involuntary, one-sided, impure, customs union*.”).

205. See, e.g., Samir Hazboun et al., *The Economic Impact of the Israeli-PLO Declaration of Principles on the West Bank, Gaza Strip and the Middle East Region*, 3 ISRAEL/PALESTINE CENTER FOR RESEARCH AND INFORMATION 2 (1994) (noting that the DOP, *supra* note 6, signed on September 13, 1993, already included several provisions concerning economic cooperation between Israel and the Palestinians). However, as the name of the document itself suggests, these provisions were, for the most part, confined to setting general principles and guidelines rather than concrete arrangements between the two parties. See also Simcha Bahiri, *Economic Consequences of the Israel-PLO Declaration of Principles: An Israeli Perspective*, 3 ISRAEL/PALESTINE CENTER FOR RESEARCH AND INFORMATION 25 (1994).

206. See *supra* notes 53-56 and accompanying text (describing the principles underlying the Paris Protocol).

207. See, e.g., Kleiman, *supra* note 95, at 682-85 (discussing the Israeli and Palestinian positions with respect to the desired model of economic integration during the Paris negotiations); Arnon & Weinblatt, *supra* note 16, at 38 (discussing the positions of the Israeli and Palestinian negotiating teams with respect to the nature of economic integration).

between Israel and the Palestinian state.<sup>208</sup> An FTA regime would also allow the Palestinian Authority to adopt its own independent trade policy. This last point is of special significance with respect to the shaping of economic relations between the Palestinian Authority and Arab countries, including those without any diplomatic, economic, or other ties to Israel.

Israel strongly rejected the FTA model, alleging that an FTA might “force the issue” of setting precise boundaries between Israel and the Palestinians and support the latter’s claim for an independent state, thereby prejudging the outcome of future status negotiations between the two sides. The economic Protocol, the Israeli negotiators in Paris argued, being part of a political interim agreement between the parties, could not pre-determine the outcome of the permanent status negotiations between them. Thus, no economic arrangement that mandated the existence of borders was acceptable. Instead, Israel advocated a customs union arrangement which, it argued, would not predetermine the question of borders between Israel and the Palestinian Authority and which postponed such a decision to the permanent status negotiations.<sup>209</sup>

The outcome of the divergent positions was a customs union with a touch of FTA flavoring. On the one hand, the Paris Protocol established a single customs envelope covering both Israel and the areas put under the control of the Palestinian Authority. The model for this arrangement was the Israeli customs regime and import policy, coupled with a certain degree of harmonization of trade measures and procedures. On the other hand, the Paris Protocol granted the Pales-

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208. See *supra* note 194 and accompanying text (indicating the need for border mechanisms in an FTA).

209. See, e.g., Elmusa & El-Jaafari, *supra* note 43, at 29 (stating that “It would have been nearly impossible to have two highly divergent customs regimes without demarcating the political boundaries between the two sides. The attenuated one-sided customs union that emerged was therefore predetermined by the DOP: politics shaped economics.”). The Israeli negotiators also feared that the absence of a unitary customs envelope might hamper Israel’s ability to protect its domestic industry in certain sensitive sectors such as glass, iron, ceramics, textiles, and wood, against competition from third countries as well as its ability to protect its public against the importation into Israel of goods that do not conform with mandatory technical requirements and standards or that are environmentally unfriendly. Gabai, *supra* note 55, at A5; Kapota Part ii, *supra* note 55, at A18.

tinian Authority the power (albeit limited to goods agreed upon by the parties and by quotas) to set its own trade policy with respect to imports from Arab countries.<sup>210</sup> This compromise recognized the special links between the Palestinians and the neighboring Arab countries, as well as the Palestinians' need for some sphere of independence in setting their own trade policy.

In 1994, Israeli and Palestinian negotiators grappled to construct a transitional model of economic integration designed to accommodate their needs during the interim phase of the peace negotiations. This is no longer the case. The question on the table today concerns the nature of the economic arrangements to be included in a political permanent status agreement.<sup>211</sup> The basic assumption underlying this Article is that political boundaries will be set west of the Jordan River. The political-legal argument made by the Israeli negotiators in Paris will no longer be relevant. Political borders will become a reality in that area. Hence, the basic question concerning the nature of the economic and trade relations between Israel and Palestine reappears: is a continuance of the customs union arrangement warranted, or should they now employ an FTA-type model? In order to supply an answer to this quandary, the economic meaning of borders between Israel and Palestine must be explored.

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210. See *supra* note 57 and accompanying text.

211. While some economic measures may certainly be taken independent of the political agreements to be reached in the permanent status negotiations between the parties, the question of economic (and political) borders between Israel and the Palestinians is closely intertwined with the structure of the economic arrangement to be implemented. Thus, while Garvey is certainly right in suggesting that there has been a shift "from the view that economic progress must await political development to the view that economic development can induce political settlement" (Garvey, *supra* note 72, at 148), the shift is not complete in so far as the nature of the permanent economic settlement will be informed by the nature of the permanent political settlement between the parties.

*1. Joining Together, Standing Apart: The Case For and Against an FTA*

The main benefit conferred on the Palestinians by an FTA model of economic integration is of a political nature, namely the existence of clear attributes of sovereignty and independence. The existence of political borders is also intertwined with trade policy considerations. An FTA model empowers the Palestinian government to exercise an independent trade policy and set its own tariffs and import policy measures with respect to goods imported to Palestine that originate in third countries not part of the FTA. This is significant for several reasons. First, the need to verify the origin of imported goods and to apply the national import policy, tariffs and duties to them will inevitably lead to the establishment of customs stations on the border between the trading partners, emphasizing yet again the existence of such an interstate border. Second, an FTA arrangement also endows the nascent Palestinian state with more bargaining chips vis-à-vis third parties with whom it may wish to conclude bilateral trade agreements. Under an FTA, Palestine is not burdened by the relatively low ceiling of the existing Israeli tariff bindings, nor by other restrictions on trade policy measures undertaken by Israel as a member of the WTO. Palestine can raise or lower its national tariffs as needed to wrestle more trade concessions from third country trading partners.<sup>212</sup> Finally, the ability to conduct an independent trade policy may prove of special significance for Palestine with respect to its dealings with Arab and Muslim countries that do not have trade or other relations with Israel.

Unlike the more advanced models of economic integration, an FTA is a model of negative economic integration. It requires the elimination of barriers to regional trade and the liberalization of trade among the participating states. However, it does not mandate the creation of a complex supranational institutional structure, nor does it require deeper level of coordination of governmental policies among the member states.<sup>213</sup> As such, negative integration is particularly

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212. See Molkner, *supra* note 72, at 1448.

213. See JAN TINBERGEN, INTERNATIONAL ECONOMIC INTEGRATION 117-23 (1954) (explaining that negative integration focuses on the elimination of such barriers to trade as quantitative restrictions and import duties, whereas positive inte-



suited to accommodate the economic benefits of integration with the political needs of sovereignty and independence. This, of course, makes it appealing to young developing nations considering the possibility of economic integration with an economically superior country. Developing countries, therefore, are particularly prone to adopt mechanisms of low-level economic integration, preferring those to "deeper" institutional structures of higher-level economic integration. Developing countries, many of them young and born out of the process of decolonization, have a heightened national consciousness while economic issues seem secondary to political needs.

The freedom to adopt and conduct an independent trade policy is important for another reason. The narrow tax basis existing in the Territories, as well as the apparent difficulties in collecting direct taxes from the local population, make tariffs, import duties, and indirect taxation important sources of revenue for the Palestinian government. Indeed, experience has taught us that most developing nations rely on tariffs as an important source of revenue rather than imposing unpopular direct taxes.<sup>214</sup> By having the freedom to establish its own tariff and import duty levels, the Palestinian government may attempt to set its tariffs at a revenue-maximizing level. Forced adoption of the Israeli tariff walls would deny the Palestinian government an important tool to increase its revenues.

An FTA arrangement, however, is not without its costs and limitations. Most significant of all is the relatively limited implementation that an FTA may achieve in the Israeli-Palestinian context. Much like complete separation, an FTA requires a well-monitored border in order to prevent smuggling between the member states. This would lead to an informal trade deflection and deny the "importing" country of deserved revenues. However, past experiences, including that of the partially successful Israeli attempts to seal off the Territories in the mid-1990s, demonstrate the futility of efforts to separate completely the two areas or to monitor tightly the border between them.

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gration is concerned with measures designed to remove inconsistencies that may exist between the duties and taxes of different countries as well as with governmental action in the area of production).

214. See, e.g., GILPIN, *supra* note 114, at 171 (discussing the role of tariff revenues in the financing of government of less developed countries).

This is especially true with respect to the forthcoming borders between Israel and the Palestinian state in the West Bank, where the geographical contours do not dictate a clear border.<sup>215</sup> Moreover, the physical proximity of major population centers, industrial zones, and businesses on both sides of the border, as well as the ease with which official customs stations and official border crossing points can be by-passed and circumvented, can lead to massive smuggling.<sup>216</sup>

The permeability and porosity of the future border between the two neighbors are likely to be pronounced even more when Israeli settlements and Jerusalem are taken into consideration. Some Israeli settlements may remain in the West Bank (and, perhaps, even in the Gaza Strip) as part of the permanent status agreement, making transfer of goods and people between Israel and the West Bank an even easier task. In addition, any political arrangement seeking to ensure that Jerusalem remains an open and undivided city would hamper

215. See, e.g., AHARON KLIEMAN, *COMPROMISING PALESTINE: A GUIDE TO FINAL STATUS NEGOTIATIONS* 117-19 (2000) (analyzing the porous nature of the "green line," which is the line marked as part of the 1948 cease-fire and that distinguishes Israel from the territories which came under its control in 1967); Ze'ev Schiff, *Robbing the Country Blind*, HA'ARETZ, Aug. 21, 1998.

216. Klieman argues that:

in the course of the last several years Israeli civilian, military, and police authorities increasingly admit their inability to seal off Israel from daily encroachments of one sort or another from West Bankers. In other words, even once redeployed west of the green line, for Israel this 'seam' will be anything but seamless.

KLIEMAN, *supra* note 215, at 118. Klieman further notes the wide scale phenomenon of car thefts in Israel where tens of thousands of cars are stolen in Israel, driven into the territories controlled by the Palestinian Authority, cannibalized there and their parts resold in Israel as spare parts. *Id.*; see also Douglas Jehl, *Car Thefts Lead Israel to Wall Off West Bank*, N.Y. TIMES, Aug. 19, 1998, at A13 (discussing the changed attitudes of Israelis who abandoned opposition to erecting barriers between Israel and the West Bank as a result of the rise in car thefts); Aliza Marcus, *Palestinian and Israeli Car Thieves team up*, SUNDAY TELEGRAPH, July 5, 1998, at 29 (according to the Israel Insurance Association "Israel has the highest car-stealing rate in the world"); Patrick Cockburn, *Cars: Palestinians turn car theft into act of rebellion*, THE INDEPENDENT, Dec. 30, 1997, at 9 ("Israel's rate of car theft is three times higher than that in the U.S. ... As Palestinian living standards plummeted ... car theft became one of the few growth industries."). It has also been noted that where car thieves cross the borders, so too might terrorists, KLIEMAN, *supra*, at 118-19; Schiff, *supra* note 215.

any serious attempt to block effectively the transfer of people and goods between Palestine and Israel.<sup>217</sup> This should clearly bring home the broad political implications of any economic model adopted by the parties. A “pure” FTA arrangement requires a clear and well-enforced border in all points of meeting between the two neighbors, including in or around the city of Jerusalem. Jerusalem could not be a truly open city inasmuch as there would have to be limitations and restrictions on the movement of persons and goods to and from the city. Not only does this limit the range of acceptable options for a possible political agreement, but it also leads to the marginalization of the capital. Rather than becoming a bustling, boisterous center for commerce and trade between the two countries, and perhaps even beyond them to the region at large,<sup>218</sup> Jerusalem would become a frontier city with limited prospects of playing a significant role in the economic and political development of the region and in its transformation from conflict to peace.

Even if an effective border between Israel and Palestine were conceivable as a practical matter, one may not disregard the costs involved in putting it up and enforcing it on a daily basis. The direct cost of erecting a border fence around the Gaza Strip, stretching for some 63 kilometers (39 miles), is estimated to be \$16 million.<sup>219</sup> The direct cost of erecting a similar fence between Israel and the West Bank is around \$150 million, due to both the length of the fence and the topographical features comprising over 314 kilometers (195

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217. See GAZIT, *supra* note 23, at 211 (finding that the destruction, on June 29, 1967, of the wall separating the eastern and western parts of Jerusalem has blurred the borders between Israel and the West Bank).

218. See, e.g., Awartani & Kleiman, *supra* note 139 (concluding that the markets for Middle East exports lie outside the region and that the observed low propensity towards intra-regional trade results from fundamental economic causes, but that there is a prospect for substantial border-type trade among Israel-Jordan-the Territories due mainly to their physical proximity); Kleiman, *supra* note 168, at 33-37 (concluding that “the cause for the relatively small volume of intra-regional trade ... is, primarily [the fact] that these are, to a large extent, economies that produce the same things ... markets of oil and camels have nothing to export to markets of oil and camels” *id.* at 37). Compare with Ajami, *supra* note 144, at 377-83 (identifying potential synergies associated with increased trade between Middle Eastern countries).

219. Gross & Sagi, *supra* note 45, at 68.

miles) of the territory.<sup>220</sup> Of course, in addition to initial direct costs, other costs must be taken into consideration related to the physical maintenance, monitoring, and guarding of the border.<sup>221</sup>

The operation of customs stations along the Israeli-Palestinian border would add administrative expenditures. There are also the costs involved in administering rules of origin at those stations, especially those resulting from complicated inspection procedures.<sup>222</sup> Rules of origin may be used as a non-tariff protectionist barrier to trade, thus undermining some of the economic benefits of the free trade regime.<sup>223</sup> These rules could also lead to increased trade diversion, even within the FTA structure.<sup>224</sup>

Finally, costly rent seeking activity is more likely to take place under the conditions of an FTA model than under models of deeper economic integration. This is so because under an FTA structure

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220. *Id.*

221. See, e.g., KLIEMAN, *supra* note 215, at 119 (noting that the separation of Israel and the West Bank by use of physical obstacles such as fences, walls, safety railings and so forth, and recruiting, training and funding additional police and security forces to monitor the green line, are likely to cost over NIS 100 million a year, but would only achieve partial coverage); see also Jehl, *supra* note 216, at A13 (discussing heightened Israeli interest in erecting barriers to funnel traffic between Israel and the West Bank through controlled check points).

222. See, e.g., David Palmeter, *Rules of Origin in Regional Trade Arrangements*, in REGIONALISM AND MULTILATERALISM AFTER THE URUGUAY ROUND – CONVERGENCE, DIVERGENCE AND INTERACTION 341, 346 (Paul Demaret et al. eds., 1997) (quoting a study showing that the total economic cost of rules of origin is 5 percent of the value of traded goods between the European Communities and the EFTA nations, leading exporters of up to 25 percent of the presumably eligible trade to forego the preference and pay the MFN duty). The complexity inherent in the implementation of rules of origin is further exacerbated in the Israeli-Palestinian context, since Israel is a member of several overlapping FTAs, which may not necessarily prescribe similar rules of origin. In this “hub and spokes” scenario, applying rules of origin between Israel and Palestine may become increasingly more complex and, therefore, more costly.

223. See, e.g., Joseph A. LaNasa III, *Rules of Origin and the Uruguay Round's Effectiveness in Harmonizing and Regulating Them*, 90 AM. J. INT'L L. 625, 626-28 (1996) (describing how rules of origin act as barriers to trade); David N. Palmeter, *Rules of Origin or Rules of Restriction: A Commentary on a New Form of Protectionism*, 11 FORDHAM INT'L L. J. 1 (1987) (discussing how quotas based on a determination of country of origin restrict trade).

224. See Kanafani, *supra* note 57, at 46.

there is more room for interest groups to pressure their governments into adopting policies designed to further the protection of domestic sectors. Thus, there are costs resulting from rent-seeking behavior on the part of interest groups seeking to manipulate existing rules in their favor or influence the content and scope of future rules of origin.<sup>225</sup>

The existence of border control mechanisms, such as customs stations, may lead to abuses and interference with the free flow of goods and services between Israel and Palestine.<sup>226</sup> Domestic protectionist pressures may increase, resulting in calls on the governments to limit the flow of goods and services. In addition, decades of hostility and mutual suspicion between Israelis and Palestinians may result in trigger-happy conduct by each party's national authorities, using and abusing "security" considerations as pretext to interfere with trade.<sup>227</sup> Indeed, even assuming a bona fide attempt on both sides to allow free and uninterrupted movement of goods and services between themselves, the quantitative magnitude of goods and persons moving through the official border crossings may be such that crossing arrangements will form non-tariff barriers to trade. This is due to long delays at customs stations, causing frustration, increasing costs, and creating yet another incentive to engage in smuggling. Border control mechanisms may also lead to administrative abuse and corruption on both sides of the border. This is particularly alarming in light of the serious and persistent allegations of corrup-

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225. Anne O. Krueger, *Free Trade Agreements versus Customs Unions* 14-15 (NBER Working Paper No. 5084, 1995); Jagdish Bhagwati, *Directly Unproductive Profit-Seeking (DUP) Activities*, in *THE NEW PALGRAVE DICTIONARY OF ECONOMICS* 845 (John Eatwell ed., 1987), reprinted in *POLITICAL ECONOMY AND INTERNATIONAL ECONOMICS* 129 (Douglas A. Irwin ed., 1991) (characterizing monopoly-seeking lobbyists that seek to establish rent-generating monopolies as "directly unproductive profit-seeking activities").

226. See, e.g., Fischer & Schelling, *supra* note 15, at 9 (noting that opening customs posts at the borders between Israel and the Territories would "set up a potential dynamic that ends with extensive import restrictions . . .").

227. See, e.g., Garvey, *supra* note 72, at 176-77 (discussing regional dispute settlement as a mechanism to counter "arbitrary, discriminatory and unduly burdensome security related measures").

tion taking place in the Palestinian Authority.<sup>228</sup>

There is yet another important consideration militating against an FTA arrangement in the Israeli-Palestinian context. Being the lowest level of economic integration, the classical FTA model does not extend to the free movement of factors of production, *i.e.*, it does not guarantee a free movement of labor within the integrated area. Yet, Palestinian export of labor services to Israel is a major component of the Palestinian economy and is likely to continue playing that role after the creation of the Palestinian state. Its absence from the economic agreement between the two parties means ignoring a core economic issue in Israeli-Palestinian relations.

## 2. *Uniting for Peace: The Case For and Against a Customs Union*

The Paris Protocol adopted a customs union model for regulating the economic relations between Israel and the Palestinians. By treating Israel and the Territories as one economic unit and negating the need for drawing (economic) borders between them, this arrangement suited Israel's perception of an interim agreement. But does it also accommodate the long-term needs of both parties under the framework of a permanent peace settlement?

The customs union model answers most of the concerns raised by the FTA. It entails lower costs of managing the economic integration between the parties. In the context of the Israeli-Palestinian relations it may be difficult, if not impossible, to estimate the precise amount of trade creation and trade diversion resulting from the adoption of either model.<sup>229</sup> This results from the lack of reliable Palestinian sta-

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228. *See supra* note 74 and accompanying text (detailing a pattern of institutional and individual corruption among senior officials in the Palestinian Authority).

229. *See, e.g.*, ROBSON, *supra* note 97, at 19-20. The trade creation—trade diversion analysis is the standard starting point for analysis of the costs and benefits of economic integration measures. Trade creation refers to a shift from the consumption of higher-cost domestic goods to lower-cost goods imported from another state that is a member of the economic integration arrangement. Trade creation is, therefore, welfare increasing. Trade diversion refers to a shift in the source of imports from lower-cost external sources (*i.e.*, outside the regional trade arrangement) to higher-cost internal ones. Trade diversion is, therefore, welfare reducing.

tistics concerning pertinent economic data and the historical nature of the distorted economic relations between the parties.<sup>230</sup> Yet, a customs union arrangement is Pareto-superior to an FTA – in terms of wealth maximization – since there can be no more trade creation and there can be more trade diversion, under an FTA than under a customs union.<sup>231</sup>

Viewed through the prism of static gains, a customs union ought to be preferred to an FTA. Forming a customs union covering the Israeli and Palestinian economies, however, has its own deficiencies and limitations. First, it runs contrary to the Palestinians' political aspirations of establishing and manifesting their independence, both politically and economically, from Israel.<sup>232</sup>

Second, a customs union arrangement limits the Palestinians' room to maneuver in negotiating with third countries, including other Arab states, by locking them into the common external tariff of the union, thus preventing them from offering preferential treatment to countries outside the union. A customs union also makes it measurably more difficult for Palestine to request other countries and international organizations to grant it preferential treatment.

Third, to the extent that the economic case for a customs union is expressed in terms of more trade creation than trade diversion (and no worse results on that account than under an FTA), political opposition is likely to arise. Trade creation is more likely to be viewed as harming domestic producers than trade diversion, since the former

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230. Kanafani, *supra* note 57, at 34-35.

231. Krueger, *supra* note 225, at 11-17. On the necessary economic assumptions for this conclusion *see id.* at 15-16. *But see* Kanafani, *supra* note 57, at 36 (arguing that a customs union has a certain potential of trade diversion that an FTA model can avoid or at least minimize since under an FTA a member state can manage its external tariff structure in a way that will better ensure that goods are imported from the most efficient source, whether inside or outside the FTA). However, to minimize trade diversion with respect to its imports under an FTA, a member state must be able to impose lower customs duties on goods imported from countries that are not members of the FTA than those that would be imposed under a customs union regime. *See* Kanafani, *supra*, at 36-37, 41-44. This is unlikely to be the case with respect to the tariff structure of Palestine.

232. *See* Kleiman, *supra* note 95, at 686-89 (discussing decision-making processes in the framework of a customs union, in general, and the Paris Protocol, in particular).

means that domestic producers lose markets to producers from other member states, whereas the latter means merely that the markets shift from third country producers to producers located within the regional trade arrangement.<sup>233</sup> With the possible domination of producer interests over consumer interests in the domestic political process, such opposition is significant.<sup>234</sup> This is especially so in the context of the Israeli-Palestinian relations when stabilizing economic relations is done contemporaneously with stabilizing political relations between the two peoples. Hyper-sensitivities derived from entrenched suspicion of the opposing party may quickly derail both processes.

Fourth, the experience of the implementation of the Paris Protocol casts grave doubts about the applicability of the customs union model in the region, at least at this stage of Israeli-Palestinian relations.

#### IV. A HYBRID MODEL

In the framework of a permanent peace settlement, the relative shortcomings of the FTA and customs union models as viable structures for the economic relations between Israel and Palestine may be, somewhat simplistically, summarized as follows: the FTA is better on the political side but weaker on the economic side, while the situation is reversed with respect to the customs union. Thus, there is a need for a more sophisticated model that will combine the political interests of sovereignty, national independence, and security with national and regional economic welfare and development. Presenting such an alternative model for structuring the economic relations between the two parties is the focus of this Part of the Article.

Based on a concept of flexible, permeable borders, the proposed

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233. Krueger, *supra* note 225, at 21-22. However, it is not necessarily the case that a customs union will result in more trade creation than an FTA. *See* Kanafani, *supra* note 57, at 35-36.

234. *See, e.g.*, MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* (1965) (explaining how producer interests trump thinly-spread consumer interests due to mobilization, lobbying costs, expected gains, and free riding). *But see* TREBILCOCK & HOWSE, *supra* note 180, at 15-17 (critiquing the assumptions that domestic producers that are easily politically mobilized uniformly favor protectionism, whereas lay consumers who represent the sole or principal cost-bearers, are politically disabled).



model promotes bounded functional cooperation and integration between Israel and the Palestinians.<sup>235</sup> The model facilitates cooperation and integration while, at the same time, taking account of national aspirations and political desires. The distinctive feature of this model is its attempt to combine elements from the FTA model with the free movement of factors of production seen in a common market, thus maximizing the particular benefits of each model while minimizing its disadvantages in the particular context at hand.<sup>236</sup> Furthermore, recognizing the economic downside of FTAs, the model seeks to minimize the costs resulting from the existence of economic borders.

Some of the contours of the model introduced below are drawn along the lines that had been suggested for the first time by an informal joint Israeli-Palestinian team of senior economists, working under the auspices of the Norwegian government.<sup>237</sup> After half a year of intensive deliberations, the joint team produced an agreement detailing a proposal for an "Economic Permanent Status model" ("EPS").<sup>238</sup> This Part of the Article takes the EPS as its starting point, analyzes some of its salient features, and makes further suggestions concerning the structure of the economic relations between Israel and Palestine to foster a long-standing and just peace in the region. The Article goes on to suggest that while not necessarily a first-best model, the proposed model may well offer the best practical chances of achieving a successful accommodation of the relevant economic

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235. See also KLIEMAN, *supra* note 215, at 120 (suggesting a "separate but together" concept for the economic relations between Israel and Palestine).

236. See Kleiman, *supra* note 48, at 371-72 (arguing that the Paris Protocol itself went down a somewhat similar road as the EPS suggesting that "Quantitatively speaking, the [Paris Protocol] is first and foremost a customs union. But in allowing also some, even if not completely free, movement of labour, it contains also an element of a common market. In the exemptions of Lists A.1 and A.2 it combines also, albeit for limited quantities only, some elements of an FTA agreement."); See also Kanafani, *supra* note 57, at 24-25.

237. This author took part in the work of the joint team as one of two legal advisors to the Israeli negotiating team.

238. The Economic Cooperation Fund, DATA Studies and Consultation & Higher Commission for Investment and Finance, *The EPS Model – A Possible Set of Israeli-Palestinian Economic Understandings for Permanent Status* (Nov. 1998) (on file with the author) [hereinafter ECF & DATA-HCIF].

and political considerations.

(1) *Independent Trade Policy and Decision-Making*. To have any meaningful chance of success in the Israeli-Palestinian context, a model for economic integration of the two economies must recognize and accommodate the Palestinian aspirations for national sovereignty and independence. As the previous discussion demonstrates, this is the major advantage presented by the FTA model and the main weakness of the customs union model. Thus, the proposed model incorporates that element taken from the FTA regime in granting to each participating state the ability to determine its own independent trade policy with respect to third countries.<sup>239</sup> At the same time, the premise of the proposed model, like all other models of economic integration, is the free movement of goods and services between the two participating markets, subject to certain qualifications such as conformity with standardization requirements of the importing state. In their trade relations, the two trading partners commit themselves, under the model, to refrain from imposing any tariffs, charges, levies, duties, or taxes, or from using any measures having equivalent effects with respect to goods originating in the other member state or exported to it.<sup>240</sup> They also agree to refrain from using any non-tariff barriers to trade, such as quantitative restrictions, or other measures having an equivalent effect.

Thus, the proposed model is aimed at enhancing the Palestinian sense of independence from Israel by emphasizing the existence of two sovereign states transacting with each other. Following the EPS model's emphasis of "political separation and economic cooperation"<sup>241</sup> the proposed model underlines Palestinian political independ-

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239. *Id.* at 17, Article A3(4)(b) (stating that "[w]ith regard to imports from Third Parties, the Sides shall agree upon appropriate measures to preserve each Side's respective import and taxation policies, while facilitating fast forwarding of goods."). However, under the EPS the two parties commit to coordinate and even harmonize, when appropriate, their "rates of customs, purchase tax, levies, excises and other charges, and rules of origin," based on "their independent decision-making." *Id.* at 17, Article A3(4)(c).

240. *Id.* at 19, Article B2(3).

241. *Id.* at 10 (Preamble) ("the shared vision of political separation and economic cooperation based on partnership for growth and development."). Along the same line, the EPS model does not include any mandatory requirement for harmo-

ence and economic sovereignty.

(2) *Clearance of Revenues and Flexible Borders.* The issue of revenue clearance proved to be an important one in the post-Paris Protocol years. Article III(15) of the Paris Protocol established the place of final destination as the basis for the clearance of revenues between Israel and the Palestinian Authority of all import taxes and levies.<sup>242</sup> Thus, if a product is imported into Israel with import documentation specifying the place of final destination as the territories transferred to the control of the Palestinian Authority, Israel should transfer the import-related revenues, collected at the port of entry into Israel, to the Palestinian Authority. Although the Paris Protocol concerned only import taxes and levies for the purpose of revenue clearance, the same arrangement has been extended in practice to cover also purchase taxes.<sup>243</sup> Revenues transferred by Israel to the Palestinian Authority under the Paris Protocol constitute more than sixty percent of the total revenues of the latter.<sup>244</sup>

Import-related revenues have become a major stumbling block in the process of economic normalization between Israel and the Palestinians. First, the financial significance of these revenues to the Pal-

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nizing the rate of the value added tax ("VAT") imposed in each country. Instead, each of the trade partners enjoys full discretion to decide independently its own VAT rate within broad, pre-set confines of a twelve percent to twenty-two percent framework. *Id.* at 19, Article B2(1). Under the Paris Protocol, the Palestinian Authority was authorized to levy VAT at one fixed rate of fifteen percent-sixteen percent. Paris Protocol, *supra* note 7, Article III(7). Similarly, the EPS sets flexible provisions with respect to other taxes such as the purchase tax. *See* ECF & DATA-HCIF, *supra* note 238, at 19, Art. B2(2). Both parties agreed, however, to apply an identical rate of purchase tax with respect to an agreed upon list containing 15 to 20 products including, *inter alia*, durable goods, cigarettes, alcohol, and petroleum products. *Id.* Art. B2(2)(a). The products to be included are those on which there is a high rate of purchase tax imposed by Israel. Thus, the Israeli negotiators feared the circumvention of the Israeli tax system and substantial trade deflection if Palestine could impose a low purchase tax on such products.

242. *See* Paris Protocol, *supra* note 7, Art. III(15) (discussing the clearance of import taxes and levies between Israel and Palestine). Article VI(5) establishes the rules for the clearance of VAT between Israel and the Palestinian Authority. The rest of the discussion in the text, however, refers only to the clearance of import taxes and levies in accordance with Article III(15). *See id.*

243. *See* Einhorn, *supra* note 74, at 441.

244. Arnon & Weinblatt, *supra* note 16, at 40.

estonian Authority allowed the Israeli government to use them as a “stick” to exert pressure on the Palestinian Authority. In reaction to two consecutive suicide bombings in the central market of Jerusalem, killing sixteen and injuring 178, Israel announced that it was stopping the transfer of import-related revenues to the Palestinian Authority.<sup>245</sup> Israel stated that the transfer of revenues to the Palestinian Authority would resume once the Authority cracked down harder on Islamic terrorist groups operating in Palestinian territories.<sup>246</sup>

Second, the mechanism for clearance of revenues proved insufficient for dealing with certain phenomena of fiscal leakage, namely the non-recovery of taxes on imports.<sup>247</sup> These situations concern goods imported into Israel (*i.e.*, the place of final destination indicated in the import documents was Israel) and then re-exported to the Territories,<sup>248</sup> inputs imported into Israel and later used in goods that are exported to the Territories,<sup>249</sup> and goods imported into the Territories (whether directly or indirectly via Israeli seaports and airports)

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245. See Douglas Jehl, *Palestinians Deprived of Funds from Israel*, N.Y. TIMES, Aug. 5, 1997, at 8; UNSCO, *Closure*, *supra* note 61 (implicating the Israeli Government’s suspension of reimbursements of taxes and other fees owed to the Palestinian Authority).

246. See Carmi Gillon, *The Best Way to Protect Israeli Security*, N.Y. TIMES, Aug. 17, 1997, at 15 (outlining the various attempts by the Israeli Government to thwart Islamic terrorists groups operating within the Palestinian Territories). A partial resumption of revenue clearance and transfer took place within less than a month of the suicide bombings. See UNSCO, *Closure*, *supra* note 61; see also Douglas Jehl, *Israel Releases Some Palestinian Funds, But Sticking Points Remain*, N.Y. TIMES, Aug. 19, 1997, at A3 (discussing Israel’s decision to freeze the transfer of import-related revenues to the Palestinian Authority). One result of this policy was a shift in import trends into the Palestinian territories from indirect imports via Israel to direct imports, the revenues on which were directly collected by the Palestinian Authority. Barnett, *supra* note 70, at 5.

247. See Kanafani, *supra* note 57, at 27-28 (discussing fiscal leakage in general and in the Israeli-Palestinian context in particular).

248. See Molkner, *supra* note 72, at 1448 (according to Palestinian tax officials estimates, “tens of millions of dollars of revenue, if not more, is [*sic*] being lost annually on this basis.”).

249. See Kanafani, *supra* note 57, at 27.

and later re-exported into Israel.<sup>250</sup> In each of these cases, a party to the Paris Protocol does not receive import-related revenues it would otherwise be entitled to under the Paris Protocol. Consumers in one party to the Paris Protocol bear the burden of import tariffs and duties, while the government of the other party collects and holds the import revenues from such payments.<sup>251</sup> This creates competitive relations between the two parties with respect to import revenues, which are not conducive to establishing cooperation under the Paris Protocol.<sup>252</sup>

A properly functioning FTA regime addresses the fiscal leakage associated with revenue clearance by applying rules of origin in the customs stations located at the border crossings between the member countries, but this entails heavy economic costs. Some of the existing customs unions and common markets demonstrate other solutions to this problem while minimizing the potential interference with trade that is inherent in an FTA regime. Thus, for example, customs and other import duties imposed on non-member states are a source of the European Community's revenues, which are then used for the benefit of the Community as a whole.<sup>253</sup> This solution is unlikely, however, to be applicable to the Israeli-Palestinian context if only for the fact that to be operative it requires a strong sense of community that is absent in the region.<sup>254</sup> The Southern African Customs Union ("SACU") is an interesting case insofar as it includes four small developing countries together with a significantly larger, more devel-

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250. See Einhorn, *supra* note 74, at 441-43 (suggesting that the de facto extension of the revenue clearance mechanism to purchase tax collected on imported goods creates an incentive to trade diversion with respect to goods subject to high rates of purchase tax under Israeli law). *But see* Kanafani, *supra* note 57, at 28.

251. See Kanafani, *supra* note 57, at 27.

252. Einhorn, *supra* note 74, at 441-43.

253. See, e.g., ROBSON, *supra* note 97, at 139-48; Einhorn, *supra* note 74, at 442.

254. See Guy Mundlak, *The Limits of Labour Law in a Fungible Community*, in *LABOUR LAW IN AN ERA OF GLOBALISATION* (R.M. Fischl & K. Klare eds., forthcoming 2001) (on file with the author) (noting that "[l]abour law in particular, and social law in general, necessarily rely on a sense of community that is perceived by its members as more than a marketplace. The fragile state of peace is yet to provide a new sense of a regional community, but the current movement of capital across borders distances the possibility of its establishment in the future.").

oped country.<sup>255</sup> The SACU implements a revenue-sharing formula under which each member state transfers all the revenues from import customs, excises, duties and charges collected by it to a central pool managed by the Reserve Bank of South Africa. Thereafter, that bank proceeds to divide the revenues among the member states according to a set formula.<sup>256</sup>

It does not seem likely, however, that Israel and Palestine can come to an agreement that would transfer all the import-related (and potentially other) revenues to a joint pool. It is unlikely that either would agree to the management of such a pool by a third party, or to a national central bank dedicated to fulfilling that role. If the economic regime between Israel and Palestine is to be aimed at combining the political interests of sovereignty, national independence, and security with national and regional economic welfare, the SACU's precise revenue-sharing arrangement is an inappropriate model.

Responding to these difficulties, the proposed model seeks to use the economic borders between Israel and Palestine for revenue clearance purposes (as under an FTA) while minimizing the adverse implications of the existence of a border on the free, uninterrupted flow of goods, services, and factors of production between Israel and Palestine. While allowing for economic borders to exist within the framework of economic integration in the region, the model makes economic borders as flexible and permeable as possible in order to make this FTA resemble a customs union. Each state is allowed to establish monitoring stations within its territory<sup>257</sup> that serve primar-

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255. At present, SACU's five members are: Botswana, Lesotho, Namibia, Swaziland, and the Republic of South Africa. See ROBSON, *supra* note 97, at 275-76.

256. See Kanafani, *supra* note 57, at 51-56 (detailing the revenue sharing formula implemented under the SACU); Robert Davies, *The Southern African Customs Union (SACU): Background and Possible Issues for Negotiation Facing a Democratic South African Government*, in RECONSTITUTING AND DEMOCRATISING THE SOUTHERN AFRICAN CUSTOMS UNION 29, 29-35 (Max Sisulu et al. eds., 1994) (discussing the revenue sharing formula as well as the economic significance of the agreement); ROBSON, *supra* note 97, at 275-76.

257. The EPS joint team could not come to an agreement regarding the name of these stations. Whereas the Palestinian members of the joint team insisted that the stations be called "Customs Stations," the Israeli members suggested the name "Entry Stations." This terminological quibble revisits the Palestinian desire to pull

ily to accumulate information on trade flows between the two partners and to monitor the movement of goods between them.<sup>258</sup> In a sense, the stations serve as information collection facilities, documenting the transfer of goods through them. The documentation and information collected are used later as data for the operation of a revenue clearance mechanism carried out on a government-to-government level. In order to minimize the potential adverse impact of an economic border on the free flow of trade between the two partners – such as delays, paperwork and formalities, and potential for corruption – these border stations are not used to collect taxes or other payments from persons passing or goods processed through them.

The operation of the stations in the information-collecting format may improve the available data concerning fiscal leakage and enable the parties to address the problematic situations on both the macro and micro (*i.e.*, transaction-by-transaction) levels. However, it is apparent that this mechanism is not sufficient, in and of itself, to prevent the recurrence of phenomena such as one country stopping unilaterally revenue transference due to its trading partner. In the absence of political will to cooperate and work together economic and legal arrangements will not suffice. However, in an attempt to minimize the occurrence of such abuses, another feature of the proposed model is a meaningful dispute settlement mechanism.<sup>259</sup>

(3) *Movement of Factors of Production.* An important element of the proposed model concerns labor services. As noted above, neither an FTA nor a customs union requires free movement of factors of production. Both models refer only to free movement of goods and services. The proposed model adds to the basic structure the free movement of factors of production.<sup>260</sup> Thus, under the EPS, both par-

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in the direction of an FTA with maximum symbols of sovereignty, while the Israelis sought the “economically superior” customs union arrangement.

258. ECF & DATA-HCIF, *supra* note 238, at 21-23, Art. B5.

259. See *infra* notes 282-284 and accompanying text (discussing dispute settlement under the proposed model).

260. See, e.g., Krueger, *supra* note 225, at 6 (noting that “an FTA might provide for some arrangements permitting greater mobility of factors of production”). It should be noted that there are those who consider the EPS’ emphasis on free movement of labor to be misdirected. The argument is often made that a shift from

ties agree to “free, normal, and reciprocal cross-border movement of labor to allow Israeli and Palestinian citizens to enter the territory of the other side respectively, in order to work or to seek employment.”<sup>261</sup> It is difficult to overemphasize the significance of this commitment. As noted above, Palestinian workers’ employment in Israel has played a crucial role in the shaping up of the Palestinian economy. Yet, the Paris Protocol did not include a firm commitment to the free movement of workers from the Territories into Israel.<sup>262</sup> It may be questioned whether an explicit legal guarantee of free movement of labor could have mitigated the effects of the closure policy on the Palestinian economy. However, the *absence* of such a guarantee certainly removed a potential breaking mechanism on the slippery closure slope.

Freedom of movement may collide at times with the security needs of the parties to the agreement. Thus, each party ought to be allowed to restrict the entry of the other party’s workers into its own territory for security reasons.<sup>263</sup> At the same time there is a need for

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direct Palestinian export of labor services to Israel to an indirect export – via the export of Palestinian, domestically manufactured goods – is desirable. *See, e.g.*, Meshar, *supra* note 90, at 667-70; RICHARD LAYARD ET AL., *EAST-WEST MIGRATION: THE ALTERNATIVES* (1993). *But see* Kleiman, *supra* note 95, at 682 (replacing export of labor service with export of labor intensive goods is a long-run process).

261. ECF & DATA-HCIF, *supra* note 238, at 30, Art. D1(1).

262. *See Paris Protocol, supra* note 7, Art. VII(1) (stating that “[b]oth sides will attempt to maintain the normality of movement of labor between them, *subject to each side’s right to determine from time to time the extent and conditions of the labor movement into its area.*”) (emphases added). *See* Kleiman, *supra* note 48, at 356-57; Leila Farsakh, *Labor Related Articles in the Economic Protocol* (1999) (analyzing the text of the labor related articles of the Paris Protocol and examining the extent to which they have been implemented in practice). On the use of vague language in the Oslo process *see, e.g.*, AHARON KLIEMAN, *CONSTRUCTIVE AMBIGUITY IN MIDDLE EAST PEACE-MAKING* (1999); Jasmine Jordaan, *Proposal of Dispute Resolution Mechanisms for the Israeli-Palestinian Interim Agreement: A Crucial Step in Establishing Long-Term Economic Stability in Palestine and a Lasting Peace*, 23 *BROOK. J. INT’L L.* 555, 593 (1997) (the Paris protocol and the Interim Agreement are “steeped with vague generalized language.”); Khoury, *supra* note 138, at 39-40.

263. *See* ECF & DATA-HCIF, *supra* note 238, at 30, Art. D1(2) (“Free movement of labor can only be restricted for reasons directly related to public health, public security, and the general rule of law and order”).



mechanisms that limit either party's ability to abuse this power of imposing restrictions. A model seeking to facilitate the "free, normal, and reciprocal cross-border movement of labor"<sup>264</sup> between Israel and Palestine needs to include safeguards against the use of "national security" and similar arguments as mere pretexts to unwarranted intervention and interference with the free movement of workers. From the legal perspective the basis for implementing such mechanisms is found in putting the onus to prove that a particular restriction on free movement is justified and warranted squarely on the shoulders of the restricting party. The basic rule is that of freedom of movement. Any restriction or deviation from that general rule must be justified.<sup>265</sup> Indeed, the need to give reasons and publicly explain and defend one's actions serves, in and of itself, as a limitation on state action.<sup>266</sup>

In addition, other measures designed to facilitate "quick cross-border movement of labor"<sup>267</sup> must be considered. Such measures may include, for example, a centralized computer network, effective identification system, coordination mechanism regarding the movement of vehicles, and coordinated procedures for temporary presence of Israeli and Palestinian workers in the territory of the other party.<sup>268</sup>

In addition to these mechanisms, which are designed to prevent unwarranted interference with the movement of labor, other measures designed to positively promote such movement ought to be considered. Thus, for example, recognizing the particular significance of Palestinian employment in Israel to Palestine's welfare, and realizing the social benefits that Israel stands to reap from employing Palestinians rather than third country foreign workers, the EPS model calls for the granting of financial incentives – including tax benefits – to Israeli employers that prefer Palestinian workers over foreign ones,

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264. *Id.* at 30, Art. D1(1).

265. See Garvey, *supra* note 72, at 174-77 (discussing the significance of the need to find justifications as a check against the arbitrary use of power).

266. See Frederick Schauer, *Giving Reasons*, 47 STAN. L. REV. 633, 656-57 (1995) (suggesting that the process of giving reasons commits governmental actors and limits their freedom of action and decision).

267. ECF & DATA-HCIF, *supra* note 238, at 45, Art. J3(4).

268. *Id.*

all other things being equal.<sup>269</sup> The EPS model also envisions stronger ties between Israeli and Palestinian public employment services and trade unions. Finally, it is suggested that Israel and Palestine enter into a bilateral agreement regulating the working conditions and social rights of nationals of one party employed in the territory of the other party or by persons or firms who are nationals of the other party, based on international conventions, in order to minimize incidences of exploitation.

(4) *Asymmetries and Differential Treatment*. As noted above, there are vast asymmetries between the Israeli and the Palestinian economies. To be successful in the long run, any economic arrangement between Israel and Palestine must consider this asymmetry.<sup>270</sup> Such an arrangement can, and indeed should, seek to counter the existing asymmetry with asymmetries of its own, by facilitating differential treatment with respect to the two parties involved, thus giving the smaller Palestinian economy more time to adjust to integration.

Differential treatment trade structures among countries at varying stages of economic development are common on both the multilateral and regional trade levels.<sup>271</sup> In the Israeli-Palestinian context,

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269. *Id.* at 31, Art. D3(3)(b) ("Each Side shall not impose VAT on its employers who directly employ employees of the other Side"). A study published in February 1997 by Kav La'Oved (Workers' Hotline), an Israeli non-profit organization focusing on the protection of the rights of workers in Israel, showed that the cost for an Israeli employer of employing a Palestinian worker are forty percent higher than the costs involved in retaining a foreign worker to do the same job. Kav La'Oved, *Newsletter*, Feb. 1997, at 1-2 (on file with the author). Under these conditions it is clear that the Palestinian employment seeker stands no chance in competing with the foreign worker in the Israeli market. *See also* Kav La'Oved, *Newsletter*, Nov. 1999.

270. Indeed the first principle for economic permanent status agreed on by the EPS joint team was that of "[c]onsideration of the differences in development between the two economies." ECF & DATA-HCIF, *supra* note 238, at 16, Art. A2(1); *see also id.* at 17, Article A4 ("Adherence to the Differences in Economic Development").

271. *See, e.g.*, Philippe Cullet, *Differential Treatment in International Law: Towards a New Paradigm of Inter-state Relations*, 10 EUR. J. INT'L L. 549 (1999) (discussing at length the increased use of differential treatment as a means for making international law more responsive to the new challenges of globalization and for fostering substantive equality among states). *See also* Organization of American States, Trade Unit, *Special and Differential Treatment in International*

asymmetrical arrangements can pertain, for example, to allowing greater tolerance for government sponsored promotional measures, such as domestic and export subsidization, on the part of the Palestinian government than on the part of its Israeli counterpart,<sup>272</sup> differential time frames for the implementation of various commitments such as those pertaining to market access, and differential requirements as far as substantive obligations are concerned. One example of such differential treatment may address the issue of rules of origin. With the Palestinian economy being as small as it is, applying identical rules of origin to identifying Israeli and Palestinian goods that would enjoy free movement under the agreement between the parties may prove too difficult for the Palestinians, who may, for example, be unable to meet the relatively high levels of required added value.<sup>273</sup> Setting a parallel system for rules of origin – used for identifying “Israeli” and “Palestinian” goods under different quantitative or qualitative criteria – may prove beneficial in this context.<sup>274</sup> Injecting future trade relations between Israel and Palestine with an element of differential treatment minimizes the perceived political risks of an economic integration as far as the weak partner to the negotiations is concerned, by addressing some of the fears of economic

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*Trade* (1996). *But see* Kotschwar, *supra* note 47, at 152-53 (arguing that the age of differential treatment is coming to an end).

272. *See* Vernon et al., *supra* note 33, at 64.

273. *See* Moshe Hirsch, *The Asymmetric Incidence of Rules of Origin: Will Progressive and Cumulation Rules Resolve the Problem?*, 32 J. WORLD TRADE 41 (1998). Hirsch argues that: “[t]he restrictive impact of rules of origin is not equal for all trading parties ... a party with a larger factor endowment pool is less constrained by the operation of rules of origin . . . .” *Id.* at 45. The EPS envisions the use of progressive rules of origin by allowing for the possibility of according preferential treatment to Palestinian goods in so far as “the value of local ingredients in a Palestinian good can be lower than the value of local ingredients in an identical Israeli good.” ECF & DATA-HCIF, *supra* note 238, at 26, Art. C2(3)(e)(1). It is also specified that “[t]he extent and scope of the preferential treatment to a certain good shall be gradually phased out based on an agreed-upon timetable.” *Id.*, Article C2(3)(e)(2).

274. Hirsch, *supra* note 273, at 47-50 (arguing that there are two mechanisms to address the asymmetric restrictive impacts of rules of origin on trading states with different factor pools, namely the use of progressive rules of origin and the cumulation of origin). Hirsch explains that cumulation of origin may be used as a mechanism to enhance cooperation in strife-ridden areas such as the Middle East. *Id.* at 52-53.

take-over by the economically stronger partner.<sup>275</sup> At the same time, creating such asymmetries is unlikely to cause grave harm to the Israeli economy precisely because of the vast differences in size between the two markets.

(5) *Redistribution of Benefits*. Orthodox economic trade theory speaks of the benefits reaped from free trade in aggregate, national terms. It does not purport to address distributional issues. Yet, the distribution of benefits created by economic integration is critical, especially in the Israeli-Palestinian context. As a result of the phenomenon of polarization, some domestic regions may be disproportionately hurt by integration, as industries and businesses may settle in, or relocate to, other alternative sites within the integrated region.<sup>276</sup> It is quite likely that regions already economically disadvantaged prior to the integration will be most hurt by such an economic move, resulting in further adverse social and economic effects.<sup>277</sup> Thus, the move toward economic integration between economically stronger and substantially weaker states may be opposed in the former, particularly by those fearful for their jobs as a result of "pauper labor" competition.<sup>278</sup> In the latter, objections may be made by industrialists fearful that their industries cannot compete with the more sophisticated and more powerful industries of the economically stronger trading partner. While this may be the case in other situations of economic integration between parties that are economically unbalanced, in the Israeli-Palestinian context the stakes are much higher. Economic integration is not an end, but rather a means of procuring and maintaining long-lasting peace in the region. The just nature of such peace is a crucial element affecting its longevity and prospects for success. Peace dividends must be felt and seen as tangible by all social and economic strata of the relevant societies. If not, mutual blame of the other party for one's woes is certain to fol-

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275. See, e.g., Meshar, *supra* note 90, at 670.

276. See *supra* notes 97-98 and accompanying text.

277. See, e.g., ALI M. EL-AGRAA, *THE EUROPEAN UNION - HISTORY, INSTITUTIONS, ECONOMICS AND POLICIES* 369-77 (5th ed. 1998) (discussing the forces of convergence and divergence of regional disparities in the European Union).

278. See *supra* notes 179-180 and accompanying text.

low suit, thus threatening to topple the entire peace structure in the region.

Here again, experience of other countries is instructive. Redistributive arrangements are found in the context of higher levels of economic integration. Thus, for example, there is no mechanism built into NAFTA to deal with fiscal transfer payments for the redistribution of the agreement's benefits among the trading partners. On the other hand, the revenue sharing formula used in the SACU includes compensatory and distributive elements designed to improve the economic situation of the four economically weaker parties to that arrangement. That formula is designed to compensate the smaller members of SACU for trade diversion, polarization, and the loss of fiscal sovereignty as a result of that economic integration with their much larger neighbor.<sup>279</sup> Recognizing the existence of regional disparities within the members of the European Union, a regional policy implemented through the use of four structural funds was adopted.<sup>280</sup> This regional policy, aimed at improving the economic conditions in "lagging regions," "declining industrial regions," certain rural regions, and areas with very low population densities, is designed to counter regional disparities as well as the potential for a growing divergence of those disparities resulting from the integration process. The Cohesion Fund, which is aimed at providing "a financial contribution to projects in the fields of environment and trans-European networks in the area of transport infrastructure," also complements the structural funds.<sup>281</sup> Certainly, these attempts to ensure greater degree of regional convergence in economic performance within the European Union are a by-product of a developed sense of community

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279. See ROBSON, *supra* note 97, at 275-76 (elaborating upon the SACU formula for revenue sharing); Kanafani, *supra* note 57, at 51-56.

280. See, e.g., EL-AGRAA, *supra* note 277, at 377-84. Art. 130a of the Treaty on European Union, Feb. 7, 1992, OJ 1992 C 191/1, 31 ILM 247 (1992), in force Nov. 1, 1993 (the Treaty of Maastricht) states that:

In order to promote its overall harmonious development, the [European] Community shall develop and pursue its actions leading to the strengthening of its economic and social cohesion. In particular, the Community shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions, including rural areas.

281. Treaty on European Union, *supra* note 280, Article 130d.

that transcends national boundaries.

In the absence of a strong trans-boundary community in the Middle East, it is difficult to perceive of supranational regional policies. However, even in the absence of a central, supranational organization setting such policies, the possibility of fiscal transfer payments that can be used by national authorities to implement domestic regional policy should be considered as a component of regional integration.

(6) *Dispute Settlement Mechanism*. An important feature of the international trade system is the move from a power-oriented system to rule-oriented, normative, legalistic structures.<sup>282</sup> In the Israeli-Palestinian context, this transformation is of particular significance because a rule-based dispute settlement mechanism holds the promise of channeling political disputes through economic and legal pressure releasing valves, thus diffusing the political components of the disputes in the process.<sup>283</sup> Furthermore, given the economic differ-

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282. See, e.g., JOHN H. JACKSON, *THE WORLD TRADE ORGANIZATION – CONSTITUTION AND JURISPRUDENCE* 60-62 (1998) (suggesting that a rule-oriented approach has considerable advantage over a diplomacy-oriented approach, especially in matters concerning international economic affairs); Hannes L. Schloemann & Stefan Ohlhoff, “*Constitutionalization*” and *Dispute Settlement in the WTO: National Security as an Issue of Competence*, 93 AM. J. INT’L L. 424, 424 (1999) (observing that “the emergence of the WTO and its rule-based, quasi-obligatory dispute settlement system has spurred a significant shift toward legalism. Constitutional structures are developing much faster in international trade law than in any other area of international law . . . .”); Michael K. Young, *Dispute Resolution in the Uruguay Round: Lawyers Triumph over Diplomats*, 29 INT’L LAW. 389, 391 (1995) (highlighting the shift towards a more legalistic approach to the regulation of international trade). See also Miguel Montaña Mora, *A GATT with Teeth: Law Wins Over Politics in the Resolution of International Trade Disputes*, 31 COLUM. J. TRANSNAT’L L. 103 (1993); G. Richard Shell, *Trade Legalism and International Relations Theory: An Analysis of the World Trade Organization*, 44 DUKE L.J. 829, 833-34 (1995); Arie Reich, *From Diplomacy to Law: The Juridicization of International Trade Relations*, 17 J. INT’L L. BUS. 775, 776 (1997); Mark L. Movsesian, *Sovereignty, Compliance, and the World Trade Organization: Lessons from the History of Supreme Court Review*, 20 MICH. J. INT’L L. 775, 777-78 (1999).

283. See, e.g., Garvey, *supra* note 72, at 166-67, 181-83 (explaining the neutralization of confrontation through multi-polar participation in the resolution of trade disputes and the professionalization of disputes as a mechanism to diffuse their political nature).

ences between the parties, and in light of the inherent suspicion prevailing between them, a rule-based dispute settlement mechanism serves to put Israel and Palestine on a more equal footing and minimize fears of “might makes right.” Thus, the particular dispute settlement mechanism concerning the economic agreement between Israel and Palestine ought to be of a different nature than the mechanism put in place to resolve “political” disputes. While the latter is more geared toward diplomatic negotiations, the former is rule-based.<sup>284</sup>

The proposed model seeks to balance economic considerations, pulling in the direction of increased integration between the Israeli and Palestinian economies, with political considerations, pointing mostly in the direction of separation. To achieve that balance, the model goes beyond traditional understandings concerning models of economic integration, picking and choosing from among their specific features. While the advantages of this approach are evident, so are its weaknesses. Thus, the proposed model has in it certain elements that are open to abuse and manipulation designed to interfere with free movement of goods, services and factors of production between the two states. The central role played by elements derived from the traditional FTA model clearly opens the door for precisely that sort of critique that is leveled against the deficiencies of FTAs.

Yet, the proposed model for the future economic relations between Israelis and Palestinians stands a good chance of maintaining an adequate balance between the competing interests set out in this article, at least through the first stages of transformation of the political relations between the two peoples from hostility to a just and long-lasting peace. As it is not a first-best model of economic integration, this model may be replaced eventually by deeper regional integration. Indeed, as the two parties' relations become increasingly normalized, the balance between economic and political considerations may change and shift, leading them to adopt a different structure for economic integration. Such structure may also include within its am-

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284. *But see* ECF & DATA-HCIF, *supra* note 238, at 51 n.4 (suggesting that “[the dispute settlement mechanism under the EPS] shall be consistent with the general provision on Settlement of Disputes that will be concluded in the comprehensive Permanent Status Agreement.”).

bit the expansion and extension of economic integration to other countries in the region. Here too, one must recognize a major advantage of the proposed model, namely its inherent flexibility, which enables the parties to move easily from that model to other models of economic integration in the future.

## CONCLUSION

The area stretching between the Jordan River and the Mediterranean Sea is a small one, measuring a mere 27,000 square kilometers. It is here that Israelis and Palestinians have to live together in peace. Any hope of enjoying peace and tranquility in any one section of this small neighborhood depends on the ability to ensure that most people living in that area are content.<sup>285</sup> While not sufficient in and of itself to achieve that goal, economic well-being is a necessary condition for the attainment of peace. As John Kenneth Galbraith observed, laughter and economics strongly tie into peace.<sup>286</sup> In such a tight geographical space, separation and segregation cannot work in the long run. What happens in one part of the neighborhood necessarily spills over and affects life in the other parts. For much too long the neighborhood has been considered a bad one. Tourists were hesitant about visiting it, despite its beauty and historic and religious attractions; foreign investors were reluctant to invest money and resources into that area, despite its economic potential; and local residents wishing to defend themselves against attacks on their person and property spent precious resources and vast amounts on security measures, running high military expenditures.

The concept of "having something to lose" as a counter to violence seems to work well on the national and international level. It has worked extremely well in the European context. It can do the same in the Israeli-Palestinian context. But it should not come as a

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285. See, e.g., Kemal Dervis & Nemat Shafik, *The Middle East and North Africa: A tale of two futures*, 52 MIDDLE EAST J. 505 (1998) (discussing "regional neighborhoods" where countries are affected by economic spillover effects originating outside their own borders). This may be considered in the broader context of discussing positive and negative externalities on a regional-wide basis.

286. See GALBRAITH, *supra* note 119, at ix (explaining the author's reasons for including essays on economics, peace, and laughter within the same book).



“carrot” handed by one party to the other as a reward for the latter conducting its business in a way that accords to the former’s interests and wishes. Rather, both Israelis and Palestinians must work together, on the basis of their shared economic interests and stakes in the attainment of long-lasting, just, and comprehensive peace in the Middle East.<sup>287</sup> Promoting peace in the region is a joint task, not a unilateral project. Unilateral dependence is to be replaced by mutual interdependence. Economic liberalization and integration, coupled with a healthy degree of political sensitivity and fine-tuning, may together form a solid basis upon which to build the Middle Eastern neighborhood for the benefit of future generations.

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287. See LAWRENCE, *supra* note 163, at 9 (a cautionary remark made by a joint team of Israeli, Jordanian and Palestinian experts that reviewed the prospects of establishing free trade arrangements in the Middle East stating that: “the greater political vulnerabilities [of smaller economies in the context of economic integration with substantially larger economies] imply that the initiative for these arrangements should come from the smaller partners and they should certainly not be imposed, or perceived to be imposed, by the larger partner.”).