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ISRAEL'S ECONOMIC FUTURE

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before the

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CONTENTS

OPENING STATEMENTS OF MEMBERS

Representative Jim Saxton, Chairman 1
Representative Lee H. Hamilton 28

WITNESSES

Statement of Dr. Martin Sherman, Department of Political Science, Tel Aviv University 4
Statement of Colonel Yoash Tsiddon-Chatto, Past Member of the 12th Knesset and the Israeli Delegation to the Peace Talks in Madrid in 1991. 8
Statement of Dr. Eliyahu Kanovsky, Professor of Economics at the Bar Ilan University, Ramat Gan 11
Statement of Dr. Talia Einhorn, Senior Lecturer-In-Law, Israeli Center for Academic Studies (Affiliated with the University of Manchester) 14
Statement of Dr. Robert Z. Lawrence, Chairman of the Project on Middle East Trade at the Institute for Social and Economic Policy in the Middle East, The John F. Kennedy School of Government, Harvard University, Cambridge, Massachusetts 18

SUBMISSIONS FOR THE RECORD

Prepared Statement of Representative Jim Saxton, Chairman 49
Submitted by Representative Lee H. Hamilton, CRS study, "The Israeli Economy: Overview and Recent Developments" 52
Prepared Statement of Dr. Martin Sherman 88
Prepared Statement of Colonel Yoash Tsiddon-Chatto, *Israel 2000 How Will It Fare if Shrunk to Its Pre-Six Day War (1967) Borders?* 104
Prepared Statement of Dr. Eliyahu Kanovsky .127
Prepared Statement of Dr. Talia Einhorn 151
Prepared Statement of Dr. Robert Z. Lawrence. 194

ISRAEL'S ECONOMIC FUTURE

Tuesday, October 21, 1997

CONGRESS OF THE UNITED STATES
JOINT ECONOMIC COMMITTEE
WASHINGTON, D. C.

The Committee met, pursuant to notice, at 10:02 a.m., in Room 124 of the Dirksen Senate Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Present: Representatives Saxton and Hamilton.

Staff Present: Vaughn Forrest, Mary Hewitt, Juanita Morgan, Darryl Evans, Colleen J. Healy, Howard Rosen, and Kerry Sutten.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. Ladies and gentlemen, good morning. The Joint Economic Committee sits in a very unique position to evaluate past policy and analyze those policies' impact on our economy, particularly in the context of the legislative intent of the authors of law.

The Middle East is an area of vital strategic and economic importance for the United States. In 1990 and 1991, this country went to war against Iraq in order to ensure free access to the region's vast oil resources. We still have troops deployed in the Persian Gulf.

The United States also has special relationships with the State of Israel. Therefore, furthering the Arab-Israeli prospects for peace has been the cornerstone of the Middle East policy of both the Bush and the Clinton Administrations.

As Chairman of the Task Force on Terrorism and Unconventional Warfare, which is separate and apart from this Committee, as well as the Co-chairman of the Peace Accords Monitoring Group, I have had the opportunity to study the Middle East quite closely. Recently, I came across a new book, *Israel at the Crossroads*. I have a copy of it here with me this morning.

This book is published by the Ariel Center for Policy Research in Israel. The articles in this book shed new light on the emerging economic trends and defense trends in the Middle East, particularly in the context of the Arab-Israeli Peace Process.

The book's premise, as stated on the back cover, is most intriguing. I would like to read it to help set the stage this morning:

> *Entering its 50th anniversary, Israel finds itself in a unique situation. On the one hand, it is on the verge, or the beginning, of economic growth and expansion that will make it a leading economic powerhouse. It will no longer be dependent on others, nor need foreign assistance.*

That, of course, is very good news to the United States.

> *On the other hand, despite more than 50 years of struggles and sacrifices, the country not only faces existential threats, similar to 1947 and 1948, but for the first time the Israeli population is vulnerable to outright annihilation by weapons of mass destruction, a threat that did not exist during the darkest days of the War of Independence. The profound quandary facing Israel is what path will Israel follow? Will it be a path leading toward security, stability and economic growth? Or a path of capitulation and destruction? The great absurdity in all of this is that the "peace process" that should have brought Israel into the former state is actually expediting its succumbing to the latter state.*

Indeed, a most provocative assertion.

My goal in these hearings is to further investigate the economic and defense trends in the Middle East, particularly the ramifications of the Peace Process and to shed light on those important issues. Therefore, I am pleased to welcome to the Committee an extremely knowledgeable group of panelists from a variety of locations around the world.

First, we are going to hear from four of the experts who contributed chapters to the book, *Israel at the Crossroads*. First, Dr. Martin Sherman teaches political science at the Tel Aviv University. He acted as a ministerial advisor in the 1991-92 Shamir government. He also served for seven years in various defense related capacities. He is the author of numerous articles and two forthcoming books on international and Middle East conflicts.

Second, we will hear from Colonel Yoash Tsiddon-Chatto. He was a member of the 12th Knesset and the Israeli delegation to the Peace Talks in Madrid in 1991. Among his numerous positions, he was chief of planning and operational requirements of the Israeli Air Force in the middle 1960s and a member of the Raphael Advisory Board in the early 1990s. He published extensively on security issues in Israel and abroad.

Third, Dr. Eliyahu Kanovsky is a professor of economics at Bar Ilan University near Tel Aviv. He is also a senior research associate at the Begin-Sadat Center for Strategic Studies and the Ludwig Jesselson Visiting Professor of Economics at Yeshiva University in New York. He is the author of numerous books and scholarly articles.

Fourth, Dr. Talia Einhorn is a senior lecturer-in-law at the Israeli Center for Academic Studies and is affiliated with the University of Manchester in The United Kingdom. She currently is on sabbatical doing research at the Max Planck Institute for Foreign and Private International Law in Hamburg, Germany, as well as the Hague Academy of International Law and the Asser Institute for Private and Public International Arbitration and European Law, both located in Holland. She is also the author of several books and scholarly articles.

In addition, we will hear from Dr. Robert Lawrence. Dr. Lawrence is the Chairman of the Project on Middle East Trade at the Institute for Social and Economic Policy in the Middle East at the John F. Kennedy School of Government at Harvard University where he conducted several studies on trade and economic relations between Israel and its neighbors. He is also the author of several books and scholarly articles.

I look forward to hearing from each of our panelists.

[The prepared statement of Representative Jim Saxton appears in the Submissions for the Record.]

Dr. Sherman, we are anxious to hear from you this morning. So, if you would like to begin, sir, we would appreciate it.

Opening Statement of Dr. Martin Sherman, Department of Political Science, Tel Aviv University

Dr. Sherman. Mr. Chairman, thank you for your invitation to appear before this distinguished Committee.

In this brief resume of my study, I should like to focus attention on two cardinal issues. The first question is: What is the big picture? In other words, what is the overall structure of the problem under discussion?

The second question is: "Where's the beef?" In other words, how does the problem impinge upon the policy-oriented considerations of U.S. and Israel? And: what are the possible implications for the U.S. international posture in the Middle East, in particular, and in the wider global context in general?

In addressing the first question, I should like to go back to basics. The fundamental purpose of any national defense budget is to ensure the allocation of adequate resources to provide an appropriate response to threats considered to be imminent within a relevant time horizon. If the threat level is perceived to rise, so should the allocation of resources rise accordingly.

Regrettably, successive Israeli governments have conducted a policy which seems to be the very antithesis of this principle of prudent regard for national interest and national security. In the face of rising levels of a threat, defense budget allocations have decreased, and decreased significantly.

For an orderly analysis of the overall threat, which is likely to confront Israel, several distinctions should be made. The first distinction is a distinction between existing threats and emerging threats. The second distinction that should be made is the distinction between qualitative aspects of that threat and the quantitative aspects thereof.

I will begin by focusing on an analysis of the existing threats. The disturbing trend, which I mentioned earlier, of a rising threat and reduced allocation, is well reflected in the following exhibits which portray ongoing trends in several facets of the overall threat Israel may have to contend with.

Figures 1A and B, focus on the qualitative aspects and point to a growing shift in Arab weaponry from outdated Soviet systems to modern western ones. Figure 1A shows this trend in the Egyptian Air Force which, according to the deputy chief of staff of the IDF (Israel Defense Fund), General Vilnai, is becoming a carbon copy of the Israeli Air Force.

Figure 1B shows a similar trend in Egyptian armor.

Figure 2 focuses on the quantitative aspects and shows an impressive increase in the Arab armor likely to be ranged against Israel, in contrast to the virtually zero growth in the number of Israeli tanks-shown by the blue line at the bottom.

Turning to emerging threats, two of the most prominent are the ballistic threat and the territorial issue.

With regard to the ballistic issue, there is a growing consensus that Arab and Moslem states, some of whose peaceable credentials are doubtful, to say the least, will soon possess ballistic systems capable of delivering considerable numbers of conventional and nonconventional warheads over a range that includes not only the Israeli metropolis but several European cities as well. The development of an appropriate response to this threat requires a considerable additional allocation of resources.

With regard to the territorial issue, it seems almost self evident that to retreat to the kind of frontiers to which Israel is being called upon to withdraw, will result in huge additional security demands on her. To make this point, I could evoke Aba Eban's description of these borders as "Auschwitz borders" or Shimon Peres' warning that such borders would constitute "almost compulsive temptation to attack Israel on all sides" and "strip her of the deterrent capability."

But, perhaps the best phrased caveat is the one which was voiced by one of the most revered leaders of the Israeli left and a former Deputy Prime Minister on behalf of the Labor Party, the late Yigal Allon, who wrote in 1976, "the innovation and sophistication in weaponry, including the appearance of ground to ground missiles and supersonic fighter bombers, not only fail to weaken the value of strategic depth and natural barriers but, in fact, enhance their importance. This is even more true for Israel's difficult geographic position. One does not have to be a military expert to easily identify the critical defects of the armistice lines that existed until June 4, 1967... For Israel, a military defeat would mean the physical extinction of a large part of its population and the political elimination of the Jewish state. To lose a single war is to lose everything."

The need to contend with these "critical defects" again requires considerable additional resource allocations. Recent studies, including one by my colleague, Colonel Tsiddon, put these allocations in the order of tens of billions of extra dollars.

Figure 3 shows the trend in defense allocation and paints an alarming picture, which seems to fly in the face of logic. Despite indisputable increases in levels of threats, the levels of defense allocations have decreased dramatically.

Not only have smaller allocations of newly accumulated levels of wealth been made (as can be seen by the pink line), but smaller allocations of previous levels of national wealth (as depicted by the blue line), have also been made.

This, then, is the structure of the big picture. Increasing levels of threat and decreasing allocations to contend with it.

Now, how did this perilous and apparently misguided and misconceived policy come about? The answer seems to lie in the structure of the Israeli polity.

Israel is a very unusual democracy. On the one hand, it is beset externally by very severe threats to its very existence. On the other hand, its internal mode of operation is very similar to that in other modern democracies which are not threatened by such mortal dangers.

It is, therefore, very easy for a clash to arise between the short-term career considerations of elected incumbents and the long-term national interest. For, in the absence of an undeniably immediate, tangible threat to the physical survival of the country, it is very tempting to cut defense budgets and allocate the funds for more political expedient, short-term ends.

It is, therefore, unlikely that the appropriate remedy for the situation I have described will be initiated from within the party-political system. It must be exogenously induced by extra-parliamentary elites, well informed and committed to the long-term interest of the country but unencumbered by, and unsusceptible to, the vagaries of electioneering time tables.

I would now like to broach the second cardinal point: the question of "Where's the beef?" To contend with the current situation, policy related action on three different levels is required—the immediate level, the intermediate level and the long run.

With regard to the first two, these involve decision variables which are largely dependent on Israeli policy makers. And, therefore, I will gloss over them very briefly.

In the immediate level, Israeli leadership must bring home—or must be induced to bring home—the urgent need for belt tightening, for slowing the rise in living standards and for allocating resources from the civilian sector to the military. At the intermediate level, Israel must embark on a policy of enhancing the performance of her economy in order to attain levels of gross domestic product (GDP) per capita (or productivity per employee) which will allow both the maintenance of appropriate defense expenditures and adequate standards of living which will not impair the overall level of the scientific, technological and managerial skills of the population.

The long-term aspect of the issue is probably the most important and most interesting. The only way to break out of the spiral of burgeoning defense expenditure is by inducing radical reform in the structure of the Middle East polities.

Only when the regional regimes perceive nonviolence as a preferred mode of resolution of interstate conflict will the burden of defense be reduced. This can only be achieved through liberalization and genuine democratization of these regimes.

There is a growing consensus among political scientists that liberal democracy is a sufficient condition to prevent international conflict, for there is no record of war between genuine democracies. In this regard, we must be careful not to fall prey to popular myths or fashionable fallacies: Economic development is no substitute for democratic reform. Economic prosperity cannot replace, nor can it induce, democratic reform.

There is nothing to prove that well-to-do despots are less warlike. In fact, there is much to indicate the opposite.

Prosperous tyrants are not more pacific, only more powerful. Hitler's aggression came in the wake of German economic resurgence. Saddam Hussein's attack on Iran came on the back of a booming Iraqi economy. Conversely, Soviet aggression withered, with economic collapse.

In Eastern Europe, democratic reform was not induced by economic success, but by economic collapse. Therefore, Mr. Chairman, the road to a tranquil Middle East is not via U.S. (or international) pressure for territorial concessions from Israel but by the implementation of democratic and liberal reforms by the Arabs.

Until this happy circumstance arises, Mr. Chairman, the order of the day will be: *Si vis pacem, para bellum.* If you wish for peace, prepare for war.

Thank you.

[The prepared statement of Dr. Martin Sherman appears in the Submissions for the Record.]

Representative Saxton. Thank you very much, Dr. Sherman. I have several questions but will withhold the questions until everyone has had a chance to speak.

Colonel Chatto, would you like to begin at this point?

Colonel Tsiddon-Chatto. Yes, sir.

Representative Saxton. Thank you.

STATEMENT OF COLONEL YOASH TSIDDON-CHATTO, PAST MEMBER OF THE 12TH KNESSET AND THE ISRAELI DELEGATION TO THE PEACE TALKS IN MADRID IN 1991

Colonel Tsiddon-Chatto. Mr. Chairman, distinguished guests, Israel is requested by the U.N. and the U.S. Administration to withdraw to the pre-1967 Six Day War demarcation lines with minor modifications. Its acquisition of territories during that war is being blamed for the Middle Eastern explosive situation, as if peace and harmony prevailed before 1967.

When projecting the stretch of land required by the U.S. military during the Gulf War over the map of Israel, one realizes that the Jewish country is too small to allow for the deployment and maneuver of an army large enough to confront Iraq alone. But, given the nature of peace achievable agreements with the Arabs, Israel has to deter or be ready to win a war with a Pan Arab Alliance three times at least as powerful as Iraq was in 1991 which compounds the problem.

There is nothing new in there. Thirty years ago, the Israeli labor government declared, on February 22, 1967, that whenever war is imposed upon it, Israel will be obligated to preempt because of "this being the most important and, in certain circumstances, the only means of its survival."

In May 1967, Nasser's Egypt, backed by Syria, Jordan, Iraq, and others, foreswore the 1957 cease fire signed in return for the Sinai, massed troops on the Israeli border and blockaded Israeli shipping. When the U.N. peace supervising troops left, at Nasser's request, and the U.S. reneged on its guarantees, it was war.

Applying its declared offensive/defensive strategy, Israel scored a crushing victory over an overwhelmingly superior enemy. Hence, the acquisition of defendable positions now called the Territories.

Before attempting to comply with the Arab requests for an Israeli withdrawal to the 1967 lines, supported, as they are, by the U.N. and the

U.S. Administration, it is imperative to seriously weigh the question of whether Israel will maintain the offensive/defensive, i.e., preemption or options it had in 1967 that barely saved it then or, put differently, how will, or will, Israel survive into the 21st Century within the confines of its pre-1967 lines considering the enormous Arab/Iranian rearming, the last 30 years of unabated weapons technological advance, the geopolitical unfolding in Judea, Samaria and Gaza, which remain Arafat land, the very nature of the Arab/Iranian totalitarian regimes with their cultivation of hatred, their total disregard for papers signed with no backing of solid collaterals and, of course, the lessons stowed by the conflict since 1967.

The answer to the question, supported by a number of U.S. military missions, by the generals of the Russian General Headquarters who visited Israel in 1992 and by all incumbent Israeli chiefs of general staff is that in present circumstances, pre-1967 Israel is militarily untenable regardless of any monies that the U.S. might throw to support the withdrawal; that is, unless Israel assumes the totally unacceptable position to both Israel and the U.S. of surrendering independence and becoming a U.S. protectorate.

Mr. Chairman, since 1967 Arab MIG-15, 17, 19 and 21 fighters were replaced by MIG-23, 25, 29, SAHOU-24 and U.S.-made F-15 and F-16. Night vision kits and digital weapons delivery are a standard.

One modern aircraft scores more hits further than a whole squadron of 67 or 73 vintage. Stand-off weapons and ballistic missiles are main battle weapons.

We do have a weapons saturation situation in the Middle East. The Egyptian Air Force, 299 war planes strong in 1967, had 409 in 1973, 473 plus 89 attack helicopters in 1996. The Army had 1,955 tanks in 1973 and 3,650 in 1996.

Egyptian ballistic missiles nil in 1967, a few in 1973, are hundreds now coming off the production line of a plant purchased in North Korea, an unchallenged breach of the U.S. aid agreement that precludes Egypt from entertaining ties with terror-sponsoring countries. In view of Egypt's economic and social plight, why such an arms buildup? Who threatens Egypt? Or, has it any designs?

Syrian warplanes, 97 in 1967, 326 in 1973, were 468 plus 100 attack helicopters in 1996. Syrian tanks, 1,300 in 1973 are 4,800 in 1997.

Syrian ballistic missiles estimated to number 500 or 600 are also coming off the production line of a North Korean supply plant. About 2,000 ballistic missiles will be aimed at Israel by year 2000, many carrying mass destruction warheads.

The *Aviation Week* in "Space Technology," issue of September 22, 1997, mentions on the pages 48-50, a study referring to arms sales. Following are two descriptive highlights:

During 1989-1996, the Middle East has been the largest arms buyer in the developing world with contracts worth $100 billion, of which 56 were to be supplied by the U.S. This trend continues.

Facing the Arab world and Iran, Israel purchased between 1993 and 1996, Oslo years, $3.8 billion worth of arms. So Arabia alone purchased, during that same period, $20 billion U.S. dollars' worth of arms.

Mr. Chairman, an objective, professional analysis of the above fleetingly mentioned facts, as well as others related, will show that Israel faces the highest concentration of military forces ever per mile of frontier, the highest concentration ever of ballistic missiles per square mile and is threatened by mass destruction weapons coming of age, while endangered from within by an emerging Arab entity in Judea, Samaria and Gaza which casts a dark shadow over Israeli Arabs, all that in a territorial straight-jacket. Israel's antagonists are more powerful numerically than the U.S. military.

Israel will, in this case, be stripped of its conventional deterrence, which means certain war with Arabia that will enjoy a crushing military superiority exercised from a forbidding topographic superiority. Israel will not have a preemption surprise option like in 1967 because of the Saamante aircraft missiles.

Arabia and Iran can surprise, like in 1973, starting with ballistic missile salvos that will slow Israeli mobilization covering, thus, the initial critical stage of offensive moves. If, 50 years after the Holocaust, the main Jewish state will be coerced to march to its demise and the U.S. will not provide an active, very expensive, real time defense, the only probable deterrent Israel will have, if rumors materialize, is the Sampson option. Hardly a toy to play with in an area containing two-thirds of the world's oil, hardly beneficial or solidary to anybody morally, strategically or economically.

Mr. Chairman, I suggest all should stop paying big money to turn a real proven asset into a heavy liability for the sake of fleeting diplomatic expedience. Thank you, Mr. Chairman.

[The prepared statement of Colonel Yoash Tsiddon-Chatto appears in the Submissions for the Record.]

Representative Saxton. Thank you very much, Colonel. Dr. Kanovsky.

STATEMENT OF DR. ELIYAHU KANOVSKY, PROFESSOR OF ECONOMICS AT THE BAR ILAN UNIVERSITY, RAMAT GAN

Dr. Kanovsky. Thank you, Mr. Chairman and distinguished Members of the Committee and the audience, for the opportunity to present my views here.

My focus is more on the economic aspects in the Middle East. And, my starting point is the three existing Israeli-Arab peace agreements, the one with Egypt in 1979, the one with the PLO in 1993 and with the Kingdom of Jordan in 1994.

The 1979 peace treaty with Egypt was supposed to be comprehensive, which meant, in addition to refraining from, and preventing, hostile actions, there would be full diplomatic, economic, cultural and scientific relations or, what Israelis like to call, normalization. Israel expected that following the agreement with Egypt, peace pacts would soon be concluded with other Arab states.

To achieve these goals, Israel paid a very heavy price. It withdrew from every inch of territory claimed by Egypt which meant, in effect, amongst other things, giving up the oil fields which had been providing in 1979 roughly two million tons a year, about one-fourth of Israel's oil needs. The Israeli withdrawal was concurrent with the second oil shock, the one related to the events in Iran.

And, the result was, for Israel, a horrendous situation. Israel paid $750 million for oil imports in 1977. In 1980 and 1981, over $2 billion a year which incidentally exceeded U.S. grants to Israel at that time.

In return, Israel received what amounts to a non-aggression pact. Instead of friendly relations, Egypt leads the pact in its anti-Israel and sometimes anti-Semitic invective.

On the economic front, there is a minuscule volume of trade and little else of significance. Summing up, Israel paid a heavy price for what it believed to be a comprehensive peace agreement with Egypt. Instead, it has a nonaggression pact with a rather unfriendly neighbor.

What will happen when and if the Islamic extremists take over is anybody's guess.

Despite the disappointing aftermath of Camp David, the 1993 Oslo agreements again raised hopes in Israel and amongst the Palestinians that peace and prosperity were around the corner. The Palestinian Autonomy

(PA), led by Arafat, was promised by the major industrialized countries $2.7 billion over a five-year period.

The World Bank and other planners believed that domestic and external private capital would flow to the PA, creating jobs, income and so on. But, the reality was, and is, depressing.

The Palestinian economic crisis, it should be emphasized, stems from both external and internal factors. Since Arafat sided with Saddam Hussein during the Gulf War of 1990-1991, Kuwait, after its liberation by U.S.-led forces, expelled 300,000 to 400,000 Palestinians, something which is hardly reported, while Saudi Arabia imposed sharp restrictions on work permits to Palestinians.

Moreover, the financial aid which the Arab states had given to the PLO and to Jordan until 1990 was terminated.

The Palestinian acts of terror in Israel, of course, made a bad situation worse. Israel reacted to terrorism by imposing closures and by replacing Palestinians in Israel by Romanians and other workers.

If the PA economy were developing along the lines envisaged by the World Bank, the loss of jobs might have been offset over time by new job openings in an expanding economy. But, corruption of massive dimensions and inefficiency, are the hallmarks of the PA rule, which discourage private investment.

The pact with Jordan was concluded in 1994. But, in fact, there has been extensive and unofficial Israel-Jordan cooperation in suppressing terrorism since the 1970s.

Jordan was having severe economic problems in the 1980s. In 1992, its GDP per capita was 20 percent lower than a decade earlier in 1980. There was a very severe drop.

But, the massive influx of refugees, mainly from Kuwait, coming in with their capital and skills, gave a strong boost to the Jordanian economy. And, between 1992 and 1996, there was a small improvement in terms of GDP per capita. But, living standards continued to fall.

The many Jordanians and especially the professionals and intellectuals oppose the Treaty with Israel to this day, as is in the case in Egypt. But, so long as the royal family remains in control, one can anticipate a continuation of Israel-Jordan peace.

What happens under an Islamic regime when, and if, one arises, only the future will tell.

Between the mid-1970s and mid-1980s, Israel's economy was suffering from severe inflation and very little economic growth per capita. In the mid-1980s, Israel adopted a series of important, though painful, economic reforms.

And, the rapid growth of high-tech industries, the large-scale immigration from the former Soviet Union, lower oil prices and special American aid all contributed to Israel's rapid rate of economic growth between 1990 and 1996, accompanied by moderate inflation and low rates of unemployment. What conclusions can we draw from this brief survey?

1. Peace and prosperity are highly desirable in their own right but are not necessarily related. Prosperity depends mainly on the adoption of appropriate economic policies and the efficiency of their implementation.

2. Israel's economy is far more developed. The GDP per capita is about 13 times that of Egypt. And, about the same ratio applies to Jordan.

The suggestion by some Israelis and others of a Middle East common market frightens the Arabs, leaders and businessmen alike. They view it as a vehicle to attain Israeli economic domination.

3. Israel's natural markets are in the advanced and newly industrialized economies. Israel is moving more in the direction of high tech.

And, it should be emphasized also that the total Arab market—in other words, total imports by all the Arab states combined—accounts for a mere 3 percent of world imports. In other words, even with the existing situation, 97 percent of the world's markets are open to Israel. And, of course, Israel could expand this market, depending on technology.

4. Israel should shun or at least minimize joint ventures which are, by their very nature, long run. Financial disputes may become acrimonious political disputes.

If Israel or some area in Israel becomes dependent on a product of these joint ventures, for example, natural gas, there is the danger of an abrupt cutoff under a new regime. And, this, of course, happened in 1979 when Ayatollah Khomeini took over and all oil shipments were stopped to Israel.

5. In the view of the depth of hostility of the Palestinians and even of the Egyptians and Jordanians, it might be wise to pursue a policy of maximum, feasible separation for the foreseeable future. Defense policy should be based on the assumption that this hostility will be long term.

6. Israel's policy of seeking comprehensive peace agreements with all the Arab states should be modified in favor of a selective approach. In the case of Syria, which also controls Lebanon, Israel might pursue an

extension or modification of the existing separation of forces agreement brokered by the U.S. in 1974.

And, finally, in view of the failure of the PA to develop its economy, the U.S. should attempt to persuade Saudi Arabia and Kuwait to provide jobs to Palestinians. Saudi Arabia alone, employs three million foreign workers, mostly Asians. A small percentage of that, 3 or 4 percent of that, given to the Palestinians would solve their economic problem certainly for a number of years. Indirectly, this would, of course, stimulate the PA economy.

None of the above constitutes ideal solutions. But, past and present experience leaves us with few feasible choices.

Thank you.

[The prepared statement of Dr. Eliyahu Kanovsky appears in the Submissions for the Record.]

Representative Saxton: Doctor, thank you very much for your very thoughtful testimony.

Dr. Einhorn.

STATEMENT OF DR. TALIA EINHORN, SENIOR LECTURER-IN-LAW, ISRAELI CENTER FOR ACADEMIC STUDIES (AFFILIATED WITH THE UNIVERSITY OF MANCHESTER)

Dr. Einhorn. Mr. Chairman, Members of the Committee, I would like to thank you for inviting me to participate in this hearing. My statement, dedicated to the critical, crucial issue of the economic relations, will be very brief, but, I would be happy to answer any questions that you may have.

I am appearing here in my own capacity as an academic researcher and teacher of subjects concerning international law and international economic legal relations.

I would like to open with my general conclusion regarding the Protocol on Economic Relations, Annex V of the Israeli-Palestinian Interim Agreement on the West Bank and the Gaza Strip. It is my opinion that the provisions of the Protocol are not conducive to economic cooperation. Furthermore, its implementation so far raises serious doubts regarding its viability.

The Economic Protocol has created, by definition, a customs union. This entails a common level of external tariffs and the application of the same regulations of commerce to substantially all imports from Third

States combined with free movement of goods between Israel and the Palestinian Authority.

It is my opinion that the customs union is, indeed, the preferable solution. Most important, it satisfies the need of the Palestinian economy to have access to an advanced economy.

This conclusion is supported by the economic development of the West Bank and Gaza in the past decades. When fragmented and disconnected as they were before 1967, and as they have become again since the Intifada, they are stricken by poverty and economic distress.

It is only through market integration that a positive change could be brought about. This is evidenced by the 20 years prior to the Intifada which were characterized by the trade of Palestinian labor for Israeli goods.

In 1987, almost 40 percent of the Palestinian labor force were employed in Israel, creating a significant improvement in the Palestinians' standard of living. The access to the Israeli market was of special importance to the Palestinians. From the Israeli point of view, the importance was of less significance, as the Palestinians were no more than 7 percent of the labor force.

The free movement of persons can, for the time being, not be upheld due to security reasons. This makes the access to the Israeli market, through the creation of a customs union, the best possible option.

The successful establishment of a customs union is dependent upon the implementation of an economic order based upon open markets and undistorted competition. The establishment of a customs union is a matter of public law. Its functioning has to be guaranteed by the commitment to transparent, stable and enforceable private law rules governing commercial transactions and the settlement of disputes. Upon taking office, Mr. Arafat reinstated the Egyptian law prevailing in the Gaza Strip before 1967 and the Jordanian law then prevailing in the West Bank. These are two very different legal systems.

It is urgently needed to revise and unify the commercial code, company law, bankruptcy law, securities and intellectual property law, and to enact laws regarding unfair competition, safety and consumer protection. Economic activity and investment necessitate a strong, independent and effective judiciary. At present, there is a lack of coordination between the two systems in the West Bank and Gaza.

There is dire need for effective law enforcement agencies. Absent these, no private, direct investment will develop.

The legal system must be abided by private citizens and public authorities alike. Mr. Arafat's style of governance has so far been characterized by lack of transparency and lack of accountancy.

According to a report of the Budget Committee of the Palestinian Legislative Council, funds from foreign donor states were channeled through personal accounts of Palestinian officials. Members of the Palestinian Legislative Council have reported waste and misuse of 40 percent of the budget for private purposes of ministers and officials. Close monitoring and proper auditing are called for.

As a precondition to accountability, the legal system must protect individual rights and subject its authorities to open criticism. Human Rights Watch and Amnesty International have both been very critical of the Palestinian Authority's approach to human rights.

Journalists and human right activists were arrested for criticizing the PA. A Palestinian human rights group charged that Mr. Arafat's security forces systematically tortured and mutilated detainees.

Curtailment of the freedom of expression and freedom of the press may allow the PA to create distortions that frustrate the very basic tenets of a free market and would avoid public criticism. Yet, the defiance of accountability makes a customs union inevitable.

Finally, why is this customs union different from all other customs unions? The Economic Protocol has created a customs union, the objectives of which are frustrated by its own provisions. Two aspects are especially troublesome—the competition between the parties over import revenues and the absence of any competition rules prohibiting unfair competition.

According to the Protocol, all imports revenues are shared according to the place of destination stated in the import documentation. When the package comes in, reads Gaza, the Palestinian Authority collects; reads Tel Aviv, Israel collects.

The trouble is, they enter the customs union. They need not reach Gaza at all. They may lawfully react the Israeli market directly after clearance by the customs authority.

Complaints that diversion of trade is, in fact, taking place have already been sounded. The U.S. Embassy economic department in Israel has reported that "both the PA and the Government of Israel Ministry of Finance have revealed to us that the imports [to the Palestinian Authority] are, indeed, on the rise across the board in all categories."

This increase has taken place despite the repeated closures imposed on the territories and despite the economic depression and the diminishing real GNP.

The second fault is due to the absence of competition rules. Domestic anti-competitive behavior is inseparable from international trade policy.

Therefore, customs union agreements and even free-trade area agreements include provisions prohibiting anti-competitive behavior. These are missing here.

The impact was soon to be learned by Israel. The PA has set up its own agencies, or monopolies, to import goods from Israel as well as from third countries. Reportedly, there are more than 100 such.

Those are controlled by persons with close contacts to the PA Chairman, some simultaneously officials of the Palestinian Authority. This structure enables the PA to share the import revenues with these monopolies and some of the taxes may even be passed on to the Israeli customer; thus, giving these imports a competitive edge.

Independent Palestinians entrepreneurs lost a substantial share of their Palestinian market. Furthermore, the PA controlled monopolies have served to transfer income from the poorer classes to a new economic class causing a substantial rise in prices, more significant in Gaza than in the West Bank due to the tight closure there.

According to an IMF report, revenues from PA commercial activities are diverted into accounts not controlled by the Palestinian Ministry of Finance. The Economic Protocol was a step in the right direction to peace.

The deterioration of the state of security after the signing of the agreement mandated restriction of the free movement of persons. This makes free movement of goods an alternative, an attractive alternative.

The conditions for that, however, are:

1. A rule-oriented customs union. That would mean a reasonable mode for sharing the import revenues. And, the need to dismantle the monopolies and prohibit anti-competitive behavior.

2. Transparent, ascertainable and enforceable legal rules.

3. Accountability. The system must protect individual freedoms and subject authorities to open criticism.

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

Thank you very much.

[The prepared statement of Dr. Talia Einhorn appears in the Submissions for the Record.]

Representative Saxton. Thank you very much, Dr. Einhorn. Dr. Lawrence.

STATEMENT OF DR. ROBERT Z. LAWRENCE, CHAIRMAN OF THE PROJECT ON MIDDLE EAST TRADE AT THE INSTITUTE FOR SOCIAL AND ECONOMIC POLICY IN THE MIDDLE EAST, THE JOHN F. KENNEDY SCHOOL OF GOVERNMENT, HARVARD UNIVERSITY, CAMBRIDGE MASSACHUSETTS

Dr. Lawrence. Thank you very much, Mr. Chairman. It's a pleasure to be with you and the Members of the Committee to talk about the prospects of the Israeli economy.

I think if we look at the Israeli economy, we relearn lessons which we know about economic performance in general.

The first is the importance of knowledge and skills in the economy. And, the second is the importance of relatively flexible labor markets.

I think both of these are the key to international competitiveness. And, they explain the performance of the Israeli economy since the immigration from the former Soviet Union in the 1990s.

It's true that there is much to be done in the Israeli economy. It's moving too slowly, but it is moving in the right direction.

The four keys are privatization, deregulation and trade liberalization. And, in addition, deficit reduction.

In the first three, Israel has made progress, although not sufficient. And, when it comes to deficit reduction, though, there remain considerable problems.

But, I should note that it has been impressive that Israel has been able to absorb hundreds of thousands of new immigrants into the economy and basically to employ them, something which many economies in the world can look at and envy.

Now, I think that there is no dispute about the centrality of domestic economic policies and adjustment in determining economic performance. But, I do believe that among us there may be some differences about two other elements that I think are very important.

The first is the importance of peace to economic development. And, the second is the related importance of regional economic integration to Israel's economic future.

What I would like to do is to talk about each of these two. It is clear that for most of its history Israel has had neither peace, nor regional economic integration.

It has developed under conditions of war, certainly no peace, and in isolation. In addition, it's regional integration was thwarted by the Arab boycott.

Now, these factors are changing. And, I believe that they have made a positive contribution to Israel's growth over the past few years and could continue to do so well into the future.

We've seen how the peace process has changed Israel's prospects, particularly in opening new markets in the dynamic Asian economies. Countries such as India, Malaysia, Indonesia, and the Moslem states of the former Soviet Union have now become growing and important markets for Israel.

Something like almost 30 percent of the growth in Israeli exports since 1992 have come in trade with Asia and with Africa, not traditional Israeli markets. So, we are seeing a reorientation of the Israeli economy to exploit these new opportunities.

And, I would submit they are directly related to the peace process.

Secondly, we've also seen an improvement in Israel's international risk ratings since the mid-1990s. Israel is a much more attractive economy in which to invest.

Now, the bulk of the reason is its domestic reforms and its domestic economic prospects. But, again, I think its international position has contributed to this attractiveness.

If we look at the position of the Israeli economy, we see one which has a large, current account deficit, is highly dependent on international capital inflows and, therefore, highly dependent on the confidence of both foreign and domestic investors. And, I think that the peace prospect has made a contribution in this regard.

Now, let me turn to the question of Israel's regional economic relations. It's common—and we heard it said again today—to point out that Israel's neighbors are simply too small and too poor to bother about; and, in addition, their economies are mismanaged; and, therefore, the potential gains from economic interaction aren't very large.

Now, what's striking to me is that if you look at the relationship between Israel and its neighbors, say, Israel and the Palestinian economy, it's almost identical in proportions to the relationship between the United States and Mexico. And, yet, we, in the United States, are not saying Mexico is too small to worry about.

Mexico is about 5 percent of our GNP. The Palestinian economy is roughly 5 percent of the Israeli GNP.

The average incomes in the Palestinian economy are about a tenth of those in Israel. Similar kinds of relationships exist with Mexico.

We don't say, "Let's not worry about that. It's not important to our economy." We have appreciated the potential interaction and synergies that exist between our two economies.

And, I would submit the same potential synergies exist between the Israeli economy and its neighbor economies. On the one hand, a high technology, high-wage economy. On the other hand, low-wage economies. And, there is immense complementarity.

You can leverage the competitiveness of your firms in international markets by being able to source some components where labor is cheap and other components and value added where labor is knowledgeable and highly skilled. This is the kind of complementarity we've seen in Asia, in Hong Kong, for instance, and with Shenzen Province. So, I think we should not dismiss the potential of the complementarity in regional integration.

I think, in addition, the Israeli economy has a structural problem. Its need for unskilled workers is manifest.

Israel has been pressured by immigration. And, indeed, the Israelis have been forced, as we heard described, to accede to immigration from countries like Rumania, Thailand and Nigeria.

As we look out into the future, these problems are not going to get better. They are likely to get worse as wages rise in the Israeli economy, as it moves to fuller employment.

Well, the question is who will provide that labor. Is Israel going to deny itself the labor; or, will it come in some form or another?

I would submit, again, that regional integration offers immense opportunities, not simply for allowing workers into the economy, which has problems, but also through trade, trade in labor intensive products. You can bring the products in instead of the people in, and the natural source of some of those labor intensive products is in the neighboring regions?

So, that's why I see a key role from the regional situation.

Now, I also believe that peace and economic growth are complementary. I think it is in Israel's interests to have prosperous neighbors.

And, indeed, there can be no question that for the Palestinian economy the Israeli economy is immensely important. We have seen the evidence of how important the Israeli economy is for the Palestinian economy as a result of economic developments over the past few years.

Now, I think we have to admit that the peace process has not worked successfully. Indeed, if you ask the man in the street in Israel what has the peace process meant, I think you would get the answer, "It has meant more terror." I think if you ask the man in the street among the Palestinians what the peace process meant, I think you would get the answer that, "It has actually represented economic depravation."

We look at what has happened to the GNP in the West Bank and Gaza, we see it falling by almost a third. We look at what has happened to wages, we look at the rise in unemployment.

This is not a situation, clearly, that is conducive to this process going forward. It requires action on both fronts.

It requires dealing with terror on the one side; and, it requires acknowledging the requirements of economic development of the Palestinians, on the other.

I have been working, together with Ambassador Robert Blackwill, who is a colleague of mine at the Kennedy School, in trying to investigate the question of how can we increase the amount of economic interaction without compromising security. That's really the key question here for us.

And, we've been working, together with experts in the region, to try to come up with concrete suggestions. They are numerous. And, they are contained in the submission which I have placed before the Committee.

I think much can be done in the line of taking practical measures. Some of them are small, but they would try to help more of the economic interaction.

Finally, I believe that the Palestinian economy has not been well managed. But, it's economic situation is such that even with geniuses for managers it could not have succeeded under the conditions constituted currently by the economic closure.

We have a small, highly dependent economy which has been subject to large amounts of an interruption in its trading relationships. Indeed, we've heard testimony about the dangers of monopolies in the Palestinian economy.

Competition or antitrust policy is one way you can tackle monopolies. But, the best cure for problems of monopolization, in my judgment, is free trade and open competition.

If a monopoly tries to raise prices and we have open competition, then, in fact, it cannot survive. So, if we actually had an operating customs union—and I agree that the customs union is the right way for the transitional arrangements between these two economies—the key is to try to get rid of the border barriers.

We have border barriers today because of closure. And, so it's not the economic design, it seems to me, that is at fault here. It's the operation—it's the failure to achieve an improvement in the situation on terror.

I think, finally, that I would also disagree with the prescription that, as we look out into the future, joint ventures should be shunned, economic engagement between the Palestinians and the Israelis should be minimized, separation should be the goal and that the Palestinians should try to find their economic salvation in Saudi Arabia or somewhere else. I do not believe that that is the right path toward achieving peace and prosperity. And, I think they are interrelated.

Thank you.

[The prepared statement of Dr. Robert Z. Lawrence appears in the Submissions for the Record.]

Representative Saxton. Thank you very much, Dr. Lawrence.

Let me begin my question based on a statement by Dr. Lawrence. He said that peace and economic growth are complementary. I think we can all find common ground there.

Dr. Kanovsky, Dr. Einhorn and Dr. Lawrence, on several of my visits to Israel, whenever you travel around Israel, you find yourself driving through some Palestinian villages that are very poor. And, I think that's an understatement.

And, it seems to me that perhaps just the converse of peace and economic growth are complementary. I think you can turn that and say that war and misery and very poor people are common to follow each other.

It seems to me that it's in everyone's best interest to—everyone, meaning the Israelis as well as the Palestinians and others in the area—have significant and sustained economic betterment of the Palestinian people. That is a very basic question and one, I believe, that has to come somehow with peace.

And, that is the basic question that everyone has been struggling with. I would like to ask each of the three of you to—perhaps all five of you to comment on what it is that Israel needs to do, perhaps together with the PA or whoever we decide that we have to deal with, in order to accomplish that.

Dr. Einhorn.

Dr. Einhorn. Okay. Well, the problem—it is true that investment, private investment, could have brought much prosperity and improvement. And, I agree that there is room to use the labor intensive potential of the West Bank and Gaza.

The problem is that no private investor in his right mind would be able to invest in a place where there is no rule of law. And, here I differ also from Dr. Lawrence, because the main issue—Dr. Lawrence said, "Well, let's just open the borders. The monopolies will go off themselves."

I'm afraid that the United States has an antitrust law, despite the fact that it has the Commerce Clause and interstate free trade. And, the European Community has very strong competition rules especially designed to help market integration without which this would never have happened. So, this means that even under the best conditions, you need competition law.

And, I would go further than that. The problem with the monopolies is that they create a very vicious circle.

There are people out there who have interest in the closures, economic interests. The people who control these monopolies have an interest in the people being poor, in the prices being high, in maintaining the closure, because the fact is that within Gaza they manage to raise the prices much more than in the West Bank because of the closures. So, they have interest in terror. And, it's a very, very sad story for the Palestinians and, of course, also for Israel.

As a reflection, what should be done. But, that is—how can Israel do that? That is, create this legal order, create the auditing? Even the donor states who intend to help would have difficulties with that.

It is a major task to create these rules of law and enable the free movement of goods that would come to replace free movement of persons. Free movement of persons is given in very few places all over the world. Even the European Community started with the free movement of goods, and that developed much further than free movement of persons. The same is true for GATT.

It starts with goods and the WTO, even today, speaks mainly of free movement of goods. The free movement of services is far less developed.

Representative Saxton. So, you are saying, then, that one of the biggest impediments or one of the biggest obstacles to economic growth is the tendency on the part of some to create monopolies, because they monopolize the market and they make all the profits that are to be made in whatever market niche there—

Dr. Einhorn. Yes.

Representative Saxton. —happens to be; and, that laws and rules need to be established and enforced obviously, I guess, by the PA in order for these kinds of—Dr. Lawrence, would you like to respond or comment?

Dr. Lawrence. No. I—well, I would like to agree with your statement, Mr. Chairman, about the importance of the economic development among the Palestinians. And, while obviously it does not guarantee you that there will be no terror and fundamentalists will occur even in a period of prosperity and a prosperous economy, the fact is that for many desperate people terrorism offers an opportunity.

However, if they achieve some economic benefits and you improve their economic welfare, you could make a huge impact on the overall political situation.

Now, what is tragic about the situation, in my view, is that if you look at, say, the size of the Gaza economy, it's very, very small. You could turn it around with a few operational projects.

You have a work force, you know, on the order of half a million. It's a small city basically.

And, I think really putting emphasis on the opportunities in industrial zones is one major, practical measure that has to be worked out. These allow for a better control of the security situation.

They may also give opportunities for better rules and legal regimes to be implemented, for tax policy and other kinds of mechanisms to be established. Progress has been all too slow on that front.

I think another key area lies in giving the Palestinians access to the rest of the world, both in the region and more broadly. Because of security concerns allegedly, sometimes in ways that are hard to justify—for instance, Palestinian cut flowers have had tremendous problems getting into the European market simply to get out, because the customs authorities have inspected them for weapons and so on.

Representative Saxton. Well, you would kind of expect that, I guess.

Dr. Lawrence. Well, going out? Going out to Europe? Flowers?

Representative Saxton. Yes.

Dr. Lawrence. Well, I think when we heard—we actually discussed this with security experts in Israel, and they could not explain this behavior as security. There may be other motives for that. But, that is not going to develop the Palestinian economy if we are talking about egress.

Another, heartening development, which would be very, very important, is the opening of the airport, which is being discussed. Hopefully, some headway will be made.

Representative Saxton. I'm sorry. When you say "the airport," please—

Dr. Lawrence. Okay. The Palestinians are negotiating with Israel to open an airport, which will service Gaza, which will allow, therefore, for products produced in that area to be exported. There is not a threat to Israel except inasmuch as the operation of the airport itself raises security questions. Those have to be settled.

But, again, progress can be made on this front. It's not a threat to Israel security. It can help the Palestinians' economic development.

Representative Saxton. Thank you. Dr. Kanovsky, would you like to comment on this general question of what it is that is needed to help elevate the lot of the Palestinian people?

Dr. Kanovsky. Let me say the following with respect to that issue: I think that the primary task of elevating the economy of the Palestinians is, of course, one which the PLO and their leader should be taking care of.

My view is very much a minority view. I don't wish to give the impression here that my views are the majority in Israel or even by a substantial minority. I have—

Representative Saxton. If anyone can define what the majority of the Israelis believe—

Dr. Kanovsky. That would be a very, very tough question to answer.

(Laughter.)

Dr. Kanovsky. But, I don't think it's Israel's task or job to undertake to improve the Palestinian economy, because they resent it. They don't want it.

I had a talk a while ago—I don't think I should mention names— with a high official in Jordan, a person with a very advanced education in economics at Oxford University, and we discussed the Arab economic boycott against Israel. I asked why wasn't it abolished, why isn't it being abolished completely.

And, the answer was that if you abolish the Arab economic boycott, that's tantamount to economic suicide for the Arab states.

In January of this year, there was a large protest movement led by a former prime minister—not by anyone, but a former prime minister—of Jordan, because Israel wished, and finally did arrange, to open up a trade fair in Amman. There were massive protests and threats to the businessmen, the Jordanian businessmen, that if they participate there would, be retaliation in terms of business boycotts and so on.

The solution to the problem with the Palestinians lies with the Palestinians, not with Israel. Nor should it lie with Israel, in my personal view.

Investment can be made attractive if you have proper governance. Recently, the World Bank has done all kinds of studies, which show how proper governance is crucial to the economy.

Well, I don't know why they had to spend all that money to find that out. But, in any case, there's no question that it's true.

When you have a situation in which the auditor of the PLO reported not long ago that 40 percent of the budget was wasted, siphoned off into private accounts and so on, 40 percent, this, of course, is horrendous. When you have that kind of situation, it's very difficult to conceive of proper economic development.

With respect to the rest of the budget, a major part of it was spent on the so-called police force which has been, expanded very greatly and, according to one U.N. official, this was a make-work kind of arrangement. What I am trying to get across is the following:

You cannot compare Israel and Palestine or Israel and Arab countries with the U.S. and Mexico, with all due respect. Mexico and the U.S. have good, friendly relations, have had good, friendly relations for a long time. This, unfortunately, is not the case between the Arabs and Israel. Having a shotgun marriage can end up with violence.

This situation was true in Iran. I don't know whether it's well reported or not.

Israel had widespread economic relations with Iran under the Shah. The pipeline that was built from Eilat to Ashkelon was not only for Israel's use of oil but also for further exports through Israel to the European countries.

There were many projects, agricultural and others, which were undertaken by Israel to the satisfaction of the Iranians.

Ayatollah Khomeini came into power in 1979, and that was the end of it. Immediately, all these things were stopped regardless of the economic cost.

These are things which Israel has to consider when it goes into joint ventures. It is not a joint venture between the U.S. and a French firm or the U.S. and a Mexican firm.

You are dealing with a situation where there is a residue of unfortunate hatred. And, by increasing the points of friction between the two, you don't help these situations. You make them worse.

Separation is not ideal. I learned the law of comparative advantages. I'm sure these gentlemen did, Dr. Lawrence and everyone else, learned how important trade is and how much it can help the economies. And, there is no question that it's true.

But not in a situation where you have a residue of hatred—not a residue, but in the case of Egypt it's 18 years or something, since 1979 or close to that. The hatred continues amongst the intellectuals, amongst the leaders.

The solution under those circumstances, in my view—and it's not an ideal solution, by any means—it's better to have separation than to have more and more points of conflict.

Representative Saxton. Doctor, you and Dr. Einhorn seem to have a lot of common ground relative to the necessity of proper governance, rules, regulations that everybody—

Dr. Kanovsky. That's crucial.

Representative Saxton. —agrees to live by and, in fact, does live by. Thank you very much.

I have some questions for Dr. Sherman and for Colonel Chatto. But, I would like to turn to my friend from Indiana, Mr. Hamilton, who just, for the interest of everyone here, served as a very successful Chairman of the Joint Economic Committee several terms ago. Mr. Hamilton.

OPENING STATEMENT OF REPRESENTATIVE LEE H. HAMILTON

Representative Hamilton. Thank you very much, Mr. Chairman. It's a pleasure to be with you.

I was informed a moment ago that you received last night the Guardian of Israel Award from the American Friends of the College of Judea and Samaria. And, I want to extend my congratulations to you on that. It's certainly well deserved.

Representative Saxton. Thank you.

Representative Hamilton. And, I would express my appreciation to the panel.

Mr. Chairman, I wonder if I might ask unanimous consent to have this CRS study on the Israeli economy included in the record.

[The CRS study appears in the Submissions for the Record.]

Representative Saxton. Certainly, without objection.

Representative Hamilton. I will be referring to that in a moment. I want to focus for just a moment on the Israeli economy.

I was reading through this CRS study that I just asked to be put into the record. And, I was impressed with a number of figures in it relating to the extent of the government intervention in the Israeli economy.

I am going to cite some of those to you. Government expenditures in the 90s have averaged 46 to 48 percent of GDP. The government owns or controls 116 companies. The largest 10 of those companies have assets exceeding $20 billion.

About 600,000 jobs are in the public sector. That's about 30 percent of all of the jobs in Israel.

Ninety-three percent of the land is owned by the government. And, the government controls a number of retail prices in areas like meat, transportation, medicines.

I think, if I gather the drift of your thoughts—and I didn't hear everyone, but I heard three of you testify— the interventionist aspects of the government in the Israeli economy are something you would like to reduce. I've listened to a lot of Israeli prime ministers over a period of years, and I really can't remember any of them saying they wanted more government intervention in the economy.

They have all come to the United States pushing free markets and open-trading systems and all of the rest. But, the fact of the matter is, you end up with an economy today that has an extraordinary amount of government intervention by any measure.

Now, I'm assuming the premise here is that that's not desirable. And, I would like you to comment, if you would, not in great detail—I think I've got the drift of it—but what kinds of things would you like to see the Israeli economy do to get rid of this government intervention and to become what I guess we would all say would be a much more dynamic and viable economy.

Now, let me hasten to say that I understand that Israel confronts some extremely difficult problems and has since 1948 in their economy. And, we all appreciate, for example, the very, very heavy burden of security expenditures that the country has had to confront.

But, I guess the question, then, becomes, in brief: What should be done here to move Israel in what we would consider the right direction?

Representative Saxton. Whoever feels the urge to respond.

Doctor.

Dr. Kanovsky. Well, your statement with respect to the magnitude of government intervention in the economy, your statement is absolutely accurate. What I would like to add to that is the question of the trend over time. I think that's very important.

When you say 46 percent, the government expenditure is equal to 46 percent of GDP, that's accurate. But, it used to be double that.

Representative Hamilton. Used to be?

Dr. Kanovsky. It used to be double that. In other words, the trend is in the right direction.

Representative Hamilton. Yes.

Dr. Kanovsky. Is it fast enough, the trend? Is it good enough? I'm not sure. But, certainly I think it's going in the right direction and quite strongly.

There was a small change last year or two years ago with an upturn. But, that's another particular issue with respect to the question of health care in Israel. It became that—what turned out is that instead of semi-private kind of arrangements, the government took over the health care system and is collecting this health tax. This has increased, to some extent, government intervention.

But, overall the trend is not in that direction. The trend is definitely toward a diminution.

Incidentally, I'm not here to defend the Israeli government, neither the present nor the past. I try to be as objective as I can regarding the developments.

With respect to privatization, the current government is doing more than in the past. I'm not saying enough.

The major bank in Israel now has been privatized. And, that was a very, very big accomplishment.

With respect to price controls, the same thing is true. Price controls, at one time, were ubiquitous. Almost anything was price controlled except for possibly real estate and that kind of thing. That situation has changed very, very radically.

Again, it is not the American economy by any means. But, there is a very strong trend toward reduction of price controls because of increased imports.

And, what Dr. Lawrence mentioned earlier, the best antidote to a monopoly situation is one where you have free imports. And, Israel does have an agreement with the U.S., and prior to that an agreement with the European Economies. And, the result, of course, is there are free imports and the ability to raise prices is very much impaired.

In the case of services, that's another story. Services, of course, are not internationally competitive "or" real estate and so on.

Again, with respect to jobs, when you say 30 percent are in the public sector, one has to know how the public sector is defined. It includes, for example, the universities, which are technically private, and other nonprofit organizations of that nature—in other words, it's a broader definition of public sector than is common in the United States or elsewhere.

But, again, it's high. But, I think it's moving slowly in the right direction.

The immigration that came in the last number of years from the Soviet Union, a very significant number were absorbed in the private sector. And, I think the trend is in that direction.

Representative Hamilton. All of you, I presume, would like to see more privatization and–

Dr. Kanovsky. Absolutely.

Representative Hamilton. –you would like to see fewer price controls.

Dr. Kanovsky. Without any question.

Representative Saxton. Dr. Einhorn, I think, would like to comment, if you don't mind.

Representative Hamilton. Sure.

Dr. Einhorn. First of all, yes, I agree. I mean, the data are very accurate.

And, in addition to what Professor Kanovsky had to say, I would like to add that also the legal situation is conducive to more freedom in the respect that, for instance, now Israel is in the process of revising its trade laws due to the accession to the WTO, which is very important.

Representative Hamilton. Deregulation is going on?

Dr. Einhorn. You see, in a small country, no matter how much you deregulate, unless the imports come in, it is very difficult because you will never have more than two or three industries that produce any one product will deal with anything. So, the true competition comes often from outside.

Secondly, the courts of law themselves have been doing a beautiful job over the past two years. They abolished safeguard duties. Even the United States, in that respect, is quite protectionist, I would say, sometimes when it comes to these kinds of duties.

But, the Israeli court has, in fact, interpreted Israeli legislation according to Israel's international obligations. And, this has been a very fine development.

So, it shows that the rule of law can do a lot of improvement in that direction as soon as you have one.

Representative Hamilton. Let me ask you one other question. This may not exactly be a fair question, but one of the things that Prime Minister Netanyahu said when he was here early on after his election was that he wanted to eliminate U.S. economic aid to Israel. I don't know whether he is still saying that or not. But, I do remember that.

What if that came about? I think it's $1.3 billion or something like that now? I'm talking now just about economic aid.

Would that have any big impact in the Israeli economy today? What's the significance of that if it were done?

Dr. Kanovsky. Mr. Chairman.

Representative Saxton. Doctor, go ahead, please.

Dr. Kanovsky. The aid that Israel receives from the U.S., for which, of course, we are grateful, has been in the order of $3 billion a year for the past 10 years or so, in the form of a grant, of which $1.8 billion is military and $1.2 billion is civilian.

The $1.8 billion that is military goes for mainly for the purchases of American military equipment, which I don't think Israel could do without. My colleagues here are experts. I'm not. But, I don't think anyone would even suggest, in his wildest dreams, that one could dispense with that.

Representative Hamilton. No, that's right.

Dr. Kanovsky. With respect to the $1.2 billion, what is not well known is that most of it goes for paying back debts to the U.S., unlike Egypt and Jordan. When Israel signed a treaty with Egypt, Egypt requested and received from the U.S. a wiping out of all debts, $7 billion at that time. Jordan did the same when it concluded a treaty with Israel.

With respect to Israel, there was no wiping out of any debts. So that Israel is paying—most of the $1.2 billion it is paying is going mainly for debts that were accumulated mainly because of the Sinai withdrawal. Israel, in 1979, when it withdrew from the Sinai Peninsula had to then build bases in the Negev, in the southern part of Israel—

Representative Hamilton. You seem to be making an argument that it ought to continue.

Dr. Kanovsky. What I am saying is that if these gentlemen are correct—and I assume that they are—that the defense burden of Israel will have to increase rather than decrease. In the last 10 years, it has been going down. The defense budget has been decreasing and the ratio of defense expenditures to GDP has been diminishing.

But, if these gentlemen are correct—and I assume they know what they are talking about—Israel is going to have to change its policies and increase its military expenditures. It would be very difficult, under those circumstances, for Israel both to repay the debts of the past and to add to current expenditures for defense purposes.

Dr. Lawrence. Mr. Chairman, I think the goal of reducing and, indeed, eliminating economic assistance, I think, is an appropriate one, given Israel's level of economic development. We have here a developed country.

And, when we look at it, it's very anomalous that we are giving $1.2 billion to this country when you look at it in the context of our overall aid appropriations and strategy. But, I think the timing has to be done very, very carefully.

Because Israel currently has a very considerable current account deficit, it is highly dependent on capital inflows into its economy. Whether—regardless of purpose, it all sort of balances out at the end of the day when you look at the pressures on the exchange rate and so on.

Israel does have a 10 percent inflation rate. So, a sudden withdrawal of funds or an expectation of a withdrawal of funds could lead to depreciation of the currency, more inflation, management problems. It has to be handled delicately.

Representative Hamilton. Would you support a phase out of it?

Dr. Lawrence. I think discussion should begin on how that phase out ought to be, ought to take place.

Representative Hamilton. Mr. Chairman, I have just one other question. And, that is, in general, the relationship between the economy in Israel and the peace process.

Is there a relationship there; or, is there not? Does Israel benefit if there is a peace process that is making progress as the economic statistics in the early 90s might suggest; or, is the peace process something that is irrelevant to the strength of the Israeli economy; or, does it do it harm?

Colonel Tsiddon-Chatto. Sir, I am not an economist, but I will try to give it perspective. I am the eldest of the crowd here.

(Laughter.)

At the end of the British mandate, we were about 600,000 people in Israel, in Palestine then, scrapping the bottom of the barrel of the British war economy at the end of the war. We are now about five million Jews in Israel with a GNP per capita equal to that of Britain's.

Now, that means that even under these very difficult conditions— and, if you will allow me a tinge of humor, in spite of the Jews and their governments—we've made a fair track with all these wars. Obviously, peace will affect positively the economic situation.

But, I would like to make a remark to Dr. Lawrence. The upswing —I mean, the dramatic upswing of the Israeli economy started three years before Oslo. And, it started with the high-tech explosion.

Israel is today the second country in the world in number of high-tech start-ups after the United States, not relatively but absolutely ahead of Japan and Europe. So, that started.

It's both the combination of good training and defense requirements fall out and the input, the very important input, of the Russian immigration. It started in 1990.

And, it was already on the way up when the Oslo agreements came.

And, I repeat: Peace will be very, very important. But, unfortunately, I would like to say that, you know, the academia in some political forums tend to avoid defining peace.

Peace, defined in the dictionary, is one of two things: Either a state of harmony between people and goods or a state of no war. A state of harmony between you and Canada, state of no war between you and the late U.S.S.R.

So, the state of harmony depends on the similarity of cultures, similarity of economies, similarity of GNP. Look at the difficulties of introducing Greece and Portugal in the common market or integrating Germany.

And, of course, on disposition and free exchange of goods and ideas and so on and so forth and no aggressive motivation and no conflict of interests. Now, you don't have this.

What you have in the Middle East is all these in negative. And, therefore, all you can achieve at the moment—and this is where I tend to differ a bit—is a peace of no war. And, the key to maintaining this peace of no war is deterrence, the way you did with the U.S.S.R. and everybody else in this world.

So, now since this—since the deterrence is the key to peace, be it of no war, anything, any development, be it the export of flowers or the operation of the airport at Raffia, which is a beautiful building incidentally. I've seen it. Really beautiful. It's of Jewish/Moroccan architecture.

But, anything that you do there, if it affects defense you can't tolerate it. If it affects deterrence, you can't tolerate it.

So, I am surprised that in an area where security has been the capital issue for a century, it is relegated now by some people to some sort of an

"Oh, yes, security, too," situation. And, that encompasses our economic situation needs.

Representative Saxton. Thank you, Mr. Hamilton. There seems to be—with regard to the economic aspects of our conversation today, there seems to be a general agreement between and among all of you that perhaps less government influence—and following Mr. Hamilton's question on less government influence—in the economy would be healthy.

In fact, this Joint Economic Committee, a year or so ago, commissioned a study on our government. We currently, as a government, consume something like 21 percent of our GDP. And, we have produced a study that shows that while it is necessary to do certain things through the federal government to provide for our common national security, provide for transportation systems, provide for educational opportunities for the American people, once we exceed something like 17 or 18 percent of our GDP, every dollar we spend through the federal government has a negative impact on economic growth.

And, obviously the Israeli government is headed downward. And, that kind of sets the basis for the question that I have, that I would like to ask Dr. Sherman and Colonel Chatto to respond to.

You both made a very compelling case, and one with which I do not disagree, that the defense dollars that are currently being spent and contemplated for the immediate future in Israel perhaps need to be enhanced somehow. If that is the case, and if the trend for less government spending is to continue downward, how is it that Israel can spend more in defense, if, in fact, that's the decision that Israel makes, and still continue with the downward trend in terms of percentage of GDP consumed by the Israeli government?

Colonel Tsiddon-Chatto. Sir, thank you very much for the question.

As I say, I repeat, the deterrence is the main factor. One of the things that should be imperative in discussing within any type of peace negotiations would be the disarmament, mutual disarmament. I don't think it will hurt the Syrian people or the Egyptian people or the Iranian people if they will buy less arms.

Some people will get less commissions. But, that's all. So, this is imperative.

As long as the Arab/Iranian arms buildup is there, I have no choice. And, when reminding people of history, we have lived through it all our lives. And, fortunately, it will slow down.

So, I am in favor of accelerating the proper economic measures that both Mr. Hamilton and Professor Kanovsky mentioned, accelerating privatization and all these things that we are all for, so that the GDP will increase so that we shall be able to put more money where the deterrence requires it, especially anti-missile deterrence.

We should go into international agreements. For instance, when we talk about the nuclear developments in Iran, because if Iran becomes nuclear and we stand alone against that and they have the means of delivery, we might find ourselves scrounging, I would say, for a very expensive piece of equipment like missiles equipped, nuclear or non-nuclear submarines. And, the Mediterranean being a small pond, to have them stationed in the Indian Ocean, that means access to Diego Garcia.

So, obviously we have to talk about the maintenance of deterrence and unloading the burden from the Israeli economy in terms of more international goodwill, in terms of pressures. Now, obviously the deterrence is a capacity to fight a war and win it. It is an economy that can sustain those.

So, the solution, sir, as far as I see it—and it's a very difficult one—is increase the Israeli productivity output, et cetera, so that deterrence will not be that big a burden, increase cooperation with the U.S. where it counts. In other words, in preventing nuclearization of Iran and promoting disarmament in the area and not necessarily in terms of generating more money.

Representative Saxton. Dr. Sherman.

Dr. Sherman. As I mentioned in my initial address, there are three time levels which have to be addressed in the issue that you raised. At the immediate level, there would have to be some belt tightening.

In other words, the government is going to have to cut back on the civilian sector. And, here I think there are a number of sectors or a number of areas which could be easily identified. For instance, the very large transfer payments to the ultra-religious parties, and ultra-religious institutions; or, the very large support given to failing industries like the military industry, et cetera, et cetera.

So, there are resources, which in the short run, could be transferred from the civilian sector to the military sector for building the required deterrent capacity.

Representative Saxton. In a perfect world but not necessarily a political world in Israel.

Dr. Sherman. Well, this is the point I made in my initial address when I said that part of the reason for this adverse trend is that politicians put their short term political career considerations before the long term interests of the country. And, that's why the appropriate public mood must be created externally by an exogenous elite, which would not be encumbered by an electioneering timetable. It is in this way that leadership must be induced to make those cuts.

Looking at the ongoing trend, people sometimes ask me, "You know, this has been a trend of successive governments. Do you think that so many successive governments have ignored the national interests?" I think you can explain the trend of the decreasing allocations for defense in three ways—by good judgment, bad judgment and misjudgment.

In the early '80s when inflation rates were high and defense spending levels were high, it probably made good sense to try and contract the defense budget. But, as both inflation and defense expenditures were lowered, this eventually became counterproductive. And, that's where the bad judgment began, with politicians putting their short-term considerations of political expediency before the long-term national interest.

And, then, of course, you have misjudgment, whereby governments make the wrong decisions because they misread reality. We saw that in the 1930s with the French and the British weak response to the massive rearmament campaign of the Germans. We saw that in 1973 in Israel when a very distinguished group of people, which included three ex-chiefs of staff and one serving chief of staff plus the head of intelligence, with current intelligence in their hands, accepted the assessment on the 5th of October that the probability of war was lower than low. On the 6th of October, they were proved tragically wrong.

In fact, I think I have a very interesting document here which appeared about 10 weeks before the outbreak of the Yom Kippur War, written by a very respected statesman and military officer, Yizhak Rabin. In this article which appeared on a full page article under the title, "The Slow Road to Peace," Rabin claimed that there was no need for Israel to enlist its reserves even when the Arab armies were making menacing maneuvers, that there was no chance of war breaking out because the Arabs could not coordinate their political—

Representative Saxton. Let me just use that as an opportunity to ask my next question, Dr. Sherman and Colonel Chatto.

In my opening statement, I had mentioned that I am the Chairman of a group here, which is called the Task Force on Terrorism and

Unconventional Warfare. And, I have chosen to devote a fairly large share of the time that I have available here in Congress to address those issues, because my reading, particularly of the situation in the Middle East, was that following the Intifada two major threats seemed to be enhanced.

One was terrorism, which was not new but it seemed to me that it was enhancing itself, if you will, or there were those who were providing for the enhancement of it, I guess I should say. And, of course, unconventional warfare, basically meaning chemical, biological and nuclear and the proliferation following the Cold War throughout the world, particularly in Iran, China, Korea, and other places in the Middle East.

So, I've chosen to become a student of those issues. And, I was somewhat surprised to hear you talk in such depth, with such conviction about the situation involving Egypt, which appears to be more of a conventional threat, knowing that the Syrians are always on the northern border and the northeastern border of Israel, knowing that the Iraqis had a threat that could reach to Israel of probably a conventional type, although unconventional as well, and knowing that the Camp David Accords had provided for a relatively peaceful situation between Egypt and Israel.

I've recently begun to hear, and today especially, of the conventional threat, that apparently it is enhanced almost daily now by the Egyptians. And, I would like to ask you if you would care to comment further with regard to that situation?

Dr. Sherman. Over the last two decades, I think, the Egyptian behavior has been totally incompatible with that of a friendly peace partner. The Egyptian press, which is in many ways state regulated, has consistently published vitriolic attacks with anti-Israeli (and even anti-Jewish) undertones and overtones.

Egypt has led a hostile diplomatic offensive in many international forums against Israel. Senior Egyptian officials have singled out Israel as Egypt's major strategic enemy.

In recent Egyptian army maneuvers Israel has been portrayed as the chief adversary. There has been a report by a recent claim raised by President Mubarak for additional territorial demands which include Eilat (the Israeli Red Sea Port). According to this report, on the 5th of April of this year, he addressed the officers of the Second and Third Army, saying that the struggle for Egyptian territory is not yet over and that Um Rashyash (Eilat) is part of Egypt and Egypt will not be willing to forgo it.

So I feel that this peace agreement, which as Professor Kanovsky pointed out, has turned out to be not a peace agreement but a nonaggression agreement, would be a very, very poor guarantee of future non-belligerence between Israel and Egypt.

In fact, it was Shimon Peres who once pointed out the number of agreements violated by the Arabs in the Middle East is no less than the number of agreements honored by them. Since then, of course, a further number of agreements have been violated. So, I don't think this could really increase our confidence in the viability or the durability of that peace agreement.

Representative Saxton. Colonel.

Colonel Tsiddon-Chatto. Sir, insofar as Israel is concerned, again from a long time experience, one can consider that part of the Palestinian government to be true, where it says that we face the Arab Nation. Insofar as we are concerned, the PAN Arab alliance is like an Arab Nation.

So, one has to look at the deterrence facing the whole Arab Nation where you have three distinct sectors—Egypt, with its own peculiarities and so-called peace, which is, in a way, much more than the Cold War that you had with the U.S.S.R. But, you have a buffer zone that gives you a time distance, breathing space, if something happens.

You have the Jordanian sector. The Jordanian interests are definitely in tune with ours. They would like to have a strong Israel that protects Jordan from the incursion of its brethren. But, when they believe that Israel collapses, like in 1967, they joined the others. They had no choice, or in the Gulf War.

Now, if Jordan is invaded, again you have a certain time distance space, breathing space. The one place which is the most acute if we withdraw to the borders is the Syrian frontier, because there you have Syria sitting on top of you right there in physical contact and in contact, in physical contact, with Iraqi and the Iranian, potential allies. And, there are already negotiations going through.

So, if I stress the—or I ask the question about Egypt's aspirations, it is seeing the country at peace would mean not threatened by Saddam or Libya, with a GNP per capita going down. Why do they need arms? I think I have an answer for that, the answer being that the recent treaty signed between Egypt and Syria and the recent declarations by President Mubarak that they will not stand idle in case of war. And, I believe it, because this is what always happened.

And, it does not depend on a signed peace or not. It depends only on one thing, deterrence.

So, sir, we have to look at this as one. And, obviously terror is militarily, purely militarily speaking, it's of a nuisance value. But, it has an accumulating effect on the morale, on the will and on all other components of deterrence. Therefore, it has to disappear from the scene.

The problem is if I surrender, say, territory, for the sake of the argument, even temporarily and by doing it I lose deterrence vis-a-vis the Arab Nation at large, am I wise? I doubt it.

Representative Saxton. Thank you. Dr. Lawrence, let me return to an issue which obviously has a lot to do with the ability of the Palestinian people to manage themselves. And, I would like to ask you this question, and Dr. Einhorn and Dr. Kanovsky.

One of the issues that Dr. Einhorn has referred to several times in her testimony and in subsequent answers to questions has to do with the ability or inability of the Palestinian, of the PA, to provide for adequate policing. And, I mean the term "policing" in the most general sense of providing a mechanism through which the Palestinian people, the Palestinian business people, the Palestinian institutions have a set of rules to follow.

We had a rather unpleasant experience a year or so ago in finding some fairly credible evidence that American dollars that were provided to the Palestinian Authority were not used for the purposes for which, at least, we intended. And, it was really quite unsettling, because it was one of the first—it was one of the first pieces of evidence that we had that the peace process built on a basis of helping the Palestinian people become able to uplift themselves was probably not going to be as successful as we had hoped simply because we had now found evidence, which we referred to as the Pektar papers, which I think became commonly known in that regard.

And, I don't see any real evidence at this point, at least, that the Palestinians have been able to correct that very fundamental flaw. Would you comment?

Dr. Lawrence. Well, I agree about the importance of a legal order, about the dangers of corruption. It's just like an arbitrary tax regime basically in stifling economic growth and development.

And, I do think that, you know, there is some foundation to the allegations and, indeed, the evidence that has been presented that all is not ideal, to put it mildly, in the operation of the Palestinian Authority. Actually, the best—the most heartening experience that we've had has been the publicity actually by the Palestinians themselves of these practices. I think ideally a free press but open, openness, and revealing these practices is a very critical element in curtailing them to some degree.

But, let's just understand, firstly, that corruption is prevalent everywhere, that many countries have high levels of corruption. And, in addition, even if we assume it away—and I do think when granting aid we have to be very vigilant at how it's spent and, indeed, donors have increasingly tried to put into place constraints and regulations which ensure that their money is not being misspent. Nonetheless, I think it is not enough.

If we are looking to this economic development, we have to realize a legal order unnecessary. I don't dispute that. But, much more is required.

If you were thinking about investing, you would worry about the tax and legal regime. But, you would also worry about whether your goods could get out of the territory. You would worry about getting inputs in.

Representative Saxton. Yes, but excuse me. Isn't there a pyramid that has to be built?

Dr. Lawrence. It's both.

Representative Saxton. And, doesn't the foundation of that pyramid come with people who do what they say they are going to do? And, when they are given or when they have at their disposal—I don't say given, but when they have at their disposal funds for which statements are made that they are going to be used for certain purposes, without that basis of trust, how do you know, the issue of exports, isn't that further up the pyramid and doesn't that all rest on—

Dr. Lawrence. I'm sorry?

Representative Saxton. The issue of exports—

Dr. Lawrence. Yes.

Representative Saxton. —isn't that further up the pyramid and doesn't that rest on a basis of law and fundamental order and trust?

Dr. Lawrence. I couldn't agree with you more. I think trust is absolutely critical.

And, I think it is the missing element today actually. But, it goes both ways.

There is the trust that you refer to, which has to do with the legal order. There is also tremendous mistrust between the two participants, the two major participants, in this—

Representative Saxton. Of course.

Dr. Lawrence. —process. Establishing and getting their trust is the most important thing. Without it, nothing is going to work.

Representative Saxton. Dr. Einhorn.

Dr. Einhorn. Yes. I agree that establishing the trust is very important. And, that can only be done through rules of law.

This is what happened after the Second World War in Europe. Laws and rules were established so things could move further. And, nothing would have moved without them I mean, you can have an airport. If you don't produce anything, what would you sell through it? If there is no industry, no factories.

I mean, it's good to have an airport. But, it's not enough, to have an airport. And, a gateway has to be opened to get something that has been produced.

This is based on the rules of law. Now, mentioning that the Palestinian Legislative Council managed to produce one report, yes, it's good.

But, let's remember that the Palestinian Human Rights Commissioner, Dr. Bassenov Eid, was jailed and arrested several times for his activities. Daoud Kuttab, who is a journalist, and, under the Israeli occupation, was awarded an international prize—as soon as he opened his mouth under the Palestinian Authority he found himself in prison. And, had he not been an American citizen, he may have not been released so quickly.

And, when the teachers had a strike and complained that their salaries were intolerable and every family has about 13 children to support, on the average, or at least a very large number of children, and they complained, the leaders of the strike were arrested and, the strike came to a very quick end.

So, it's not only a matter of trust between Israel and the Palestinians. There is a serious problem among the Palestinians, within the Palestinian Authority itself. And, this has to be taken care of.

The trouble is that no matter how many funds you put in, the population has become poorer and poorer. And, there is, on the other hand, the class that has become richer and richer at their expense.

There has been some kind of wealth transition within the Palestinian Authority, not necessarily in the right direction. And, to help the people out of the misery, we must think of the people themselves.

And, this cannot be done in the absence of the rule of law. Thank you very much.

Representative Saxton. Thank you, Dr. Einhorn. Unless there are others who wish to comment on this issue—Dr. Sherman.

Dr. Sherman. I think the example of Saudi Arabia may prove a point here. The enormous income that the Saudis got during the oil boom did nothing to set up a vibrant, stable, diverse, industrial production base in that country.

Much of that wealth now has been squandered, and, the country is suffering serious deficits.

So, it's not just a matter of throwing money at the problem. You have to set up not only the legal framework but the political framework which will allow the decentralization of resource control within the country.

I must say I found the economic argument very puzzling, because in the pre-Intifada era, the standard of living of the Palestinians in the territories rose tremendously. That did nothing to prevent Intifada from taking place.

This points to the fact that the conflict does not turn on economics. The conflict is political.

And, because it's political, the bargaining situation is almost insoluble. The maximum that Israel can offer the Palestinians is less than the minimum the Palestinians can accept.

Therefore, you have a situation which is inherently conflictual. It would be very difficult to find a cooperative solution to it.

Even today, with the reduction in the standard of living in the Palestinian territories, the GNP per capita is still double what it is in many Arab countries. So, why should a $2,000 GNP per capita in the Palestinian territory be explosive; whereas, a $900 GNP per capital in Egypt not be?

These are questions which have no answers if you adopt the economic approach.

Representative Saxton. Let me just ask one—let me bring one other topic to the table as it relates to the Middle Eastern economy. Obviously, one of the factors that we haven't discussed in any depth today is the roots of terrorism in the Middle East which may be partly political but, I would submit, partly have a religious basis as well.

It would seem to me that one of the impediments to looking at economic growth in the area from someone's economic vantage point would have to take into consideration those activities that are necessary in the Middle East to combat what we generally—those activities that we generally refer to as terrorist activities. What kind of an effect has that had over the past decade on economic growth?

Colonel Chatto.

Colonel Tsiddon-Chatto. Sir, your question is basically the answer. The roots of terrorism in the Middle East are cultural, religious—and culture derives from religion. Where the Islam is—how would I say—vitriolicly against both the Jews and the West. And, Israel represents both Jews and West.

Now, unfortunately, we do not have an Attaturk in the Arab/Islamic world.

Representative Saxton. I'm sorry?

Colonel Tsiddon-Chatto. An Attaturk, the one that made the revolution in the secularization of Turkey.

So, in my opinion, the evolution is a very slow moving evolution. And, in my opinion, here is again where the United States, without spending money or excessive sums of money, by pressing for further democratization, liberalization, opening of the closed Islamic society— you might have read Uris' *Hedge* or you might have read—what's his name, the—well, there are quite a few books about it, about the concept, the conspiracy theory and everything that governs the Arab society.

Until they escape this kind of fortress, mental fortress, until they accept open exchange of views and so on, nobody will be successful, because when Mr. Peres, good willing, in Amman and the Amman conference, came saying that, "We can do a lot for you, gentlemen. Our GNP is higher than that of Saudi Arabia," everybody took it as an affront instead of thinking, "Well, how can I tap this?"

And, when—and there were quite a few mistakes. And, actually when the Hamas leader, Meshal, a few days ago, say that he fears the economic conquests of Israel, instead of trying to say, "Hey, let's have a marshall plan."

So, it is true that terrorism has been a tremendous hindrance. And, whatever achievements Israel has had was in spite of terrorism.

Now, obviously if we can do away with terrorism, but there, in my opinion, the position of the world at large has to be more unified, has to be stronger, has to be clearer, has to be more outspoken. And, this doesn't cost any money. This costs an effort and the genuine under-standing that terror is a hindrance to the Arabs. And, Martin said it very well. Before the Intifada, they had practically twice the GNP per capita that they had after the Intifada. And, it's going lower and lower. And, why is it going lower and lower? Because, Dr. Lawrence, we can't take a crate of flowers—granted, we can't see the operation of that airport without making sure that mortars and bazookas, et cetera, don't go through.

The moment you will be able to, you will see how far these things move.

Representative Saxton. Dr. Lawrence.

Dr. Lawrence. Well, one comment with respect to that. We can have 100 percent security if we destroy trade. It's simple. We just don't allow it. We could also have free trade and have inescapable risks.

The real question, it seems to me, is how you make the tradeoff between those two. You have to, unfortunately, make a tradeoff.

And, so we are not arguing about, you know, someone's security or another person's trade. It's a question of where do we draw the line.

The lines that some of you would draw are clearly different from me. Partly, I don't live there. I have no right to draw some of those lines. But, I can certainly ask you and others whether you are actually maximizing the economic interaction compatible with a reasonable level of security.

Secondly, I think that to see the evidence of what terror has done, we should look at the Palestinian economy today, because we do see an economy in ruins. And, the closures, the responses that have occurred because of terror, have taken an extreme toll.

People, unfortunately, care about what happens to them. They don't look around and see what has happened to their neighbors or someone else.

So, whether people are richer or poorer somewhere else in the world doesn't matter to them. What they worry about is what has happened to them and what has happened recently.

They are always asking, "What have you done for me lately?" And, for the typical Palestinian, "It's a third drop in my income," or, "It's a loss of my job."

And, the Intifada was very interesting, because it was led by young people who had no economic interests.

I disagree also—yes, undoubtedly there are fanatics who will not be persuaded by their economic position. But, I think fanatics are heard by a broader population, depending on how well those people are doing, too, whether the fanatics are heard or not.

I think Hamas is popular today or has the popularity that it has because of economic privation in those territories. And, Hamas offers them some kind of solution. It's a solution that I would reject categorically, but it appeals to certain people who are willing to accept it.

So, I don't discount. I think it is very dangerous to discount economics and economic well being.

And, I think that, on the one hand, fighting the terror and, on the other hand, stimulating the economic growth have both to be objectives.

Representative Saxton. Colonel Chatto.

Colonel Tsiddon-Chatto. Thank you, sir.

Representative Saxton. I might say that we are going to have to finish up here in about five minutes, unfortunately. The House is in session and there is business on the floor. And, I am going to have to leave.

But, please, Colonel Chatto—

Colonel Tsiddon-Chatto. It will be one minute, sir.

Representative Saxton. —and then Dr. Sherman.

Colonel Tsiddon-Chatto. The basic difference is on the interpretation of peace. The question is by signing a piece of paper, can you reach a situation which is a state of harmony between people or goods, as the dictionary says; or, by signing a piece of paper, in view of 100 percent of past experience, you are not achieving anything unless this piece of paper is backed by collaterals called deterrence?

Now, this is where we are. And, we have to secure the collaterals in order to secure peace. And, this is where the divergence of opinion— you can theoretically go anywhere.

Thank you, sir.

Representative Saxton. Thank you. Dr. Sherman.

Dr. Sherman. I would like to say a word about the closure. I find the demands for lifting closure quite puzzling, because the whole rationale of the Oslo agreements was to extricate the Palestinians from Israeli control.

And, now people say the only way to maintain the Oslo agreements is to put them back under Israeli control, where they would spend all their waking hours. So, there seems to be a serious contradiction in that.

Moreover, to blame the rise of Moslem extremists in the Palestinian territories on Israeli policies seem again very strange, because you have these Moslem elements all over. You have them in Lebanon. You have them in Algeria. You have them in Egypt, which has signed a peace agreement and got everything it asked for.

I think it must be very demeaning for the Palestinians to find that people say that without the Jews they can't get their act together, because if they really are part of the Arab Nation, surely this massive population from the coast of the Atlantic Ocean to the approaches of the Hindu Kush should be able to mobilize the resources to help them ignite their economy. I mean, if you compare the point of departure of Palestinian economy to the point of departure of the Israeli economy when Israel was founded, there is a huge difference.

Israel was surrounded by a sea of enemies, had no land borders through which it could export anything. The Palestinian point of departure seems far superior. And, they should be able to do very well without Israel.

Representative Saxton. Dr. Sherman, thank you very much. And, for a last word, Dr. Kanovsky.

Dr. Kanovsky. Yes. With respect to the whole issue of peace and prosperity, do they go together or are they possibly separated?

I suggested in my talk that the two are not necessarily related. One can have peace and not have prosperity. And, the opposite can also be true, depending on the circumstances.

One of the points that I think bears mentioning—and this was not mentioned in the whole discussion—both countries that signed peace agreements with us, Egypt and Jordan. Together with the peace agreements, they requested additional military aid from the U.S. and have received it. Egypt, for the last, what is it, almost 20 years, has received $1.3 billion a year in military aid in addition to civilian aid. And, in other words, despite the fact that they have a peace agreement, there has been no reduction in allocations to the military.

One of the basic premises of the whole idea of having peace was that there would be a diminution in resources allocated to the military in favor of the civilian. And, that would bring about prosperity in the country.

The opposite has happened or certainly this hasn't happened at all. And, in addition, as I said, you have now a situation in which they request additional military aid for additional military equipment.

This, of course, fits into what two of the gentlemen were speaking about.

I think peace can be achieved. I think prosperity can be achieved. I think both of them can be achieved but only in the long run.

Anyone who tries to achieve a comprehensive peace with Syria overnight or within a short time, I think, is fooling himself. One has to proceed at a very slow pace.

The Jordanians are different from the Syrians. The Egyptians are different. They are not all the same.

And, I think the policy of a comprehensive peace agreement with everyone and all the way through and having it today or tomorrow I think the whole policy has been misleading and possibly counterproductive.

Representative Saxton. Well, thank you very much, Dr. Kanovsky.

And, thank all of you very much for traveling here from whether it happens to be from Harvard or the U.K. or from Israel. We thank you for coming to share your ideas and your thoughts on these very complex and difficult issues with us.

We look forward to working with you in the future as we, as perhaps Dr. Kanovsky would put it, try to put in place peace and prosperity over the long haul.

Thank you very much.

[Whereupon, the hearing is adjourned at 12:10 p.m., Tuesday, October 21, 1997.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Ladies and gentlemen, good morning. Thank you all for being here.

The Joint Economic Committee sits in a very unique position, and I would suggest an ideal position to evaluate those policies' impact on our economy, particularly, in the context of the legislative intent of the authors of the policies.

The Middle East is an area of vital strategic and economic importance for the United States. After all, in 1990-91, this country went to war against Iraq in order to ensure free access to the region's vast oil resources. We still have troops deployed in the Persian Gulf. The United States also has special relations with the State of Israel. Furthering the Arab-Israeli Peace Process has been the cornerstone of the Middle East policy of both the Bush and the Clinton Administrations. As Chairman of the Task Force on Terrorism and Unconventional Warfare, as well as Co-chairman of the Peace Accords Monitoring Group, I have had the opportunity to study closely the Middle East.

Recently, I came across this new book- *Israel at the Crossroads*- published by the Ariel Center for Policy Research in Israel. The articles in this book shed new light on the emerging economic and defense trends in the Middle East, particularly in the context of the Arab-Israeli Peace Process. The book's premise, as stated on the back cover, is most intriguing. Let me read it to you:

> *Entering its 50th anniversary, Israel finds itself in a unique situation. On the one hand, it is on the verge, or the beginning, of economic growth and expansion that will make it a leading economic powerhouse. It will no longer be dependent on others, nor need foreign assistance. On the other hand, despite more than 50 years of struggles and sacrifices, the country not only faces existential threats, similar to 1947-48, but for the first time the Israeli population is vulnerable to outright annihilation by weapons of mass destruction-a threat that did not exist even during the darkest days of the War of Independence. The profound quandary facing Israel is what path will Israel follow? Will it be a path leading toward security,*

> *stability and economic growth? Or a path of capitulation and destruction? The great absurdity in all of this is that the 'peace process' that should have brought Israel into the former state, is actually expediting its succumbing to the latter state.*

Indeed, a most provocative assertion.

My goal in these hearings is to further investigate the economic and defense trends in the Middle East, particularly the ramifications of the Peace Process, and to shed light on these important issues.

Therefore, I'm pleased to welcome to the Committee an extremely knowledgeable group of panelists. First, we are going to hear from four of the experts who contributed chapters to the book, *Israel at the Crossroads*.

Dr. Martin Sherman teaches political science at the Tel Aviv University. He acted as a ministerial advisor in the 1991-92 Shamir government. He also served for several years in various defense related capacities. He is the author of numerous articles and two forthcoming books on international and Middle East conflicts.

Colonel (Res.) Yoash Tsiddon-Chatto was a member of the 12th Knesset and of the Israeli delegation to the Peace Talks in Madrid back in 1991. Among his numerous positions, he was the chief of planning and operations requirements of the Israeli Air Force in the mid-1960s, and a member of the Raphael advisory board in the early 1990s. He publishes extensively on security issues in Israel and abroad.

Dr. Eliyahu Kanovsky is a Professor of Economics at the Bar Ilan University, near Tel Aviv. He is also a Senior Research Associate at the Begin-Sadat Center for Strategic Studies, and the Ludwig Jesselson Visiting Professor of Economics at Yeshiva University in New York. He is the author of numerous books and scholarly articles.

Dr. Talia Einhorn is a Senior Lecturer-in-Law at the Israeli Center for Academic Studies and is affiliated with the University of Manchester in The United Kingdom. She is currently on a sabbatical, doing research in the Max Planck Institute for Foreign and Private International Law in Hamburg, Germany, as well as the Hague Academy of International Law and the Asser Institute for Private and Public International Arbitration and European Law, both in Holland. She is also the author of several books and scholarly articles.

In addition, we are going to hear from Dr. Robert Z. Lawrence. Dr. Lawrence is the Chairman of the Project on Middle East Trade at the

Institute for Social and Economic Policy in the Middle East, the John F. Kennedy School of Government, Harvard, where he has conducted several studies on trade and economic relations between Israel and its neighbors. He is also the author of several books and scholarly articles.

I look forward to the enlightening testimony of each of our panelists.

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CRS Report for Congress

The Israeli Economy: Overview and Recent Developments

October 8, 1997

Raymond J. Ahearn
Specialist in Trade Relations
Foreign Affairs and National Defense Division

CRS

Congressional Research Service • The Library of Congress

The Israeli Economy: Overview and Recent Developments

Summary

The Israeli economy belies simple categorization. Based on a per capita income level of $16,783, a large services sector, and hundreds of dynamic high-tech companies, it is modern and advanced. Based on the large role the government still plays in the economy, it is interventionist and regulated. And based on the country's high defense requirements, chronic trade deficits, and political economy, it can be described as distinctive or unique.

Since 1948, the economy has experienced three different stages of development. The first (1948-1972) and third stages (1989-1995) were classic boom periods fueled primarily by rapid increases in the stock of labor. The second stage (1973-1988) was characterized by considerable economic instability and turmoil.

The Israeli economy currently may be entering a fourth stage where concerns once again are being raised about stability and performance. The increase and size of the current account deficit (4.8% of GDP in 1996), combined with an overvalued exchange rate, are matters of particular concern because they can be precursors to a financial crisis. This is a situation of special concern to Israel because it already imports a large amount of capital to finance its deficit, and there is no certainty that sources of funding at reasonable cost will continue indefinitely.

These economic problems have been fueled by an expansionary fiscal policy and a relatively restrictive monetary policy. In order to promote economic stability, most economists agree that Israel needs to pursue a less expansionary fiscal policy mainly by cutting non-productive government expenditures. This, in turn, would allow central bank authorities leeway to run a less restrictive monetary policy without jeopardizing other macroeconomic objectives.

A reduction of the high degree of government intervention in economic activity also could help Israel promote economic growth and macroeconomic stability through a more efficient use of the country's resources. Given the likelihood of a slower growing labor force, productivity increases brought about by structural reforms may become even more critical in the future. However, progress has been gradual in reducing the government's role in owning and running enterprises, as well as reforming capital and labor markets. Progress has been more rapid in liberalizing foreign trade and currency barriers and in increasing competition in certain sectors.

Although there appears to be a consensus within Israel on the policy actions that should be taken to avoid serious economic problems, implementation of a coherent economic strategy continues to be politically difficult. A perennial problem is that as Israel's political system produces coalition governments, the majority party in the government is often hampered in implementing its preferred economic policy by competing claims from small coalition partners. A larger unknown is the commitment of the two major political parties, Likud and Labor, to deficit reduction and structural reforms.

Contents

Profile of the Israeli Economy 1
Advanced Economy Attributes 1
Interventionist Attributes 3
Distinctive Attributes 4

Stages of Economic Growth 6
First Two Stages (1948-1972 and 1973-1988) 6
Stage Three (1989-1995) 7
Stage Four (1996-Present) 9
Growth 9
Employment 11
Inflation 12
Balance of Payments 12

Current Macroeconomic Policy Issues 14
Fiscal Policy 14
Monetary And Exchange Rate Policies 16

Structural Reforms — Recent Developments 17
Privatization 18
Capital Markets Reforms 19
Labor Market Reforms 20
Foreign Trade and Currency Reforms 21
Other Reforms 22

Outlook 23

Statistical Appendix 26

List of Figures

Figure 1. GDP Growth Rate, 1990-96 10
Figure 2. Unemployment Rate, 1990-96 11

List of Tables

Table 1. Basic Economic Data[a], 1986-95 ... 8
Table 2. Savings, Investment, and the Current Account, 1990-96 (Percent of income, annual rates) ... 13
Table 3. Main Indicators of Fiscal Policy, 1990-1996 ... 15
Table 4. Revenue From Privatization ... 18
Table 5. Israel: Destination of Exports, 1989-96 ... 26
Table 6. Israel: Origin of Imports, 1989-96 ... 27
Table 7. Israel: Commodity Composition of Exports, 1991-96 ... 28
Table 8. The Largest Government Companies as of December 31, 1995 ... 29
Table 9. Regulated Prices in the Consumer Price Index ... 30
Table 10. Israel: Labor Market Indicators, 1977-95 ... 31
Table 11. Israel: Real Wages, Labor Costs, and Productivity, 1988-95 ... 32

The Israeli Economy: Overview and Recent Developments

Profile of the Israeli Economy

The Israeli economy belies simple categorization. Based on a per capita income level of $16,783, a large services sector, and hundreds of dynamic high-tech companies, it is modern and advanced. Based on the large role the government still plays in the economy, it is interventionist and regulated. And based on the country's high defense requirements, chronic trade deficits, and political economy, it can be described as distinctive or unique.

Advanced Economy Attributes

Based on a population of 5.7 million and a Gross Domestic Product of $95 billion, the per capita income level in Israel in 1996 was $16,783. The World Bank categorizes countries at this level as high-income economies. Countries with comparable per capita income levels include Ireland, Spain, and New Zealand.

The structure of the Israeli economy is also representative of an advanced industrialized country. Services (public and private, financial, transportation, commerce, and tourism) now account for nearly 70% of the total output of the economy. Industry, including construction, accounts for around 30% of total output, and agriculture, for less than 3%. The dominance of the service sector prompted the International Monetary Fund to reclassify Israel as an economically advanced country in 1977.[1]

In addition to its large and modern services sector, Israel today has a large and diversified manufacturing sector. A skilled, highly educated, and innovative labor force is perhaps its most important asset. The economy is export-oriented and well-integrated into the world economy.

The heart of Israel's manufacturing capability is a thriving, rapidly growing, and innovative high-tech sector. This sector consists of an estimated 1,000 start-up companies. Electronics and software companies, with annual sales of $7 billion, lead the way. All these start-up companies rely on an abundance of highly trained and educated scientists and entrepreneurs, many of whom immigrated from the Soviet Union in the past seven years. Israel now boasts the highest number of scientists and engineers per capita in the world.

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[1] Ezrahi, Yaron. "In Israel, Peace Means Prosperity," New York Times, January 21, 1997, p. A 23.

Many of Israel's high-tech companies have utilized technologies developed in the army and defense industries. Recent products providing improvements in Internet security systems, encryption, and real-time video services all emanated from military technologies.[2]

Approximately 90 of Israel's high-tech companies are traded on NASDAQ, the U.S. exchange devoted to young and aggressive companies here and abroad. This is more than any country other than the United States and Canada. These companies attracted over $1 billion in financial investment in 1996, compared to $543 million in 1995 and $335 million in 1994.[3]

With a small economy and a relatively limited domestic market, Israel depends increasingly on international trade for its economic growth. In 1996, exports of goods and services accounted for approximately 30% of GDP and imports of goods and services accounted for about 40% of GDP.

The extent to which international trade plays a key role in Israel's growth is highlighted not only by the contribution of exports to final demand, but also by the composition of its imports. In 1996, for example, production inputs and investment goods accounted for 69% of Israel's imports, thereby serving as a major source for bolstering the productive capacity of the economy.[4]

The European Union (EU), assisted by geographical proximity and a 22-year old free trade agreement, is Israel's main trading partner. In 1996, the EU purchased 31 % of all Israel's exports and supplied Israel with 49% of its imports.

The United States is Israel's other main trading partner. In 1996, the United States purchased 28% of Israel's exports and supplied 21% of its imports.[5]

Israel's export base is well-diversified, with metals, machinery and electronics accounting for a growing share of total exports. Israel also remains one of the leading centers for diamond cutting and polishing, with diamond exports accounting traditionally for one-fourth of total exports. In addition, Israel exports substantial amounts of chemicals.[6]

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[2] Sugarman, Margo Lipschitz, "High-Tech, Highstakes," *Jerusalem Report*, February 6, 1997, p. 37.

[3] Rosenberg, David. "Hard Times for High-Tech?", *Jerusalem Report*, February 6, 1997, p. 41.

[4] International Monetary Fund. "Israel: Selected Issues and Statistical Appendix," IMF Staff Country Report No. 97/2, February 1997 [hereafter cited as IMF Staff Report], p. 52.

[5] For more detail, see appendix tables 5 and 6.

[6] U.S. Department of State. "Background Notes: Israel, October 1996" p. 2. For more detail, see appendix table 7.

Interventionist Attributes

By tradition, circumstances, and ideology, the government of Israel has played a leading role in developing the economy and in influencing economic activity. When Israel was established in 1948, the economy was primarily agrarian with only a small manufacturing sector. The state possessed minimal natural or financial resources, little economic infrastructure, and few public services. Faced with the daunting task of settling a huge influx of immigrants from Europe and the Middle East who generally lacked savings or skills, Israel's political leadership gained control over a large part of the country's investment resources and economic activity to provide food, clothing, housing, and jobs for its new citizens. Government control of the economy was also prompted by the need to deal with these challenges in a hostile external environment.[7]

A significant part of all business came to be controlled by three sectors: private, public, and Histadrut (the General Federation of Laborers in the Land of Israel). Histadrut, whose membership initially encompassed nearly all the labor force, came to own or control a significant portion of Israeli industry as a result of its vast pension fund holdings.

While significant steps have been taken over the years to reduce the government's high level of intervention in the economy, the Israeli economy retains an interventionist character today. Security challenges, social welfare considerations, and the small size of the economy have served as justifications by Israeli authorities for keeping a sizeable portion of economic activity under government regulation or control or for going slow on reducing the level of intervention.

Government expenditures, which in the 1990s have averaged 46% to 48% of GDP, symbolize the large role government still plays in the economy.[8] Continued ownership or control of approximately 116 companies, with the largest ten companies accounting for over $20 billion in assets, is a second vivid illustration.[9] Other notable manifestations include some 600,000 public sector jobs, which account for 30% of all jobs. An estimated 93% of the land is also owned by the government, a condition that has contributed to rising land and housing prices. And the government still controls or supervises a number of retail prices, such as meat, transportation fares, and medicines. These goods constituted 18% of the consumer price index (CPI) as of August 1996[10]

The government has played a dominant role in capital markets from the beginning due to its need to finance large budget deficits and its interest in channeling the flow of capital within Israel's economy. High levels of spending on civilian services (health, education, and welfare), bolstered by a strong domestic consensus

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[7] Kreinin, Mordechai E. "Israel's Trade Policy Review," In *The World Economy: Global Trade Policy 1996*, Blackwell Publishers, p. 120.

[8] A comparable figure for the United States in recent years is round 20%

[9] See appendix table 8 for more detail.

[10] See appendix table 9 for more detail.

in favor of the "welfare state," and defense have driven the domestic budget deficits historically. By controlling bank and other credit lines and by establishing tax incentives, the government has exercised major influence on the scale and pattern of investment throughout the economy. A high concentration of capital among a handful of large conglomerates continues to stifle competition.[11]

Israel's labor market is affected by structural rigidities and restrictive government regulations. The labor market is dominated by Histadrut, which now represents about 60% of all Israeli workers, including the vast majority of workers employed in the public sector or government-owned enterprises.[12]

Cartels and monopolies, many of which are legal, affect a significant portion of the Israeli economy. The resulting lack of competition in certain sectors is often preserved by a considerable, albeit declining, level of import protection.

Despite having negotiated free trade agreements with the European Union and the United States, the Israeli economy remains relatively protected from imports from generally lower-wage, Asian countries. The protection mainly takes the form of a variety of user taxes and high duties.

Due to these myriad governmental interventions in the marketplace, Israel often is ranked relatively low on various surveys of international competitiveness or economic freedom. Most of these surveys attempt to develop one overall measure of governmental interference in economic activity based on analysis of the state's tax, trade, budget, regulatory, and monetary policies.

Distinctive Attributes

The Israeli economy has several distinctive features. Three of the more prominent ones are associated with high defense requirements, chronic balance of payments problems, and a political system that make economic policymaking more difficult or uncertain.

Since its establishment, Israel has been subject to almost constant hostility from neighboring states. As a result, defense has almost always come first in terms of the overall allocation of resources. Annual defense expenditures have been high compared to other countries both in per capita terms and relative to the size of the economy. In recent years, defense expenditures have declined, but still average around 10% of GDP.[13]

Israel's defense burden can be measured by the budgeted resources diverted to defense that could have been used for other civilian purposes. The defense burden also includes the opportunity cost of labor working for the defense sector that is unavailable to work in the private sector, thereby reducing the economy's potential

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[11] Rivlin, Paul. *The Israeli Economy*, Westview Press, 1992, p.115.

[12] See appendix table 10 for more detail.

[13] IMF Staff Report, p.81.

output. In addition, defense spending has been an important factor behind the size of the state budget and persistent budget deficits.[14]

Israel's precarious security environment has also insured that foreign policy or geo-political considerations are given priority over purely economic policy issues. As a result, sound economic policy decisions (e.g.) to cut government expenditures in order to promote macroeconomic stability) are often given short shrift when the security environment is tense.

Chronic balance of payments deficits are a second distinctive feature of the Israeli economy. Driven by its need to import most all of its energy requirements, most of its raw materials, and considerable weaponry, Israel historically has run merchandise trade deficits. To finance the deficits, Israel has long had to rely on foreign capital transfers via loans, grants, foreign investment, and borrowing. A perennial concern is that rising trade deficits and capital imports together can lead to a precipitous decline in the value of the Israeli currency. This concern, in the past, however, has also been the catalyst for economic policy changes that would avoid a sell-off of foreign currency reserves and a financial crisis.

A third distinctive feature relates to Israel's political system where seats in the 120-member Knesset are allocated according to proportional representation. Any political party that receives 1.5% of the national vote is allocated seats in the Knesset. The effect of this system is to produce coalition governments where the power of small, mostly single issue parties is greatly enhanced. Currently, nine such parties ranging from the ultra-religious to the left-wing peace parties hold almost half the seats in the Knesset while the two main parties (Labor and Likud) combined control a slim majority.[15]

The need for the Prime Minister to consult leaders representing nearly every faction of the governing coalition on most major decisions serves as a formidable constraint on pushing ahead with fundamental economic or structural reform initiatives. A 1996 political reform that provided for the direct election of the Prime Minister arguably has served to reinforce this tendency by encouraging the formation of small parties and by forcing the Prime Minister to cater to the whims of the support groups that elected him.

Within the Israeli government, the Bank of Israel remains the main force supporting macroeconomic stability, particularly low inflation, and liberalization of the economy. Acting as a independent central bank only since the last decade, its willingness to raise interest rates to combat inflation is considered critical. However, a number of political and business leaders have advanced proposals to dilute the

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[14] Pelzman, Joseph. "Israel's Economy," In Israel: A Country Study. U.S. Library of Congress, 1988. pp. 141-176.

[15] Hunt, Albert R. "The Wonders of Israel...Politics and All," *New York Times*. August 28, 1997, p. A15.

independence of the central bank. If passed by the Knesset, most economists fear that stability of the Israeli economy could be jeopardized[16]

Stages of Economic Growth

Since the establishment of the state of Israel in 1948, the economy has experienced three different stages of economic growth and related macroeconomic developments. The first (1948-1972) and third stages (1989-1995) were classic boom periods fueled primarily by rapid increases in immigration that boosted the stock of labor. The third stage (1973-1988) was a period of considerable economic instability and turmoil. The Israeli economy currently may be entering a fourth stage where a combination of problems are raising concerns once again about the stability and future performance of the Israeli economy.

First Two Stages (1948-1972 and 1973-1988)

From 1948-1972, the first 24 years of the state of Israel, the economy grew at a very rapid rate. During this period, real GNP increased at an annual rate of 10.4 percent, one of the highest rates in the world. This high rate of growth allowed for a steady rise in per capita incomes. At the same time, inflation averaged less than 10% on an annual basis.

Rapid increases in both the stock of labor and capital were largely responsible for the rapid growth of the economy. Between 1948 and 1973, the population of Israel increased nearly four-fold, rising from 870,000 to 3.3 million. The growth in the capital stock was even greater, increasing eight-fold from 1950 to 1967.[17]

Between 1973 and 1986, by contrast, the Israeli economy performed very poorly and unevenly. The economic growth rate slowed to an annual average of about 2% per year with no increase in per capita incomes. The rate of inflation skyrocketed, reaching a high of 445% in 1984. And the economy experienced balance of payments crises in 1975, 1983 and 1984/1985 [18]

Three factors — a major increase in defense expenditures following the 1973-74 Yom Kippur War, a world energy crisis, and a sharp increase in expenditures on social welfare — help explain the deterioration in economic performance during this period. In the aftermath of the June 1967 War, defense expenditures between 1970 and 1982 escalated to over 25% of GDP, up from a 10% to 16% of GDP range prior to the war. Sharp increases in oil prices in 1973 and again in 1979 imposed a huge cost on the Israeli economy, estimated at $12 billion or the equivalent of one year's GDP at

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[16]Marcus, Dockser and David Wessel. "Israel's Central Banker Stirs Controversy, New York Times. September 26, 1997, p. A18.

[17] Rivlin, Paul. pp. 6-7.

[18] Pelzman, Joseph. "Israel: The Economy," p. 141

the time. In addition, to deal with rising social unrest, government spending on education, housing, and welfare increased substantially during this period.[19]

The deterioration of the Israeli economy continued in 1985 with hyperinflation and a precipitous fall in foreign exchange reserves. To stabilize the economy, the government in July 1985 introduced an Economic Stabilization Program. The program involved an immediate 18.8% devaluation of the shekel, a freeze on price and wage increases, deep cuts in government expenditures, and monetary restraint.

The stabilization program was dramatically successful. It not only reduced inflation from over 400% in 1985 to around 20% by the end of 1986, but it also laid the foundation for the consideration of additional reforms affecting taxation foreign currency and privatization in the years ahead.[20]

Stage Three (1989-1995)

Beginning in 1989, Israel experienced a huge influx of immigrants, mostly from the former Soviet Union. From 1989-1995, approximately 760,000 new immigrants increased Israel's population from 4.52 million to 5.54 million, a 13% increase. These mostly young immigrants represented according to one analyst "the greatest migration of highly skilled human capital in the twentieth century."[21]

The Israeli government's strategy for immigrant absorption placed primary responsibility on the promotion of private sector employment without direct labor market intervention. Government expenditures for absorption, which averaged approximately 6% annually of the domestic budget, were directed substantially to the construction of public housing. In addition, the government provided Hebrew language and vocational training, as well as loans to new immigrants to start up their own businesses.[22]

The rising supply of labor spearheaded a very rapid economic growth that averaged over 6% in real terms from 1990-95. Real per capita incomes experienced healthy rates of increase during this period as well, rising from an average of $13,977 in 1986-1989 to $16,783 in 1996.[23]

The economic expansion was led primarily by investment that grew at an annual average rate of 16.2 % from 1990-1995, compared to around one-tenth of 1% in the

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[19] Ibid., 143-144.

[20] For an overview of the Israeli economy from 1985-1990, see Wertman, Patricia A. "The Israeli Economy and Its External Relations: An Overview," *Congressional Research Service*, Report 92-276E, February 28, 1992, 48p.

[21] Rosen, Howard. "Policy Parameters," In Reich, Bernard. Securing the Covenant: United States-Israel Relations After the Cold War. Praeger Press, 1995. Pp. 109-128.

[22] White House. Report Pursuant to Section 226 (k) of the Foreign Assistance Act if 1961, as amended, and Section 1205 of the International Security and Development Cooperation Act of 1985 [hereafter cited as the 1996 Loan Guarantee Report]. December 31, 1996, pp. 1-3.

[23] Bank of Israel 1996 Annual Report, Chapter 1, p. 4.

1980s. Initially the investment demand was channeled into construction for new houses, but it later spread to increases in plants and equipment. The new immigrants also stimulated private consumption (expenditures on consumer durables), which increased on average by 7.1% in the 1990s, compared to 5% annual growth in the 1980s.[24]

The impressive growth record was accompanied by favorable developments on the inflation and unemployment fronts. Unemployment fell from a 10.1% average in 1990-91 to 9.0% in 1995, and the numbers of employed increased from less than 1.5 million in 1989 to over 1.8 million in 1995. Inflation, measured by the consumer price index (CPI), dropped from 17.8% in 1990-91 to 10.8% in 1995.

Table 1. Basic Economic Data[a], 1986-95

	1986-89	1990-91	1992-95
Mean population	4,405	4,803	5,327
Population growth rate (percent)	1.6	4.7	2.8
Israeli persons employed ('000s)	1,422	1,535	1,808
GDP (NIS million, 1996 prices)	196,340	223,827	265,683
GDP ($million, 1996 prices)	61,587	70,209	83,339
Per capita GDP ($, 1996 prices)	13,977	14,617	15,630
Growth rate of GDP (percent)	3.7	6.2	6.0
Unemployment rate (percent)	7.1	10.1	9.0
Inflation rate (percent)	18.2	17.8	10.8

[a]Annual averages.
Source: Bank of Israel 1996. Annual Report, p.4

The Middle East Peace process contributed positively to Israel's rapid economic growth during this period as well. Since the Madrid conference in 1991, agreements reached between Israel and the Palestinians and with Jordan allowed the expansion of contacts with countries and companies which once boycotted Israel. The peace process also stimulated tourism, a sector which provides roughly 10% of Israel's gross foreign exchange earnings.[25]

The most important new markets opened to Israel have been in the Far East. Facilitated by the weakening of the Arab boycott, Israeli exports to all of Asia, which now constitute about one-fifth of total Israeli exports, leapt 86% from 1992 to 1995, as compared to an overall growth rate of 45% during that period. The Israeli Finance Ministry calculated that over 60% of the increase in exports in 1994 and 1995 was

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[24] IMF Staff Report, p .40.

[25] U.S. Department of Commerce. "Israel: Commercial Guide," July 1996, p.3.

due to the opening of new markets previously closed to Israeli goods, principally located in Asia.[26]

The fruits of the peace process are also reflected by increases in foreign direct investment flows, with a record $2.2 billion entering the economy in 1995.[27] A growing number of multinational companies, such as Intel, Motorola, and IBM, have established plants and R&D sites, mostly to tap the economy's skill base in science, medicine, and technology.[28]

Stage Four (1996-Present)

Beginning in 1996, the Israeli economy has experienced a slowdown in growth compared to the early 1990s, a rise in the unemployment rate, inflationary pressures, and a growing current account deficit. This combination of problems, which has occurred simultaneously with a slowdown in the immigration rate, has raised some concerns about the stability and the future performance of the Israeli economy.

Growth. Israel's GDP growth rate declined in 1996 to 4.4% from the 7.1% rate in 1995. The drop was mainly due to a sharp decrease in export sector growth and a slowdown in construction (both residential and nonresidential).[29]

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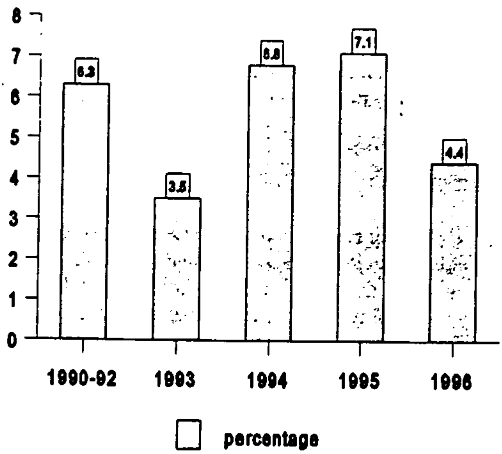
[26] LINK Magazine. "Link's Tour of the New Israeli Economy," found at http://www.link.co.il/privatization/index.htm (as of October 2, 1977).

[27] For the first nine months of 1996, foreign investment totaled $1.9 billion, composed of $1.1 billion of investments in Israeli securities and $875 million of direct investments in Israeli corporations and securities. Cited in Economist Intelligence Unit, 1st Quarter 1997 Country Report on Israel, p. 26.

[28] Passell, Peter. "Despite Welfare State Origins, Israeli Enterprise Blossoms," *New York Times*, June 5, 1997, p. D 2.

[29] Bank of Israel 1996 Annual Report, p.6.

Figure 1. GDP Growth Rate, 1990-96



Source: Bank of Israel 1996. Annual Report.

The slowdown in the export growth rate was concentrated in services. While exports of goods rose by 7.9% in 1996, a rate similar to 1995, services exports fell by about 1% in 1996, compared to a 14.5% rise in 1995. Most of the rapid expansion of goods exports was in high-tech industries such as software and biomedical equipment, while traditional goods exports such as footwear and clothing continued to shrink. A steep decline in tourism, following the terrorist attacks in March 1996, accounted for a large share of the decline in services exports.[30]

The economy has continued to slow down in 1997. During the first six months, it grew at only 1.8% — a rate well below the 4.4% growth in 1996. Slower growth can be expected to have both positive and negative consequences for the economy. On the one hand, it is likely to help moderate inflationary pressures and to reduce the current account deficit through reduced demand for imports. On the other hand, it is likely to lead to reduced government revenues, creating more pressure for significant cuts in government expenditures in order to meet budget deficit targets. In addition, slower growth, combined with a population rising at about 2.5%, means there will be little or no increase in per capita incomes. Such increases are an Israeli government goal in order to attract new immigrants, particularly from Eastern Europe.[31]

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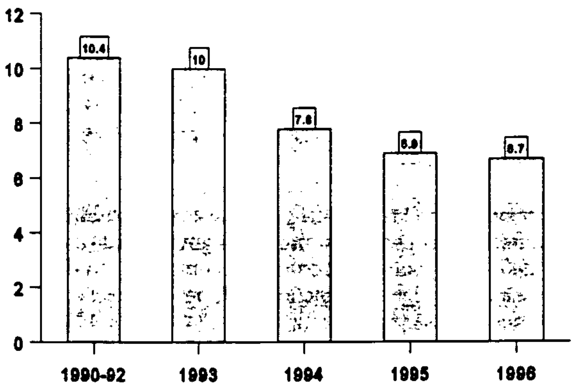
[30] Ibid., p. 7.

[31] Dempsey, Judy. "Netayahu Pledges Cuts and Extra Cash," *Financial Times*, July 12, 1997, p. 4.

Employment. Israel's labor force grew rapidly in the 1990s with the influx of new immigrants. From 1990-1992, the civilian labor force (including foreign workers and workers from the occupied areas) grew by 5.8%. Following a 3.1% rise in 1993, the labor force grew by 5.2% and 6.6% rates in 1994 and 1995, respectively. In 1996 the expansion slowed to 3.4%. Over 2.157 million workers were in the labor force in 1996, up from 2.109 million in 1995.

Despite the increase in the supply of labor, the growth of demand during the 1990s outstripped the supply. This is reflected in declines in the unemployment rate from an average of 10.1% in 1990-91, to 9.0% in 1992-95, and to 6.7% in 1996. During 1997, unemployment is projected to reverse this downward trend by rising to 7.9%[32]

Figure 2. Unemployment Rate, 1990-96



Source: Annual Report.

Regarding the composition of business sector employment, the trend of the previous three years continued in 1996: rising numbers of Israeli and foreign workers and declining numbers of workers from the territories such as Gaza and the West Bank. Israeli workers expanded by 2.8% and documented foreign workers by 40%, but employment of workers from the territories declined by 33%. (The number of registered foreign workers rose form 58,000 in 1995 to 83,000 in 1996, elevating their share to roughly 4% of total employment). This development is related to security events and the closure of the territories early in 1996.[33]

The entry of a rising number of foreign workers has led to downward wage pressures as well as a reduction of jobs in many traditional industries. This development, which has been reinforced by the on-going liberalization of foreign trade barriers, has occurred at the same time that demand for highly skilled labor has

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[32] Bank of Israel 1996 Annual Report, p.4.

[33] Government of Israel website found at: http://www.mof.gov.il/beinle/nutbug1.htm#1.MainTrends (as of October 2, 1977).

soared, causing their real wages and employment to rise. As a result, Israel, is seeing the gap between rich and poor widen in recent years.[34]

Inflation. In 1996, price increases as represented by the CPI rose by 10.6%, slightly surpassing the upper limit of the Bank of Israel's inflation target of 8-10%. This slight inflationary upturn was driven by increases in the price of fruits and vegetables and housing (25% and 14% respectively). Other contributing factors included an expansionary budget policy and low unemployment.[35]

In 1997, inflation has continued to run near the upper limit of the central bank's 7%-10% target zone. As a result, the Bank of Israel announced in August 1997 an increase in the key lending rate it charges commercial banks. This interest rate hike, by 0.7 percentage points to an annualized 13.4%, was the first since July 1996. A continuation of a tight monetary policy, combined with slower growth in 1997, is expected to keep inflation in check.[36]

Given that a large percentage of Israeli wages, contracts, and mortgages are indexed or linked to changes in the consumer price index, lowering the inflation rate to single digits through monetary restraint is quite difficult. The government, however, has tried to lessen this "structural" component of inflation by decreasing the extent to which prices are indexed.

Balance of Payments. Israel traditionally has run a large external trade deficit that largely has been offset by cash grants from foreign governments and individuals. In recent years, the deficit on goods and services has outpaced the inflow of these unilateral transfers, resulting in a significant increase in Israel's current account deficit. In 1995, this deficit reached $3.9 billion, or 4.7% of GDP. In 1996, the deficit widened to $4.4 billion — which represented about 4.8% of GDP. The deficit is large relative to past levels and by comparison with other countries.[37]

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[34] Bank of Israel 1996 Annual Report, pp. 8-9.

[35] The Government of Israel website at http://www.mof.gov.il/beinle/ nutbug1.htm#1.Main Trends.

[36] Dempsey, Judy. "Israel Eyes Broader Economic Horizons," *Financial Times*, August 25, 1997, p. 4.

[37] Bank of Israel 1996 Annual Report, pp. 10-11.

Table 2. Savings, Investment, and the Current Account, 1990-96
(Percent of income, annual rates)

	1990-92	1993	1994	1995	1996
Gross national saving rate	20.5	20.3	18.6	17.8	17.1
Public	-0.6	0.6	0.8	-0.7	-1.7
Private	21.1	19.7	17.8	18.5	18.8
Gross investment	20.8	21.7	21.6	22.1	22.0
Of which Principal industries	12.4	14.7	15.5	14.9	14.5
Transfers on capital account	0.4	0.3	0.3	0.3	0.3
Net balance of payments on current account	0.1	-1.1	-2.7	-4.0	-4.6

Source: Bank of Israel. 1996 Annual Report.

Most of the growth in the deficit was caused by a decline in Israel's savings rate. This rate dropped from an annual average of 20.5% in 1990-92 to an annual average of 17.5% in 1995-96. Low and even negative public savings, reflecting a budget deficit, occurred in 1995 and 1996. At the same time, the investment rate has remained strong in recent years, due largely to a surge in housing and infrastructure outlays.[38]

Israel has faced no problem in financing this deficit, thanks to an upsurge in foreign direct investment, expansion of the number of long-term loans, and to its borrowings under the five-year, $10 billion U.S. loan guarantee program that runs through 1998. Implied capital imports averaged an $6.8 billion in 1995-96, an amount well in excess of the current account deficit.[39]

Nonetheless, the current account deficit is a matter of concern, particularly over time. A rising deficit, combined with an overvalued currency, are often leading indicators of a possible balance of payments or financial crisis. This is a situation that Israel needs to be especially concerned about because it already is heavily dependent on foreign capital to finance its deficit and there is no guarantee that these sources of funding will continue at a reasonable cost forever.[40]

The rise in Israel's current account deficit has caused Israel's net external debt to rise in absolute terms from $16.5 billion in 1990-92 to $20.0 billion in 1996. But due to strong GDP growth, Israel's net external debt has declined from 27.6% of GDP in 1990-1991 to 20.5% of GDP in 1996. The manageability of Israel's debt is

[38] Ibid.

[39] Bank of Israel 1996 Annual Report, p. 11.

[40] Bank of Israel 1996 Annual Report, p. 11, and IMF Staff Report, p. 48.

also manifested by a falling debt service/total export ratio of 13% of GDP in 1996, as compared to 16.9% in 1991.[41]

During 1997, the slowdown in economic growth has helped reduce the current account deficit.[42] This has occurred as home demand for imports has slackened and world demand for Israeli exports has increased due to a continuing depreciation of shekel. A strong export performance is also a key to keeping Israel's debt service payments at manageable levels.

Current Macroeconomic Policy Issues

Israel's current economic problems are fueled in large part by a widening gap between fiscal and monetary policies. While fiscal policy has been expansionary in recent years, monetary policy has been restrictive. This has imposed an economic cost on the country, primarily in terms of a high interest rates. Most experts agree that a major fiscal consolidation or tightening is necessary before monetary policy can be eased. The slowdown in economic growth, however, is placing added pressures on monetary authorities to lower interest rates in order to avoid a domestic recession. The problem is that too large a drop in interest rates could lead to an large outflow of capital, precipitating an abrupt depreciation of the shekel.

Fiscal Policy

Until 1995, the burden of absorbing a large influx of immigrants was accomplished without an expansionary fiscal stance. Although the domestic budget deficit increased from 3.2% of GDP in 1989 to 5.3% in 1991, tight controls on expenditures helped drop the domestic budget deficit steadily to 2.0% of GDP by 1994. But with an election approaching in the fall of 1994, large increases in public sector wages and tax cuts, as well as by receipt of less revenues than estimated, turned fiscal policy expansionary. The result was that, in 1995, the domestic budget deficit reached 3.3% of GDP, well above the 2.75% target established by the 1992 Budget Deficit Reduction Act.[43]

Fiscal policy became more lax in 1996 with the domestic deficit rising to 4.7% of GDP. This deficit also significantly exceeded the deficit reduction target prescribed by law.[44]

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[41] IMF Staff Report, p. 48, and 1997 Loan Guarantee Report, p. 12.

[42] The current account deficit has declined from $3.6 billion during the first six months of 1996 to $2.3 billion during the first six months of 1997.

[43] In addition, the methodology used by Israel in calculating the deficits reportedly underestimates the amount compared to the methodologies used by other industrialized countries. See IMF Staff Report, p. 41.

[44] Bank of Israel 1996 Annual Report, p. 13.

Table 3. Main Indicators of Fiscal Policy, 1990-1996
(percent of GDP, annual rates)

	1990-92	1993	1994	1995	1996
Domestic budget deficit					
Legal limit	6.2	3.2	3.0	2.75	2.5
Actual	4.9	2.4	2.0	3.2	4.7
Total public deficit	4.0	2.3	1.2	3.1	4.2
Domestic public deficit	7.2	4.1	2.4	4.3	5.3
Total net public debt	111.1	100.4	93.7	89.3	89.7
of which Internal public debt	92.5	80.3	74.3	72.8	76.1

For 1992 only.
Source: Bank of Israel. 1996 Annual Report.

The deviation of the actual budget from the deficit target arose again in 1996 on the basis of both an overestimation of domestic tax revenues and failure to cut the rate of spending.[45] As in the case in 1995, more than half of the deficit overrun was caused by revenue shortfalls rather than overspending.[46] The shortfall in revenues, in turn, was attributable to a decline in income and other direct tax collections, as well as to the growing role of foreign workers who are paid in cash.[47] On the expenditure side, large increases in public sector spending occurred prior to the May 1996 election. Particularly noteworthy were rapid increases in both public sector salaries and public sector jobs.[48]

Viewing recent shifts in the composition of expenditures, two developments stand out. The first is that defense spending as a percentage of GDP has declined from around 11.5% in 1992 to just 9.5% in 1996. At the same time, transfer payments to households and nonprofit institutions have increased from 13.5% in 1992 to 15.6% of GDP in 1996. The share in the budget going to non-defense public sector salaries also has risen from 5.1% of GDP in 1992 to 6.3% of GDP in 1996.[49]

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[45] While government expenditures as a % of GDP declined from 48.2% of GDP in 1992 to 46.2% in 1996, revenues also declined from 44.4% of GDP in 1992 to 41.9% of GDP in 1996.

[46] Loan Guarantee Report, 1997, p. 9.

[47] Ibid.

[48] Bank of Israel 1996 Annual Report, p. 13.

[49] Loan Guarantee Report, 1997, 10; IMF Staff Report, tables p. 80-81.

To date in 1997, Israeli efforts to reduce the budget deficit to 2.5% of GDP have proven difficult. In December 1996, the government did get its 1997 state budget approved by Knesset. The initial $56.8 billion budget package included a variety of measures designed to bring the overall deficit back to 2.5% of GDP without raising taxes. But intense opposition to proposed cuts in transfer payments and subsidies, however, forced the Likud-led government to rely on increased taxes to obtain approximately half the proposed reduction in the budget deficit.[50]

Subsequent efforts by the government early in the summer of 1997 to obtain additional expenditure cuts have been thwarted by political pressures to increase spending, particularly for projects favored by minority parties in the coalition. Thus, meeting the budget deficit target could prove difficult again this year as the economy continues to grow more slowly.

The 1997 economic slowdown increases the likelihood that revenues will run below projected levels. As the baseline 1997 budget assumed an economic growth rate of 4%, actual growth at around 2% could translate into a revenue gap of at least $425 million.[51]

The slowdown may also increase political opposition to budget cuts. While economic theory suggests that significant budget cuts could facilitate lower interest rates and a lower exchange rate that, in turn, could generate increases in domestic production, cuts in government spending are traditionally unpopular among influential interest groups.

Monetary And Exchange Rate Policies

Since 1985, the main objective of Israel's monetary and exchange rate policies has been to reduce inflation to levels prevailing in most advanced, industrialized countries. The central bank's principal tools are control over the money supply and interest rates.

As Israel's fiscal policy turned expansionary in 1994, monetary policy turned restrictive. Throughout 1995 and 1996, a tight monetary policy has persisted with the Bank of Israel holding real interest rates at 4 to 5 percentage points above the underlying rate of inflation. Combined with an attempt to maintain a downward, crawling peg exchange-rate mechanism, this policy has had a number of side-effects.

First, high real domestic interest rates in 1995 and 1996 encouraged a surge in short-term capital inflows. By the end of 1996, short-term deposits had boosted M2 (a monetary aggregate that includes short-term deposits) to a level that exceeded foreign reserve holdings threefold. This development raised concerns that if interest rate spreads between Israel and other countries narrowed, a huge supply of shekels

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[50] Economist Intelligence Unit, Israel: 1st qtr 1977 Country Report, p. 13.

[51] Schmemann, Serge. "In Fight Over Privatization, Netanyahu Wins A Round," *New York Times*, July 24, 1997, p. 3.

could be dumped on the market as domestic agents switched to foreign currency assets.[52]

Second, the large-scale capital inflow has led to a moderate (5% since 1993) real appreciation of the shekel. While a stronger currency helps in the fight against inflation, it is controversial in the business community because it increases the price of Israeli exports.

Third, the tight monetary policy and accompanying high interest rates have encouraged Israeli firms to increase substantially their use of foreign denominated credit. The rising demand for foreign currency borrowing has forced the central bank to engage in activities to soak up the supply of shekels it has pumped into the economy in order to prevent the monetary base from growing and undercutting its inflationary targets. This process, know as sterilization, has imposed a "quasi-fiscal" cost on both the Bank of Israel and the public.[53]

In June 1997, the Bank of Israel acted to counter the negative pressures from capital inflows and the sterilization requirements. Exchange controls were further liberalized to allow provident and mutual funds more freedom to invest abroad and the exchange rate band was widened to make speculation riskier. The Bank also dropped its main lending rate from 13.9% to 12.7% after the cabinet agreed to cut the deficit by an additional 600 million shekels.[54]

Monetary authorities hope that the interest rate reduction will reduce the demand for shekels in the foreign exchange market and allow some real devaluation of the shekel to take place gradually. Their concern is that a diminution of interest rate spreads between Israeli and foreign markets could prompt a large outflow of foreign capital that, in turn, could lead to a precipitous depreciation of the shekel. Without substantial cuts in budgetary expenditures, however, monetary authorities can be expected to maintain a very cautious policy towards any further interest rate reductions.

Structural Reforms — Recent Developments

Attainment of Israel's macroeconomic objectives — particularly rapid economic growth — can also be facilitated by a range of structural reforms that would reduce the level of government intervention in the economy. The government of Israel has for a long time pursued these structural reforms not only to improve the government's finances, but also to promote a more efficient use of the economy's resources. Given the likelihood of a slower growing labor force, the main spur to the rapid growth in the early 1990s, productivity increases brought about by structural reforms that enhance efficiency may become even more critical in the future.

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[52] Economic Intelligence Unit, Israel: 1st Qtr 1997 report, p. 14.

[53] Bank of Israel 1996 Annual Report, p.18.

[54] Dempsey, Judy. "Israel Foreign Exchange to be Reformed, "Financial Times, June 20, 1997, p. 22.

Since 1985, the government's record on implementing structural reforms has been varied. On the one hand, limited progress has been made in the privatization of state-run enterprises, and the deregulation of markets for capital, labor, and land. On the other hand, more significant progress can be discerned in efforts to liberalize foreign trade barriers and to interject more competition into specific sectors that have dominated by a few large conglomerates or state-run enterprises. According to many observers, more rapid, sustainable, and non-inflationary growth.

Privatization

At the request of the Israeli government in 1987, the First Boston Corporation produced a strategic privatization plan. At that time, the government owned a stake in some 160 companies whose output accounted for a bout 10% of GDP. The plan, which was adopted by the government in 1988, identified 75 commercially oriented companies that could be sold both through direct sales to inventor groups and public equity offerings on the Tel Aviv Stock Exchange (TASE). In addition, 30 companies were identified as prime candidates for privatization within the next five years.[47]

Privatization either through direct sales to investor groups or through public offerings is desirable not only because it could enhance the economy's competitiveness, but it could also attract more foreign direct investment. In addition, sales of state assets could help the government meet its deficit reduction targets.[48]

Since the privatization program began, Israel has raised about $2 billion of an expected $5 billion from sales of state-owned companies. In addition, sales of shares in government-owned banks have raised about $2.9 billion compared to an expected $4.5 billion. As shown below, revenues from privatization has varied greatly from year to year.

Table 4. Revenue From Privatization
(millions of dollars)

1986 through 1990	423
1991-1992	1,025
1993	1,241
1994	207
1995	535
1996	201
1997 (through September)	2,370

Source: Government Companies Authority

A number of factors are often cited for the relatively slow pace of the privatization process. One important factor concerns the question whether the government should restructure industries before privatizing or should privatize enterprises before restructuring. A potential problem is that if pro-competitive structural reform is not implemented prior to privatization, the result could be the substitution of a private monopoly for a public one. Other factors include lack of political will, resistance from unions and management, and depressed conditions in the Israeli stock market.[55]

At present, the government retains control over some 116 companies. About half of these companies are commercially oriented (such as tourism), and half provide public services (such as airports).

In July 1996, Prime Minister Netanyahu promised to "privatize everything in sight". As a sign of his intention, he relocated the privatization authority from the Ministry of Finance to the Office of the Prime Minister.[56] In January 1997, a Ministerial Privatization Committee approved a limited plan that called for 12 government corporations to be sold in 1997. The leading candidates include: Bezeq, the Israeli telephone company; Zim Israel Navigation, a shipping company; El Al, the national airline; and Israel Chemicals.[57]

The government's efforts to carry out this plan have been met with predictable resistance by the unions and workers. The sale of 12.5% of Bezek's stock to Merrill Lynch for $250 million, for example, prompted a one-day general strike on July 24, 1997. This strike, which involved over 60,000 workers, disrupted telephone services and halted all outgoing flights from Ben-Gurion International airport. Unable to block the sale, Histadrut may have called the strike to negotiate maximum benefits for any workers that might lose their jobs as a result of the privatization.[58]

Despite organized resistance, the government raised over $2.3 billion in revenues from its privatization efforts in 1997 (through September). In addition to successful offerings on Bezek and Israeli Chemicals, the government sold the country's largest bank, Bank Hapoalim.[59]

Capital Markets Reforms

By imposing barriers to investment abroad, mandatory purchases of government securities by institutional investors, and high reserve ratios, the Israeli government historically has played a dominant role in the allocation of credit. The government has also played a dominant role in the banking system — a role that was solidified by a 1983 bank scandal that led the government to take over the country's three largest banks.

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[55] Dempsey, Judy. "Rough and Smooth on the Israeli Road to Privatization," *Financial Times*, January 30, 1997, p. 10, and IMF Staff Study, p. 18.

[56] Some observers believe that this change does little, if anything to insulate the privatization process from "politics".

[57] Rosenberg, David. "With A Whimper," *The Jerusalem Report*, February 20, 1997, p. 42, and The Economist Intelligence Unit, 1st Qtr. 1977 report, p. 14.

[58] Schmemann, Serge. "In Fight Over Privatization, Netanyahu Wins A Round," p. 3.

[59] Rubin, David. "Growing On Ingenuity," *Journal of Commerce*, July 28, 1997, p. 9A.

In recent years, Israeli capital markets have been liberalized by reducing the government's once dominant involvement in capital allocation and the banking system. Bank reserve ratios and requirements to hold government paper have been reduced, and directed credit schemes have been canceled. A number of restrictions placed on Israeli residents to borrow from abroad have also been lifted.

Despite the progress made, capital markets remain characterized by considerable government intervention and subsidization. A variety of regulations and restrictions affect the portfolio allocations of institutional investors and private savings. These include a complex system of taxation of different assets and the issuance of government bonds with guaranteed real rates of return. In addition, the Israeli capital market lacks a number of financial instruments found in other industrialized countries such as corporate bond issues and simple fixed-income money market certificates. As a result, the flow of funds to the private sector remains distorted.[60]

In July 1996, a committee (chaired again by Mr. Brodet) was established to explore structural reforms of the capital markets. The committee identified five major problems: absence of long-term institutional investors; high degree of concentration; tax discrimination between investors and savers; lack of regulation of financial agents; and a limited supply of stocks. Recommendations centered on ways to encourage long-term private savings, attract more investors into stock and bond markets, and make more funds available for mortgage lending. In the fall of 1996, the Knesset voted to adopt only part of these recommendations, while deferring action on proposals affecting short-term savings and pension fund reform.[61]

Labor Market Reforms

Israel's labor market historically has been relatively inflexible due substantially to a wage setting system and a minimum wage law. In regard to wage settlements, Histadrut (the huge and powerful labor federation) negotiates sector and industry wage agreements with the government and the organization of private sector employees. The agreements reached constitute a framework of wage scales for the different sectors of the economy and, with occasional changes of detail, also provide for automatic payment of a cost-of-living allowance as compensation for inflation.[62]

A minimum wage law, enacted in 1987, further reduced labor market flexibility. The law establishes a minimum wage equivalent to 45% of the average wage, and it is adjusted semi-annually as the average wage changes. Histadrut has vigorously opposed efforts to make adjustments in the law.[63]

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[60] IMF Staff Study, p. 21.

[61] Rosenberg, David. "Brodet's Mini-Market Reform," *The Jerusalem Report*, October 17, 1996, p. 44, and IMF Staff Report, pp. 24-25.

[62] Israeli Ministry of Foreign Affairs. Found at http://www.Israel-mfa.gov.il/ facts/ econ/fecon7.html.

[63] U.S. Agency for International Development. Report on Economic Conditions in israel: 1992-1993, January 5, 1994, p. 13.

More flexible labor markets, by allowing downward pressure on wage rates and unit labor costs to work their way through the economy, would help create employment and would enhance the overall efficiency of the economy. Due to the influx of new immigrants and foreign workers (many of whom take non-union jobs), and to changes in the wage bargaining process, however, the labor markets arguably have become more flexible in recent years.

The impact of a growing labor force can be seen in terms of minuscule real wage increases for non-public sector workers from 1989-1995. During this period, real wages have declined for four of the seven years. And in the years when real wages have risen, the increases have been small (1.8% in 1992, 0.3% in 1993, and 0.2% in 1995).[64]

Structural changes in the wage bargaining process may have contributed to real wage restraint in the business sector as a smaller share of the wage bill is now negotiated at the national level. With more freedom in wage bargaining at the local level, firms may have been able to negotiate wage settlements more in line with their ability to pay.[65]

Significant rigidities in the heavily unionized and regulated labor market, however, persist. The decline in real wages in the business sector has been more pronounced in the less-heavily unionized services sector of the economy, such as construction. And in contrast to the real wage declines in the business sector from 1989-1995, real wages of public sector employees increased on average by 2.5% annually. This gap between public and business sector wages continues to blunt the movement of labor from the public to the private sector. In addition, it is uncertain how a slower growing labor force will affect wage flexibility in the future.

Foreign Trade and Currency Reforms

In an effort to increase domestic competition and to expand exports, Israel has opened its economy increasingly to foreign trade. During the 1970s and 1980s, Israel substantially liberalized its trade barriers to imports from the European Union (EU) and the United States — trading partners that supply Israel with bulk of its imports. Within the context of its free trade agreements (FTA) with the European Union and the United States, Israel eliminated, or will eliminate, tariffs on the bulk of its imports from the EU and the United States. Israel has also signed agreements with a number of Scandinavian and Eastern European countries that are essentially equivalent to its FTA with the EU, as well as an FTA with Canada in January 1997.

Beginning in 1991, Israel began to gradually liberalize trade with "third countries," namely those in Latin America, Asia, and Eastern Europe, not covered by free trade agreements. Nearly all quantitative restrictions on non-agricultural products were initially replaced with tariffs ranging from 20% to 75%, with higher tariffs for such products as wood and textiles. In 1992, maximum tariffs were reduced to 60%

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[64] See appendix table 7 for more detail.

[65] Israeli Ministry of Foreign Affairs website op. cit.

for most products and to 110% for wood and textiles. All tariffs were reduced to maximum rates of 8% for raw materials and 12% for finished and intermediate goods by September 1997. However, tariff reductions on some traditional manufactures (e.g.) wood products, footwear, textiles and clothing) will not be implemented until later.[66]

While FTA's and unilateral initiatives, as well as membership in the World Trade Organization, have substantially reduced tariff barriers between Israel and its major trading partners, significant non-tariff barriers remain. These include high purchase taxes on luxury goods, artificial customs uplifts, and quotas on agricultural products. As is the case worldwide, a number of these remaining barriers protect local producers.[67]

Since 1985, the Israeli government has substantially liberalized a once rigid system of foreign exchange controls. In particular, reserve requirements on domestic foreign-currency deposits have been significantly lowered in recent years.[68]

The government has also taken a number of steps designed to make the shekel fully convertible. In support of this objective, the government recently lifted several restrictions on Israeli companies' investing abroad. The measures will also eliminate curbs on the foreign activities of Israeli banks and provident funds. Restrictions limiting the amount of foreign currency individuals may purchase for travel abroad ($1,000) and on pension funds from buying foreign securities, however, remain.[69]

Other Reforms

Since the late 1980s, the Israeli government has tried to increase competition throughout the economy by lifting, streamlining, or reducing burdensome regulations. The objective of the reforms has been not only to enhance the overall efficiency of the economy, but also to reduce prices to consumers. Reforms have cut across a broad spectrum of different sectors, including telecommunications, energy, and transportation. Initial steps have also been taken to make the market for land more efficient and to reduce subsidies to the business sector. In general, steps that have been either proposed or implemented represent modest progress towards realizing Prime Minister Netanyahu's goal of "massively" deregulating the Israeli economy.

In the telecommunications sector, the monopoly status of Bezek is being gradually eroded. The process began in 1994 when a second operator was allowed to compete with Bezek for cellular phone service. In the summer of 1997, two new companies (one backed by Sprint) began providing service on international calls. By the end of 1977, new tenders in the telecommunications field are expected for a third cellular telephone operator and for allowing broadcast satellite TV to compete with

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[66] Loan Guarantee Report, 1997, p.14.

[67] IMF Staff Study, p. 26.

[68] IMF Staff Report, p. 25.

[69] Dempsey, Judy. "Israel Eyes Broader Economic Horizons," p. 4.

cable. Concurrently, Bezek has attracted substantial private sector investors, including Merill Lynch and a British company.[70]

Regarding the transportation sector, the government recently approved a plan to open several intercity bus routes to competition and to license one additional baggage handling company at Ben-Gurion airport. And in the energy sector, the government is considering a proposal to increase the number of gas stations and to reduce the control of the major fuel chains over individual station operators.[71]

In 1994, the Israel Lands Administration (ILA), which administers the usage of nearly all land through leases, initiated a process to deregulate and privatize its activities. Contracts to lease, plan, and develop land for residential purposes are now offered through public tenders, resulting in more than 400 projects being launched outside the ILA. Despite these reforms, a more streamlined approval process for building permits and a greater number of tenders for public lands for housing construction could help bring down high housing costs.[72]

The government of Israel has also tried to reduce as well as restructure subsidies provided under the 1953 Capital Investment Encouragement Law. The restructuring has focused on directing economic incentives to promote investment in human capital and research and development, as opposed to a previous concentration on subsidies for the building of factories and the purchase of capital equipment.[73]

Outlook

The potential strength of the Israeli economy has increased in recent years due to a number of factors. These include a skilled and highly educated labor force, a growing and dynamic high-technology sector, and an economy that increasingly is integrated with other major world trading powers. To realize its economic potential in the medium-term, as well as to avoid any possible financial crisis, there appears to be broad agreement among Israel's policy elites about the proper course of action.

First and foremost, a cut in government spending is advocated by many in order to increase domestic savings. This would not only forestall any potential balance of payments problems by curbing any rise in Israel's persistent high reliance of external resources, but it would also help fund investment-led growth. Meeting the domestic deficit reduction target for 1997 and beyond would also reduce the burden on monetary policy in stabilizing the economy, and contain the possibility of an escalation in inflation. In addition, containment of generally non-productive expenditures (some business subsidies and tax preferences, transfer payments) could free up domestic resources for necessary investments on infrastructure.

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[70] Rubin, David. "Growing On Ingenuity," p. 9A.

[71] Economist Intelligence Unit, 1st Qtr 1997 report, p. 21.

[72] IMF Staff Study, p. 28.

[73] Economic Intelligence Unit, 1st Qtr., 1997, p. 13.

The acceleration of significant structural reforms could also complement efforts to promote economic growth by generating a more efficient and productive use of the country's resources. A more rapid program for privatizing state enterprises could free up resources (both capital and labor) that could be employed more efficiently by the private sector, and attract more foreign direct investment. Reforms promoting greater competition could improve productivity growth.

Despite an apparent consensus on the proper policy actions that appear most supportive of macroeconomic stability, implementation is far from certain. Formidable internal and external obstacles could continue to thwart movement in this direction.

Internally, Israel's political system tends to result in coalition governments where the majority party is hampered in implementing its preferred economic policy by competing claims from small coalition partners. As their support is necessary for the government to continue in power, small parties ranging from ultra-religious to left-wing pro-peace parties tend to predicate continued participation in coalition governments on the direction of government funds into their own preferred projects. As a result, announced economic policies and goals continually conflict with political promises.[74]

In the current Likud-led coalition, for example, Prime Minister Netanyahu agreed at a special cabinet meeting held in June 1997 to cut an extra $168 million from this year's budget to order to meet the deficit reduction target of 2.8% of GDP. Since then, Mr. Netanyahu has renewed his pledge to make the cuts while at the same time promising his coalition partners substantially more funds for their favorite projects. Similarly, Mr. Netanyahu's need to consult leaders representing nearly every faction of his coalition on most major decisions serves as a formidable constraint on pushing more forcefully ahead with a sweeping structural reform initiative.[75]

A larger unknown is the commitment of the two major parties, Likud and Labor, to implementation of budget cuts and more rapid structural reforms. Both parties have sizeable constituencies in favor of maintaining the current system and blocking real reforms. Thus, in the event that Likud and Labor ever formed a national unity coalition, it is debatable how much of a difference this could mean in terms of economic policymaking.[76]

Some observers maintain that any push for serious reform is undermined by the considerable amount of foreign aid Israel receives. This view is that the aid eliminates

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[74] Murphy, Emma. "Structural Inhibitions To Economic Liberalization In Israel," *Middle East Journal*, Volume 48, No.1, Winter 1994, p. 80.

[75] Dempsey, Judy. "Netanyahu Pledges Cuts and Extra Cash." Financial Times, July 12-13, 1997. p. 4.

[76] Miller, Ed. "Sharansky Will Lead Fight for Economic Reform in Israel," Metro West Jewish News, Vol. L, No. 23, June 6, 1996, p. 34.

any real incentives as well as the necessity for the government of Israel to push ahead with politically sensitive and economically painful reforms.[77]

Externally, any serious effort to strengthen the economy through increased international linkages will be affected by the peace process. When the future of the peace process is in doubt, there is greater likelihood that Israel's economy will be adversely affected on the margins by declining investor confidence. If the stability of the region is viewed as problematic, foreign investors are likely to hold off on making any major new investments, and international financial markets are more likely to downgrade Israel's credit rating.

[77] Rabushka, Alvin. "Scorecard on the Israeli Economy: A Review of 1996," Institute for Advanced Strategic and Political Studies, Jerusalem, and Washington, D.C., March 1997, and Kontorovich, E.V. "Israel Needs Help to Kick the Subsidy Habit," *New York Times*, July 17, 1997, p. A 22.

Statistical Appendix

Table 5. Israel: Destination of Exports, 1989-96

(Percent of total)

	1989	1990	1991	1992	1993	1994	1995	1996
Exports	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
European Community	31.8	34.9	34.3	33.6	29.6	28.4	30.5	31.1
Belgium-Luxembourg	4.9	5.7	5.9	5.2	5.5	5.5	5.4	5.4
Denmark	0.2	0.3	0.3	0.3	0.2	0.2	0.3	0.2
France	4.0	4.7	5.1	4.5	3.9	3.5	3.6	3.6
Germany	4.7	5.8	6.3	5.7	5.3	5.0	5.1	5.3
Greece	1.2	0.9	0.9	0.8	0.6	0.6	0.9	0.8
Ireland	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3
Italy	3.8	4.2	3.8	3.4	2.9	3.0	2.9	2.9
Netherlands	4.4	4.4	3.7	3.7	3.7	3.6	4.2	4.8
Portugal	0.2	0.3	0.3	0.3	0.3	0.2	0.2	0.3
Spain	1.4	1.4	1.6	1.8	1.4	1.4	1.6	1.7
United Kingdom	6.7	7.0	6.3	7.6	5.6	5.1	6.1	5.8
Japan	6.8	7.3	6.1	5.3	5.2	6.0	7.0	6.4
United States	29.8	28.8	29.7	29.7	31.3	31.6	30.2	28.2
Canada	1.0	0.8	0.8	0.6	0.7	0.6	0.6	0.5
EFTA[1] countries	4.1	4.2	3.9	3.1	3.0	3.4	3.1	2.9
Other countries	26.5	24.0	25.1	27.7	30.1	30.0	28.6	30.9

Sources: International Money Fund. "Israel: selected Issues and Statistical Appendix," IMF Country Report NO 97/2, February 1997. [hereafter cited as IMF Staff Report] p.95

[1] In 1995, Austria, Finland, and Sweden moved from the European Free Trade Area to the European community. In this table they are still classified under EFTA to enable a comparison with previous years.

Table 6. Israel: Origin of Imports, 1989-96
(Percent of total)

	1989	1990	1991	1992	1993	1994	1995	1996[1]
Imports	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
European Community	47.1	49.3	47.5	48.7	49.2	51.0	47.7	48.6
Belgium-Luxembourg	14.2	13.2	11.1	12.6	12.4	12.7	11.8	10.9
Denmark	0.4	0.4	0.5	0.7	0.7	0.6	0.6	0.6
France	3.8	3.9	4.3	4.1	3.8	4.5	4.0	4.1
Germany	10.1	11.7	11.6	11.8	10.4	10.4	9.1	9.0
Greece	0.3	0.3	0.3	0.4	0.4	0.5	0.5	0.5
Ireland	0.2	0.3	0.3	0.3	0.3	0.4	0.6	0.6
Italy	5.4	6.1	6.5	6.9	7.3	7.8	7.6	8.0
Netherlands	3.2	3.4	3.4	3.2	3.4	3.3	3.3	3.3
Portugal	0.2	0.3	0.3	0.3	0.7	0.5	0.3	0.4
Spain	1.0	1.0	1.0	1.1	1.0	1.7	1.8	2.1
United Kingdom	8.2	8.6	8.3	7.2	8.7	8.7	8.0	9.2
Japan	2.5	3.6	4.4	5.3	5.1	4.0	3.2	3.7
United States	16.7	17.8	19.3	17.0	17.4	17.9	18.1	21.2
Canada	0.6	0.9	0.8	0.6	0.5	0.7	0.8	0.6
EFTA[2] countries	10.7	11.4	10.9	9.4	10.2	9.1	8.8	8.4
Other countries	22.4	17.1	17.1	19.0	17.6	17.2	21.4	17.5

Sources: IMF Staff Report, p. 92

[1] May.

[2] In 1995, the European Free Trade Area countries moved to the European Community. In this table, they are still classified under EFTA to enable comparison with previous years.

Table 7. Israel: Commodity Composition of Exports, 1991-96
(In percent)

	1991	1992	1993	1994	1995
Agricultural products	5.8	4.5	4.0	3.7	4.2
Citrus fruit	1.4	0.9	0.9	0.8	1.2
Other fruits and vegetables	1.5	1.1	1.0	0.9	1.0
Other	3.0	2.5	2.0	2.1	2.0
Industrial products (excl. Diamonds)	69.7	70.6	71.8	71.0	69.6
Ores and minerals	2.7	2.4	2.0	2.1	2.2
Food (excl. beverages and tobacco	4.7	4.4	3.9	3.5	3.5
Textiles (excl. clothing and leather)	7.2	7.4	6.4	6.1	5.9
Other light industry products	8.7	9.4	8.6	8.2	8.9
Chemicals	13.6	13.0	13.8	13.4	13.4
Metals, machinery and electronics	32.2	33.3	36.5	37.1	35.2
Diamonds	24.4	24.9	24.2	25.3	26.2
Total	100.0	100.0	100.0	100.0	100.0

Sources: IMF Staff Report, p. 93

Table 8. The Largest Government Companies as of December 31, 1995
(in millions of U.S. dollars)

	Total Assets	Total Revenues	Percentage Direct and indirect Government Ownership
The Israel Electric Corporation	8,651	2,452	100
Bezeq - The Israel Telecommunication Corporation	4,370	2,283	77
Israel Chemicals	2,614	1,387	48
Mekorot - Water Corporation	1,861	427	100
Israel Aircraft Industries	1,599	1,394	100
Oil Refineries	1,218	1,909	74
El-Al Israel Airlines	1,072	1,235	100
Israel Military Industries	496	440	100

Source: IMF Staff Report, p. 34.

Table 9. Regulated Prices in the Consumer Price Index
(as of August 1996)

	Weight (out of 1000)		Weight (out of 1000)
A. Controlled prices		B. Prices under supervision	
Public bus transportation	14.7	Flour	1.5
Meat	7.8	Margarine	0.8
Municipal taxes	20.0	Yoghurt	5.7
Electricity (for domestic use)	18.4	Bread	9.0
Water (for domestic use)	8.6	Milk	7.6
Education fees	22.7	Cream	1.1
Sick Fund services	8.1	Butter	0.5
Train and domestic flight tickets	0.3	Cheese	9.8
Phone services	20.3	Refrigerators	5.0
Mail services	0.5	School books	4.4
Total	121.4	Medicines	4.2
		Gas (for domestic use)	3.2
		Oil and fuel (for domestic use)	0.4
		Taxi rides	3.4
		Total	56.6

Source: IMF Staff Report, p. 39.

Note: Price controls on most of Israel's dairy products were lifted on June 12. 1997.

Table 10. Israel: Labor Market Indicators, 1977-95[1]

		Average			Percentage change							
	Average 1995	1977-80	1981-85	1986-88	1988	1989	1990	1991	1992	1993	1994	1995
Israeli population of working age	3,903.4	2.3	2.0	1.9	2.0	2.0	3.9	7.1	4.3	3.0	2.9	3.0
Israeli civilian labor force	2,100.4	3.0	2.2	2.4	3.9	3.2	2.9	7.3	4.9	4.8	4.3	3.5
Total Israelis employed	1,968.1	2.7	1.7	2.5	3.5	0.5	2.1	6.1	4.2	6.1	6.9	5.2
Public services	545.0	4.5	2.0	1.4	4.2	1.9	2.3	6.6	3.2	3.5	4.8	4.0
Business sector	1,423.1	1.9	1.7	2.9	3.2	0.0	2.0	5.9	4.7	7.2	7.7	5.6
Workers from Administered areas	60.0	6.1	3.0	9.3	0.4	-4.1	2.7	-9.2	18.1	-27.3	-16.7	-14.3
Foreign workers	58.0											
Total employed	2,086.1	2.7	1.9	2.7	3.3	0.2	2.2	5.1	5.0	4.9	6.4	5.9
Memorandum items:[2]												
Participation rate	53.8	49.4	50.0	50.8	51.4	52.0	51.5	51.7	52.0	52.9	53.6	53.8
Unemployment rate	6.3	3.8	5.4	6.5	6.4	8.9	9.6	10.6	11.2	10.0	7.8	6.3

Source: IMF Staff Report, p. 59.

[1]Beginning in 1985, the data are based on the 1983 census and correspond to the population aged 15 and over. Prior to 1985, the data correspond to the population aged 14 and over.

[2]For Israeli population.

Table 11. Israel: Real Wages, Labor Costs, and Productivity, 1988-95
(Percentage change)

	1988	1989	1990	1991	1992	1993	1994	1995
Real wages per employee post[1]								
Total economy	6.0	1.3	-1.0	-3.0	1.2	0.6	2.3	2.1
Business sector								
Real consumption wages	4.7	-1.7	-1.4	-5.2	1.8	0.3	-0.4	0.2
Real production wages	9.0	1.4	0.4	-4.8	-6.1	...	...	...
Public Sector	9.8	0.3	0.1	1.6	-0.4	1.1	9.8	5.6

Sources: IMF Staff Report, p. 61

[1]Real wages in the public sector and real construction wages in the business sector are deflated by the consumer price index; real production wages are deflated by the implicit price index of business sector net domestic product at factor cost.

TRENDS IN ISRAEL'S DEFENSE BUDGET THE GROWING THREAT POTENTIAL VS. THE DIMINISHING RESPONSE CAPACITY

PRESENTED BY MARTIN SHERMAN

BEFORE THE

JOINT ECONOMIC COMMITTEE

October 21, 1997

TRENDS IN ISRAEL'S DEFENSE BUDGET THE GROWING THREAT POTENTIAL VS. THE DIMINISHING RESPONSE CAPACITY

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EXECUTIVE SUMMARY

The paper analyzes the growing divergence between Israel's defense expenditures over the last decade, and the potential threat likely to face the country in the foreseeable future. It points to the fact that although there has been an ever-increasing build-up of armaments ranged against her, Israel's policy makers have allocated ever-decreasing resources towards developing an adequate response to contend with it - both in absolute (constant dollar) terms and in relative (proportion of the GDP) terms. Attention is focused on the ongoing deterioration in crucial elements of the Middle Eastern military balance against Israel. Such deterioration has occurred both in terms of quantity and quality of the weapon systems in the hands of the Arab armies likely to take part in future conflicts against the Jewish state. Several policy-oriented implications of the analysis are examined. The resultant challenges and caveats for Israeli policy makers are discussed, as well as some of the possible detriments for the USA which are likely to arise from Israeli under-spending on national defense.

Dr. Sherman acted as a ministerial advisor in the 1991-92 Shamir government. He also served for seven years in various defense related capacities and now teaches political science at Tel Aviv University. He is the author of two forthcoming books on international and Middle Eastern conflicts (Macmillan, UK).

INTRODUCTION

On July 30th, 1997, the Israeli press gave prominent coverage to a report by a Knesset sub-committee which investigated the combat-readiness of the IDF (Israel Defense Forces). The report painted a dismal picture of a military ill-prepared and ill-equipped for the contingency of war. There was a wide-spread consensus across the political spectrum as to the seriousness of the situation. Senior Knesset members from both the Labor-led opposition and the Likud-led coalition concurred as to the accuracy of the findings and the severity of the problem they imply. There also appeared to be wide-spread consensus as to the underlying cause for the disturbing state of affairs. This was diagnosed as the prolonged government policy of defense budget austerity which has precluded the adequate acquisition of resources required to contend with the imminent military challenges of the future.

Precisely this diagnosis was expressed in the *Hebrew Daily* "Yedi'ot Aharonot" (7. 30. 97), by Israeli defense minister, Yizhak Mordechai, who claimed that over the past years, "gaps" have opened up between the national defense requirements and means allotted to meet them. According to Mordechai, there is now a pressing need to bridge these gaps.

The primary purpose of national defense expenditures is to provide a country with the capacity to contend with potential strategic dangers - preferably by means of deterrence, but if necessary, by the actual use of military force. Accordingly, an increase in the level of such potential danger should induce a commensurate increase in defense expenditures. Conversely, when the danger is perceived to recede, a corresponding decrease in defense expenditures is appropriate.

Thus, for example, this principle manifested itself with the collapse of the Soviet empire and the dismantling of the Warsaw Pact. In the wake of these events, the defense expenditures of most NATO member states dropped significantly over a short period of time, eventually leveling off at 1% to 3% of GDP.

History has shown that leaders have disregarded this principle at their peril. In more than one instance such remissness has undermined their ability to deter aggression, exposing their country and their people to the ravages of war. The most prominent examples of such cases were those of France and Britain prior to the Second World War. While Germany embarked on a program of massive military reconstruction, the British and French defense expenditures diminished to no more than a few percent of the GNP. The result was two years of military defeat in the battlefield. Historian Martin Gilbert writes of the British disregard of the growing German rearmament and the blatant threat it entailed, as "a strange ...example of the power of self-deception that Englishmen could ignore, or try to explain away, the views which Hitler had taken such pains to express".[1] The tide of battle began to turn only with the entry of the USSR and the USA into the war, radically tilting the military balance in favor of the Allies and against the Axis powers.

In the context of the Mid-East conflict, the escalation of potential threat to Israel over the last decade, on one hand, and the erosion of the response that Israel has provided to deal with this threat in terms of its defense expenditures, on the other hand, is strongly reminiscent of the ill-considered reaction of France and Britain to German rearmament in the 1930's - although admittedly the disparity has not yet reached the same degree of gravity.

However, in contrast to the Allies in the Second World War, Israel cannot allow itself the "luxury" of prolonged military reverses until salvation by a third party. For it is highly unlikely that any such third party salvation would be forthcoming, at least in terms of active participation in large scale military combat. Thus, in the event of war, Israel must overcome its enemies alone, and as rapidly as possible. Accordingly, her armed forces must maintain maximum ongoing combat readiness at all times. Failure to comply with this prescription might well endanger the very existence of the Jewish state.

In certain respects, present Israeli complacency may be likened to that which prevailed in the country prior to the combined Arab offensive in October 1973. Former president, the late Chaim Herzog, indicted the myopic policies adopted at that time and, in referring to the unmistakable Egyptian preparations for battle under Sadat, he remarked that '[s]eldom has a leader of a country bent on war enunciated so clearly his intentions to the world and to all parties concerned'.[2] The Israeli leadership would do well to heed the errors of the past, for the country - and in many respects, its allies - can ill-afford their repetition in the future.

In principle, this study has two major aims:

(a) to highlight the danger immanent in the continuing erosion in the Israeli capacity to respond to the escalating strategic threat;

(b) to present several policy-oriented assessments and prescriptions, aimed at charting some general principles of conduct for the enhancement of Israel's capacity to contend with this problem.

THE RISE IN THE POTENTIAL STRATEGIC THREAT

Continuing High Level Arms Purchases in the Middle East

Although, in line with the overall trend in the world, arms purchases have been declining over the first half of this decade, the Middle East still "remains by far the largest regional market". [3] In fact the region's imports still constitute of 40% of the world's total arms imports. [4] During the first five years of this decade, the influx of arms into the area totaled almost $ 50 billion, which proportionally to total imports, is 15 times the world average for the same period.[5] Particularly menacing is the increased acquisition of weapons of mass destruction, including ballistic missiles for their delivery - especially by regimes whose peace credentials are, to say the least, questionable.

Moreover, in spite of the overall regional decline, several of Israel's major adversaries have continued to maintain the same level of arms purchases as in the previous decade. For example, Egypt's imports continued unabated in real (1994-dollar) terms at a level of approximately US$ 5 - 5.5 billion in both the 1987-90 and the 1991-94 periods. Saudi Arabia's mammoth purchases declined only marginally in real (1994-dollar) terms from a total of just over $ 31.5 billion between 1987-90 to just below $ 30 billion between 1991-94. It is also of interest to note that in the first half of this decade (1990-94), arms imports made up 13% of Egypt's total exports, over 25% of those of Saudi Arabia and over 20% of those of Syria, this compared to 4% for Israel and to a world average of 0.7% .[6]

Deteriorating Military Balance between Israel and Her Adversaries

These ongoing arms purchases have caused important components of the military balance between Israel and her adversaries to shift against Israel, both quantitatively and qualitatively. This has been due mainly to:

- The huge acquisition of modern Western weapons by Saudi Arabia (approximately $35 billion worth in the last five years);
- The shift of the Egyptian army to a Western military doctrine, while equipping itself with high quality American weapons systems, particularly armor and aircraft;
- The growing cooperation between Syria and Russia, after a period of chilly relations following the break up of the Soviet Union.

The following two tables, together with the complementary accompanying data provided, underscore the ongoing deterioration in important aspects of the military balance against Israel, in terms of both quantity and quality. This trend has continued throughout the 1990's, with the present situation being considerably more unfavorable than that which faced Israel at either the time of the Six Day or the Yom Kippur wars.

Table 1 : The Egyptian Army's Shift to Western Equipment

Year		Main Battle Tanks	Fighter Planes
1985/6	Percent	20	0
	Western	350	0
	Total	1750	0
1986/7	Percent	33	44
	Western	750	157
	Total	2250	359
1989/90	Percent	32	46
	Western	785	201
	Total	2425	442
1992/93	Percent	47	51
	Western	1450	206
	Total	3090	408
1995/96	Percent	56	64
	Western	1900	303
	Total	3500	474

[Source: "The Military Balance" -the International Institute for Strategic Studies (IISS), London].

Between 1984 and 1995, Egypt reduced the quantitative gap in armor between itself and Israel from a ratio of 1:2.06 in favor of Israel to a ratio of 1:1.11 . If the Egyptian army's procurement plans are realized, quantitative parity in armor will be reached in the year 2000.

In the same years, Egypt radically reduced the qualitative gap in its main battle tank forces relative to those of Israel - as Tables 1 & 2 clearly show. With the completion of the current plan for equipping the army with the American battle tank (the M1 A1 being assembled in Egypt), the gap will have shrunk to about 1:1.5.

In terms of air power, the disturbing erosion of Israel's qualitative edge was succinctly summed up by Israel's deputy chief of staff, Gen. Matan Vilnai, who stated : "What worries me is [the fact] that the Egyptian air force has become a carbon copy of our own air force".[7]

Table 2 depicts the deteriorating trend in the qualitative balance between Israel and the prospective Arab coalition (as postulated by the Jaffee Center for Strategic Studies) it will be likely to face in the event of a future war.

Table 2: Israel and the Arabs: The Quantitative Balance in Main Battle Tanks

Year	Arab Coalition*	Israel	Ratio
1984	8065	3650	2.2:1
1986	8205	3900	2.1:1
1990	10,800	3860	2.8:1
1992	10,830	3850	2.8:1
1994/5	10,300	3845	2.7:1

* Composition as specified by Jaffee Center for Strategic Studies. Source: "The Military Balance in the Middle East" - the Jaffee Center for Strategic Studies.

Note that while the number Israeli tanks has remained almost constant over the last decade, the Arab armor has increased significantly - by almost 30%. Also, the disparity in main battle tanks has increased significantly to Israel's disadvantage, relative to the position that prevailed at the time of the 1967 and 1973 wars. If in the Six Day War, approximately 1.5 Arab tanks faced each Israeli tank, and in the Yom Kippur War approximately 2.1, today the ratio is approaching 3 to 1.

Note that hitherto, this analysis has largely omitted Iran as factor in the military might ranged against Israel, particularly as a prospective participant in active combat. However, as the incumbent Iranian regime is arguably the most vehemently hostile to Israel in the world today, it is doubtful whether such participation can be discounted. In this eventuality, much of Iran's military might including 1400-1500 tanks and 300 combat aircraft,[8] could be added to forces which Israel will have to contend - even without addressing the question of the Iranian ballistic missile threat (see below).

The Shape of the Future - New Impending Threats Will Require Additional Resources.

At least two other sources of impending future threats have not been factored - or have factored only very partially - into the current Israeli defense expenditures. They are, however, almost certain to have a far-reaching effect on the size of the outlays Israel is likely to be called on to make for her continued security and survival. The one source of threat arises from the purposeful policy of Israel's adversaries; the other, from the purposeful policy of Israel herself.

The Ballistic Threat:

An additional factor which presents an increase in the potential threat is the growing proliferation of ballistic missiles in the Mid-East theater.[9] Western intelligence sources warn that the Moslem states will soon possess a significant stocks of missiles capable of reaching the Israeli coastal metropolis (as well many European capitals).[10] According to some estimates, the Arabs will soon have 2,000 missiles with ranges of 300 km (Scud B), 550 km (Scud C), as well as 1100 km, (the No Dong and the Scud D, now operational in North Korea for about a year).

Even now, with the acquisition of Scud C production lines by Syria and Egypt, these states are probably capable of launching missiles attacks on the Israeli home-front from ranges that would make it extremely difficult for the IDF to destroy.

The Israeli response to the threat of ground-to-ground missiles is a defensive anti-missile project, in which the major companion is the Arrow missile. However, not only is this enterprise still in early development stages, but the cost of equipping Israel with this weapon system will be enormous - with Israel having to bear the principal burden thereof. Although estimates as to total outlay required to make the Arrow system fully operational vary, it seems unlikely that it could be less than US $ 10 billion.[11] Indeed some experts even see the development as being so costly that it may risk crippling other aspects of Israel's defense capabilities.[12]

The Territorial Factor:

The territorial withdrawals implicit in the agreements already signed by Israel, and those designated to be signed by her in the future, will impose considerable additional expenditures on Israeli defense, not only to facilitate the physical dismantling and re-deployment of existing systems, but to attempt to compensate for the crucial strategic advantages the present topography provides Israel. It is not the purpose of this paper to enter a detailed discussion of the merits of the present territorial lines and the demerits of the proposed future ones, from Israel's point of view. These have been discussed frequently and fully elsewhere. I will therefore restrict myself to citing the words of the late Yigal Allon, former Labor foreign minister and deputy prime minister of Israel:

> ... the innovation and sophistication in weaponry [including] the appearance of ground to ground missiles, supersonic fighter-bombers... not only fail to weaken the value of strategic depth and natural barriers, but in fact enhance their importance. This is even more true for Israel's difficult geographic position ... One does not have to be a military expert to easily identify the critical defects of the armistice lines that existed until June 4, 1967. [For Israel] a military defeat ... would mean the physical extinction of a large part of its population and the political elimination of the Jewish state. ...To lose a single war is to lose everything...[13]

In the context of the present analysis, the major issue is the impact of the economic burden implicit in contending with "critical defects" of the new borders to which Israel is being called upon to withdraw - borders which were once described by Shimon Peres as constituting "almost compulsive temptation to attack Israel from all sides".[14] Here again estimates vary, however few analysts believe that the total cost would be less than US $15 - 20 billion. Some recent studies see the initial cost of re-deploying existing civilian and military systems running as high as US $30 billion, not including an additional US $5 billion annually, required to maintain the considerably more costly replacement systems.[15]

Thus while it is difficult to quantify precisely the level of strategic threat confronting Israel, it appears indisputable that this threat is increasing relative to that faced in the past, and likely to do so even more dramatically in the future.

THE EROSION IN LEVELS DEFENSE EXPENDITURES

How has Israel responded to the escalation in the potential danger? Examination of defense expenditures in terms of both absolute value, and as a proportion of her GDP, reveals serious doubts as to the country's ability to respond adequately to the level of threat facing her.

Table 3 shows that Israel's constant-dollar defense expenditures fell steeply over the ten year period between 1984 and 1994 - by over 70%. As a proportion of the GNP, the decline has been even steeper, with the relative decrease approaching 300%.

Table 3 : Israel's Defense Expenditures in Terms of Constant Dollar Outlays and as a Proportion of the GDP in the Years 1984 to 1994

Year*	In Dollars (1994 prices)**	Percentage of GDP**
1984	11.3	24.5
1985	9.7	20.3
1986	8.7	17.3
1987	7.7	14.2
1988	7.0	12.7
1989	7.0	12.5
1990	7.5	12.6
1991	5.1	8.1
1992	6.9	10.1
1993	6.5	9.1
1994	6.6	8.6

Source: World Military Expenditures and Arms Transfers -1995, US Arms Control and Disarmament Agency.
* Alternative data published by SIPRI show essentially the same trends.
** Estimates of the data for the years 95-97 do not indicate any significant change in this trend.

Admittedly, official figures also point to a significant decline in the defense expenditures of Israel's adversaries. However, several factors imply that caution should be exercised in accepting these at face value. The results of ongoing studies seem to indicate that the official figures given for Egyptian defense expenditure are implausibly low, and that an examination of the minimal cost required to sustain a military of the size of the Egyptian army would necessarily require outlays 3 to 5 times those of the officially published ones.[16] Likewise, the official figures released for Syrian defense expenditures are little more than rough estimates and may be grossly inaccurate. Unverifiable deliberate understatements of outlays on the military are far likely to occur in non-democratic (or at least non-libertarian) regimes, such as Egypt and Syria, where the dissemination of information is under highly centralized government control, making both transparency and accountability considerably lower than in open libertarian regimes such as Israel. The continuing high rate of Egyptian arms imports and the growing upgrading of the quality Egyptian weaponry discussed previously, seem to lend weight to the suspicion that the official figures do not reflect the real level of spending and hence do not reflect the real level of threat that Israel may be called upon to contend with.

Moreover, in addition to the diminution of Israel's defense expenditures as a whole relative to the strategic threat, a structural change has taken place within the budget itself. This is a change that has eroded not only the combat readiness of the IDF, but also the purchasing power of those portions of the budget assigned to weapons procurement. Thus the erosion in the defense budget has taken place in two principal areas:

- **Erosion in the Structure of the Defense Budget**

  A change in the priorities within the defense budget: About 50% of the budget is presently spent on salaries, social and fringe benefits, and pensions. This structural shift in the budget - which took place over the last decade - comes at the expense of armament acquisitions and training hours. It is thus mainly the combat units that are hit by this trend. For example, the constant decline in the air force budget has taken toll on both equipment and training flying hours, as well as on the number of pilots. Similar conditions prevail in the rest of the combat corps of the IDF. In this regard, it should be noted that the increased outlay on improved remuneration to IDF personnel has been justified by the need to attract, and keep, high quality manpower in an increasingly materialistic and competitive Israeli society. This is a need, the importance of which can hardly be overstated, since a deterioration in the level of those serving in the ranks of the IDF, especially in the technical and senior command echelons, could have disastrous effects on the military capabilities of the country. Accordingly, these expenditures are likely to be very resistant to cut-backs

- **Erosion in the Purchasing Power of the Defense Budget**

  The sharp rise in weapons costs: This rise has greatly outstripped the decline in the real purchasing power of the dollar by hundreds of percentage points - as illustrated in Table 4.

Table 4: The Escalation in Cost of Armaments (in current) million dollars

Percentage Increase
Price in the 1990s
Price in the 1980s
Weapons System

318
22
First Line Plane:
F-16
70
F-15I
250
1.2

Main Battle Tank:
M-60
3
Merkava 3
366
0.3

Ground-Air Missile:
Hawk
1.1
Patriot

The above three weapons systems are a representative sample, illustrating a sharp rise in the costs of arms over the last decade which exceeds 300%. It is thus not surprising that the IDF has been forced to forgo quality armaments because of their high price - such as the Soltam gun which was considered among the most advanced of its kind in the world.

It is difficult to quantify precisely by how much the overall capability of the IDF to equip itself with adequate weaponry has been eroded. However, even a very conservative estimate would seem to indicate a rate of tens of percentage points. The decrease in the value of the $1.8 billion annual US aid may serve as an instructive illustration. Of this amount, $1.4 billion is allocated for purchase of weapons in the United States. Nominally, this sum has remained virtually unchanged since 1986. However, because of inflationary devaluation of the dollar, the real purchasing power of every 1986 dollar today is roughly

$0.60. If we factor in the rise in the cost of weapons, as shown in Table 4, this would be reduced to no more than $0.30-35. Therefore, according to the cost of weapons (COW) index, the value of American aid has been eroded by nearly 70%. Hence, deflating the nominal value of the 1986 US aid by the "COW index", reveals that the real purchasing power in 1995 has been reduced to an equivalent of $420 million. Accordingly, if in 1986, sixty-four first line aircraft (F-16 fighter jets) could be purchased with this aid, today it would suffice for the purchase of only twenty such first line planes (F-15I fighter jets).

Even opponents of increased defense expenditures admit that weapons systems of the 1990's are greatly more expensive, in real terms, than the corresponding system of the previous generation. However, they argue that their operational performance stands in direct relation to their cost and that they are thus far more effective than their predecessors. Hence, they allege, commensurately smaller numbers are needed. This argument is of course only valid as long as the opposing side does not upgrade its weapons systems as well. However, as seen previously, Arabs armaments ranged against Israel are not only of much greater quantity but of significantly improved quality, compared to the past. Moreover - and more seriously - Israel's former advantage of having preferential access to Western and, particularly US sources, no longer exists, as today many of her adversaries are equipping themselves with advanced weaponry from these sources.

The preceding data underscore the fact that over the last decade, the IDF's level of equipment procurement (at least with regard to major weapons systems) has been severely eroded. This decline in the purchasing power of the defense budget, combined with the escalating threat reflected in the enhanced quality and quantity of Arab armaments ranged against Israel, paint a somber picture of deterioration in Israel's readiness for the next war. It thus appears difficult to avoid the conclusion that a significant step up in Israel's defense expenditure is called for, if the country is to be adequately prepared to contend with the impending threats immanent in the military build-up of her potential adversaries.

POLICY ORIENTED ASPECTS

Several significant policy-related aspects emerge from the foregoing discussion, the divergent trends of escalating of potential threat on the one hand and diminishing Israeli response capability on the other, upon which it focuses. In this final section of the present study, some such policy relevant challenges and caveats are analyzed.

The Challenge for the Israeli Leadership

The preceding data show that the Israeli leadership has been prepared to invest an ever-decreasing portion of national wealth in the nation's security (Table 3). Not only has it considered it unnecessary to devote any portion of the annual increments in the GDP to bolstering the country's defenses, it has in fact seen fit to apportion less of previous GDP levels for this purpose. In light of the growing threat which appears liable to confront Israel in the future, such policy seems incompatible with prudent regard for the national interest.

The magnitude of the erosion of resources committed to national defense may be gauged from the fact that had the same rate of spending undertaken in the mid-80's been maintained today, the present expenditure would be more than double its current level and amount to approximately US $ 15 billion per annum.

The explanation for this seemingly ill-considered policy appears to lie in the tenor of public mood in present-day Israel. In the prevailing climate of unmitigated materialism and almost hedonistic consumerism, it is becoming increasing difficult for elected leaders to allocate resources for purposes which do not produce short terms dividends in terms of tangible improvements in individual and/or public well-being. In a highly diverse polity, saturated with "special interest" lobbies, concern for the "general interest" tends to be electorally unprofitable and hence put aside - or at least put off. Consequently, making cuts in the defense budget in order to allocate resources to more political rewarding ends is very tempting for those whose tenure in office is contingent upon public approval. Such cuts are easily justified by popular demagoguery. This is especially true in the era of the "peace process" in which it is easy to evoke dramatically emotive imagery such as calculations showing by how much the welfare of underprivileged children could improved by the price of one combat plane. Such arguments, however, always seem to (conveniently) ignore calculations showing by how much the security of the same underprivileged children may be undermined by the forgoing the purchase of the aircraft.

In order to remedy this malady, it has been suggested that a binding constitutional provision be made to link defense expenditure to the GDP.[17] The rationale behind such proposal is that because of the susceptibility of elected politicians to the pressures for gratification of short-term partisan demands, they should be divested of their discretionary powers in determining the outlays on national defense. Although this suggestion has some merit, it suffers from several shortcomings. Firstly, in years of crisis, defense expenditure may need to increased by significantly more that the rate of GDP growth. In such cases, constitutional encumberments are liable to be a detrimental hindrance rather than prudent safeguard. Secondly, it suffers from a certain lack of logical consistency. For if the fundamental problem is that politicians cannot be trusted to refrain from politically expedient cuts in the defense budget, because of the pressures to advance more self-seeking and politically rewarding pursuits, it seems highly unlikely that they could be induced to institute legislation (the only way such constitutional linkage could be established), which would totally preclude them from influencing the level of defense spending, and thereby eliminate, by their own hand, access to means of advancing their own special interests. Indeed it would be a little like expecting the cat who could not be trusted to guard the cream, to voluntarily and deliberately take part in erecting barriers to curtail its existing access to the cream, of which it is so eager to partake.

Thus, there seems no escaping the conclusion that the Israel defense expenditures cannot be put on "automatic pilot". Accordingly it would seem improbable that any "once and for all" techno-legalistic solution could be found for the problem of ensuring adequate allocation of resources for national defense in periods of apparent routine calm. Responsible policy has to be made by responsible policy makers. However, given the exigencies of political survival in a democracy such as Israel, it seems responsible leadership can only be exogenously (to the party-political system) induced by a well informed public, mobilized by well-informed, committed and responsible elites, who are motivated by a long term and comprehensive perspective of the national interest, independent of and unsubordinated to the vagaries of electioneering timetables. For it is only such elites who are best positioned to influence public perceptions of the relative importance of the issues on the national agenda. They are thus best positioned to induce a re-structuring of the agenda by which elected politicians determine their actions, and a re-ordering of the priorities by which they determine their cost-benefit calculations.

Such responsible national leadership in Israel faces a (or must be induced to face up to) a number of major challenges:

- Changing Prevailing Perspectives and Priorities: It must to a large degree go against the prevailing propensity to an overriding aspiration for immediate gratification of short-term materialistic needs. It must resist the seductive allure of the currently fashionable Chamberlainian slogans of "peace in our time" by displaying Churchillian resolve to confront the unpalatable realities of "blood, sweat and tears". It must spell them out with unflinching clarity to the voting public. It must impress upon the population the need to curb the rise in level in present living standards - so as to curb a rise in the level of future mortality standards. It must promote the pervasive recognition (and acceptance) of the fact that only by allocating increasing proportions of national wealth to national security today can Israel ensure her ability to withstand the impending perils of tomorrow.

It must be steadfastly immune to the criticism which will inevitably result from the adoption of demanding and initially unpopular positions - for only by repulsing such myopic censure can it serve the long-term national interest.

The above should not be dismissed merely as a recipe for some pretentious "pep-talk" or a sanctimonious lament, detached from any practical constraints, pompously admonishing the present Israeli policy-making echelons for the conspicuous lack of several undoubtedly merit worthy, but perhaps unattainable, attributes in their conduct. Quite the opposite. It should be considered a sober diagnosis of crucial policy imperatives, to be pursued by a resolute, carefully crafted program, directed at the local and foreign media, at public opinion at home and abroad, and at the decision-making echelons of her allies, with the express objective of generating a widely pervasive appreciation of the gravity of the current situations, and the even greater gravity of the situation likely to come about if the prevailing trends are not radically altered. For in the democratic context, major political changes can only be effectively instituted by winning over the hearts and minds of the majority, by means of the effective use of well-founded information, well-argued ideas and their persuasive conveyance to public. Thus, the success of such an endeavor would create an atmosphere, in which self-seeking politicians would find advocating or supporting defense cuts electorally inexpedient and even damaging.

However, as argued earlier, an enterprise of this kind, is not likely to be initiated - and certainly not likely to be sustained - from with in the present party-political system, which hitherto seems to lack the will, the foresight and the aptitude necessary for its implementation. It is thus incumbent on extra-party elites to shoulder the burden of responsibility for mobilizing the political forces and resources required to engender the essential restructuring of the prevailing perceptions as to the priorities that should be accorded the various issues on the national agenda.

- Enhanced Security through Enhanced Economic Performance: The preceding call for restraint in raising living standards must be tempered by the cognizance of the fact that only by providing her citizens an overall quality of life which is not vastly inferior to that which skilled, well-trained, and educated individuals can attain elsewhere in the affluent developed countries, can Israel hope to maintain a population endowed with the adequate scientific, technological and organizational capabilities required to overcome the severe challenges which appear likely to face the country in the foreseeable future. For in an era of accentuated materialism and declining idealism, there appear few alternatives for contending with the temptations offered by lucrative opportunities in foreign lands. As a country devoid of any natural riches of significance, Israel is almost entirely dependent on the quality of her human resources for the generation not only of her national prowess but indeed of her very capacity to survive. (To appreciate the veracity of this statement, one need only to imagine how Israel might have fared in contending with the tremendous challenges it faced over the last four decades, had the capabilities of her people not given her a qualitative edge against her adversaries, despite the latter's overwhelming quantitative advantage.) She can thus ill-afford losing significant numbers of highly capable citizens because of an inability to maintain an adequate standard of living, for this is liable to impinge upon the very viability of the Jewish state.

How are we to reconcile the apparent contradiction between the need to temper increases in living standard on the one hand, and the need to maintain and even improve them on the other? The solution resides in engendering improved economic performance of the Israeli economy. For (a) if the external exigencies not only militate against increased allocations of existing national wealth to the civilian sector at the expense of the defense sector, but indeed militate in favor decreasing such allocations; and (b) if the internal exigencies not only militate against decreased allocations of existing national wealth to the civilian sector at the expense of the defense sector, but indeed militate in favor increasing such allocations, the only possible solution is a significant overall increase in the national wealth.

Is the increase in the GDP required to resolve the conflicting demands on it a feasible objective? Initial calculation appears to indicate that it is indeed an eminently attainable target. For instance, in order to compensate for a 100% increase in the defense budget, the GDP would have to grow by approximately $6.5-7.5 billion dollars. This represents roughly a 7-8% increase in the GDP. Although this is not an insignificant rise, such a level of total GDP would still leave the GDP per capita well below that of a considerable number of developed nations. Given the level of scientific, technological, and managerial expertise in Israel, there seems little reason why such levels of GDP could not be achieved, especially in an era in which human capital, rather than other traditional forms, is becoming increasing dominant as the major determinant of national wealth.

This then is the next challenge facing Israeli leadership - to abandon the sterile "zero-sum" approach to defense expenditure issues, and aspire to create a "synergetic" solution to the country's twin needs by working to boost it's overall economic performance. This appears to be the only available method to produce circumstances in which it becomes feasible to maintain acceptable levels of defense expenditure without, inflicting unacceptable level of civilian expenditure.

It is true that even today, Israel's economy vastly outperforms that of its Arab adversaries. At present, the GDP of 5.5 million Israelis is larger in absolute numbers (estimated at $99.3 billion in 1997) than the combined GDP of 86 million Egyptians, Jordanians, Syrians, and Lebanese put together (about $82 billion). Per capita, Israel's product ($17,000) is about 17 times higher than the average in the states mentioned above ($950). Thus, even at present levels of economic output, if Israel were to allocate 15% of her GDP to defense (implying an additional $1200-1400 annual outlay per capita), there would still remain a huge differential in per capita income between her and her Arab neighbors, and still leave Israelis at prosperity levels almost three time higher than the world average.

While this situation would be bearable in the immediate short-run, it would - for the reasons enumerated above - be unsustainably acceptable in the longer term, in which far greater levels of economic achievement are required. Thus it is only by accelerated growth of the Israeli economy that a long term resolution to the conflicting needs of higher defense requirements and improved living standards can be attained.

However such accelerated growth may also constitute a blueprint for bringing about an eventual cessation of the Middle East arms race. For as the cost of modern weaponry spiral, the poorly performing economies of the Arab nations (including oil rich Saudi Arabia) will find it increasing difficult to persevere with their armaments programs.[18] Thus, much as the USSR was forced to give up efforts to match the USA militarily because it was a task beyond the capacity of its failing economy, so to the Arabs are likely to find the effort to outstrip Israel in the arms race a venture too exorbitant for their economic capabilities.

Accordingly, while there seems little chance of diplomatic pressures or moralistic arguments persuading the Arab nations to desist from accumulating ever-more expensive weapons systems, economic realities may force this upon them. However for such a fortuitous event to eventually transpire, it is essential for Israel to maintain a credible deterrence posture in order to prevent acts of aggression in the interim, as well as adequate retaliatory capacity to rapidly contain and repulse any attack with minimum casualties, should such aggression materialize.

In summary, to meet this kind of challenge Israeli leadership must mobilize the full potential of the scientific, technological and managerial skills in the country to attain national output levels fully commensurate with those skills. These levels should be considerably higher than the current ones. To accomplish this end, it must enlist all possible means to exploit fully the human potential in the country. While the details of such a program are clearly beyond the scope of this paper, they would undoubtedly include incentives for increased productivity, reduction of obstructive bureaucracy and greater streamlining central economic organs such as the capital markets. Such future economic development is of course only attainable in a climate of stability- stability which is inconceivable without Israel possessing a robust deterrence capacity that in turn is only attainable by significantly increasing current defense expenditures.

A Caveat for Israel Leadership

The hazards of a policy of under-spending on national defense are liable to extend far beyond the undermining of the physical ability of the military to deal adequately with identifiable threats which appear to be emerging in the region. It is liable to have highly detrimental long-term effects on both national morale and the economic strength of the country - both of which it is presumably designed to promote.

For, if in a climate of unfounded optimism for a harmonious peace, increasingly insufficient spending on defense erodes Israeli deterrence to a degree where aggression becomes a temptingly feasible proposition, vast amounts of resources will have to be drained away from the economy in an effort to ward it off. Such a rapid, disruptive and unplanned diversion of resources is liable to severely cripple, if not totally paralyze, much of the economy for an extended period - even if victory were eventually won. Thus efforts to promote economic growth by cutting back on the accumulation of military might are liable not only to be dangerously short-sighted, but disastrously counter-productive.

Moreover, the effects on national morale in the wake of a second "Yom Kippur" type surprise are liable to be no less debilitating. Much of the population, lulled into a false sense of secure well-being, is likely to feel disillusioned, deceived, and demoralized, alienated from a leadership which, either cynically or naively, lead -or rather misled - the nation headlong into disaster.

The long term ramifications of such results are difficult to over-estimate. For while military prowess may be a necessary condition for the creation and maintenance of credible and durable deterrent ability, it is by no means a sufficient one. Overall deterrence requires a combination of martial competency backed up by a vibrant economy, and cohesive, motivated people. The repeated trauma of a war for which the country is either ill-prepared or unprepared, is liable to shake the very foundations of its society. Thus, the chance of such an eventually occurring must be reduced to the barest minimum. History has show that this will not be achieved by ineffectual gestures of concession and compromise, especially when the adversaries involved are dictatorial regimes,[19] but resolute adherence to the ancient Roman adage: SI VIS PACEM, PARA BELLUM.

A Caveat for the US leadership

For several decades, a cornerstone of US policy in the Middle East has been a declared and unswerving commitment to the survival of a secure and prosperous Israel. Thus, should a situation arise which tangibly threatens the survival of Israel and with which Israel seemed incapable of dealing with on her own, the US would be confronted with an unpleasant dilemma of considerable dimensions.

If she were to honor her pledge to Israel's survival, she would be called on to bear the brunt of financing much of the efforts required to withstand the threat. She is thus likely to find that she is required to pour vast sums of US tax payer's money into dealing with a situation created largely by an Israeli decision to conduct a policy of inappropriate thrift with regard to its military expenditure - a situation which may have been averted, or at least had its severity greatly reduced, had larger sums of Israeli tax payers' money been devoted towards this end in a more prudently and timely fashion.

Indeed it is not inconceivable that an even more dire situation may arise as a result of misplaced frugality in Israel's defense expenditure, necessitating more than the dispatch of money and materiel. Given the current trends of inadequate expenditures combined with far-reaching territorial concessions, it is feasible to envisage a scenario in which the US may be called upon to commit troops to active combat in order to prevent Israel suffering military defeat - which as Yigal Allon pointed out "would mean the physical extinction of a large part of its population and the political elimination of the Jewish state".[20] The operational difficulties and expense involved in such an enterprise would be immense, especially as unlike the case of Kuwait, no Arab country would be likely to offer its territory as a staging point for US forces rushing to the aid of the Zionist foe.

If, on the other hand, the US decided to forswear her obligation to Israel, the political repercussions are likely to be severe, both domestically and internationally. Although the analysis of these is outside the scope of this study, there seems little doubt that such a decision would carry considerable political costs. On the domestic front, the abandonment of Israel would be strongly reminiscent of the British and French abandonment of Czechoslovakia, and create furor in many circles of influence in the US. On the international front it would be likely to constitute a dramatic blow to US credibility as a reliable ally, and greatly undermine the confidence that any foreign nation could place in her as a dependable partner.

Increased outlays on her own security would significantly reduce the possibility of Israel placing her greatest ally and major source of international support in such an unenviable predicament. Thus it would appear that not only would the Israeli national interest be well served by a considerable boost in defense expenditure, but that of the USA as well.

ENDNOTES

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ISRAEL 2000: HOW WILL IT FARE IF SHRUNK TO ITS PRE-SIX DAY WAR (1967) BORDERS?

PRESENTED BY YOASH TSIDDON-CHATTO
BEFORE THE
JOINT ECONOMIC COMMITTEE
OCTOBER 21, 1997

EXECUTIVE SUMMARY

In May 1967, Egypt broke its signed engagement to preserve demilitarization of Sinai and allow free Israeli shipping to the Red Sea. The U.N. troops stationed in Sinai left at Nasser's request, and the U.S. reneged on its obligation to guarantee the demilitarization and passage. Terror increased in proportion to Israel's deterrence discreditation. Facing an overwhelmingly superior enemy at close quarters, Israel's very survival depended upon a total risk preemption with a "no margin for error" air strike followed by a spectacular victory.

The insistence of the U.N. that Israel withdraws to its pre-1967 lines "with minor modifications" raises the question of Israel's survivability within the U.N. requested lines, given the proven Arab and international disrespect for contracted obligations, the lessons of later wars, and especially, the qualitative and quantitative escalation in the Arab Order of Battle. This paper attempts to provide an answer.

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BACKGROUND

Whether the Six Day War of June 1967, when Israel's brilliant victory relieved it from the strangling clutch of the Arab countries, was Nasser's brinkmanship that missed the brink, or his deliberate act to annihilate Israel when he felt, wrongly as it turned out, that he is capable of doing so, is a matter for historians' research. The fact is that he created a situation that forced Israel to either capitulate or open fire. Israel chose to preempt.

Living on a jumpy "Qui vive?" was possible for Israel at that particular time on three conditions:

- That the Sinai be demilitarized, and the southbound Israeli shipping through the Red Sea unhindered, as was agreed in 1957 at the end of the Sinai Campaign, in a U.S. brokered Cease Fire agreement.

- That the U.S. will honor the obligation it undertook to guarantee the said passage and demilitarization, backed by U.N. troops stationed in the Sinai for as long as Israel deemed necessary.

- That the neighboring Arab countries will accept Israel's existence and refrain from warlike acts like terror, shelling, incursions, etc.

As it turned out, in May 1967 the Sinai was re-militarized and Israel's southbound shipping blockaded. The U.N. troops left when asked by Nasser to do so, and the U.S. reneged on its guarantees while warlike acts continued. During the trying weeks of end May and beginning of June 1967, the whole Western world sympathized with Israel and denounced the Egyptian-Syrian threats that were actively encouraged by the Soviets. However, nobody did anything to help the Jews in a situation that threatened to become a second holocaust.

The one act that prevented Israel's downfall was its preemption, led by the Air Force's successful surprise attack which destroyed the main body of the Egyptian, Syrian and Jordanian Air Forces and opened the Arab ground forces to relentless air attacks and unhindered Israel ground forces pursuit.

Disregarding the circumstances that led to that war as well as the pre-war sympathy, the world community demands to this day that Israel withdraw to its pre-June 1967 demarcation lines with "minor modifications".

Given, on one hand, the international and Arab pressure to withdraw and, on the other, the fact that Israel barely, though victoriously, extricated itself in June 1967 from mortal danger by preempting against heavy odds, the question is how secure can Israel be within the pre-June 1967 borders, considering today's volume of forces and potent weapon systems as well as yesterday's lessons?

This paper will attempt to provide an answer.

A RAW NERVE - ISRAEL'S PRE-1967 SECURITY CONCERNS

On February 22, 1967, that is about three months before the Six Day War, Yigal Allon[1] made a presentation, surveying Israel's security situation. Following are some quotes from there[2]:

> "In my coming speech I want to prove that Israel is entitled, nay, obligated - and therefore also capable of opening preemptive hostilities whenever war is imposed upon it, this being the most important and, in certain circumstances, the only means of securing its survival".
>
> "There are six possible scenarios that entitle or, rather, compel Israel to go to war:
>
> - In case of offensive troops concentrations that endanger Israel.
> - When it becomes certain that the enemy is preparing a surprise air strike against Israel air bases.
> - If our nuclear facilities and research centers will be subjected to a pinpoint air strike.
> - If the guerrilla, mining and terror shelling will reach such proportions that will render our passive defense and retaliatory raids inadequate.
> - If Jordan will conclude a military pact with another Arab country and will permit the concentration of foreign forces within its borders, and especially west of the Jordan River. [3]
> - If Egypt will blockade the Tiran (Sharm-el-Sheikh) Red Sea passage".
>
> "...the method that may be used by the enemy in a surprise, Blitz-Krieg type war, taking the following actions:
>
> - A surprise air strike against the Israeli Air Force, catching it on the ground [4].
> - A simultaneous ground offensive on a number of fronts, covered and supported by an Air Force which enjoys full air superiority (see a. above).
> - Seaborne landings, be it with limited objectives like harassment, disruption or diversion of forces or even a large scale invasion or large scale guerrilla operations or even the use of parachutists or seaborne infiltration in the rear, whose objectives will be to spread confusion and harass transportation [5].
> - Air and sea bombardment of urban and industrial concentrations.
>
> Such a Blitz-Krieg war or anything similar will aim to accomplish facts before a full (Israel) general mobilization and before an international intervention will, if it will, materialize to achieve a cease fire".

Important Note

The reader should bear in mind that the much criticized Israeli obsessive preoccupation with defense, is unfortunately, well founded:
Guided by their respective declared Aims of War, Arab-Israeli wars unfold by a unique set of rules:

- An Israeli victory means demands for peace and cooperation and meant, in the past, the consolidation of defensive positions to answer further threats.
- An Arab victory means, as blunt as it sounds, national and even personal extermination.[6]

ANALYSIS OF A CRUSHING VICTORY - JUNE 1967 - A PREEMPTING AIR STRIKE REVIEWED

Prevailing Circumstances

The Middle East is an almost ideal arena for air warfare. Mostly desert or arid, with hardly any vegetation, where targets are hard to conceal and tactical intelligence reads from an open book. The movement of ground forces which relies on wheeled vehicles for logistics is, or rather was supposed to be, limited to the few roads existent. The climate is, mostly, clear weather with good visibility.

Not having any territorial depth to maneuver or to trade for time, Russian or French fashion, Israel developed its Air Force as far as its modest means and limited access to suppliers permitted, so as to achieve an outreach in depth and shift the war to enemy territory as soon as possible.

The 1956 Sinai Campaign was fought jointly with the British and French forces that (although their ground forces' achievements were far from brilliant) carried much of the burden of air superiority. When air superiority was secure, air-to-ground warfare proved to be a merciless, deadly weapon in the desert, especially when the anti-aircraft weapons were relatively primitive.[7]

The political fiasco of the Sinai Campaign/Suez Affair, taught those ready to learn a most crucial lesson which was later applied to the contingency planning that became the Six Day War: When a number of days into the war, the Soviets threatened the British, French and Israelis with a nuclear strike unless fire ceases immediately and the angry Eisenhower Administration did not par the threat[8], the fire had to cease. Having achieved all its objectives in four days, Israel was ready, even content, to oblige and negotiate. As against it, the Anglo-French, whose cumbersome moves prevented them from occupying the length of the Suez Canal, their objective, before the Soviet ultimatum matured, had to capitulate, not being in a position to negotiate. They lost the battle.

The conclusion, applied when planning the coming contingency, was that when fighting a conventional war in a theater of super-power active interest, a military decision had to be reached as close to the opening moves as possible, within a maximum of 10-14 days before a super-power nuclear threat, unchecked by another side, could become real, having run its warning, weighing, decision-making, readiness and ultimatum course.[9]

- By June 1967, the Combined Enemy Air Forces Superiority was Crushing:
  - Type of aircraft
    - Egypt, Syria, Jordan, Iraq
    - Israel
    - Ratio
  - Fighters & bombers
    - 582
    - 203
    - 2.87:1
  - Transport
    - 118
    - 51
    - 2.3:1
  - Helicopters
    - 106
    - 45
    - 2.36:1
- Number of top priority targets (air bases) to be attacked:
  - by the Arabs 4
  - by Israel >25
  - Ratio: 6.25:1 in Arabs' favor.
- Penetration of radar covered, missile/flack defended distances to targets:
  - Depth of penetration:
    - For Arabs: 10-40 km
    - For Israel: 40 ->500 km
- Some weaknesses in Arab defenses:
  - All aircraft were parked, parade fashion on open aprons, in straight rows (they looked nice).

- Radar coverage was good at altitude, cluttered with "white noise" (no Doppler) at low altitude, negligent when looking west.

- Missile defenses, SAM-2, moderately dense, were very efficient at altitudes over 10,000 ft. (electronic warfare means, in their infancy, were activated and outmaneuvering evasive tactics, demanding a fair amount of skill, were developed), but below that altitude the SAM-2 became rather inefficient. At low altitudes they were worthless.

SUMMING UP

- In the existing circumstances, Ygal Allon was proven right. Israel had no choice but to preempt when threatened, or risk its very existence.

- If a decisive victory had to be achieved within the shortest possible span of time (see above Prevailing Circumstances), the choice of arena was crucial: nothing would do but going simultaneously for the "jugulars" of the 25 top priority targets, when the fate of the war would be decided. The "jugulars" were the runways whose cratering would prevent the main body of the enemy Air Force from taking off (special armaments, among others, the French Matra Durandal, were conceived and forged to Israeli Air Force definition).[10]

- The bomb load of the Israeli attacking force would be critically limited because of fuel loads required by ranges to targets, especially when flying low under radar coverage (which is most wasteful on fuel) and when requiring a reserve for possible air-to-air engagement and breakaway upon returning. Intensive training, superb intelligence data, runs on models and personal target allocation, with photos and procedures memorized, helped overcome the scarcity of armament.[11]

- Targets were to be hit simultaneously, by order of priority, in a way that mutual support, i.e., one air base's aircraft defending the (other) one attacked, was rendered impossible as far as conditions would allow, through meticulous timing. Back up formations sent to ascertain kill, had secondary and tertiary targets allocated if/when their back-up missions became redundant due to successful first runs.

- Where/when runways were put out of commission, strafing runs were to be made by the attacking fighters to destroy anti-aircraft artillery and as many enemy aircraft on the ground as possible.

- SIGINT and post-strike photo reconnaissance (including the strafing aircraft's gun camera) were to be put to efficient use to prevent escape of unhurt targets or duplication of attacks.

- Electronic warfare, in its infancy, was to be used as a supplement to special missile suppression/diversion sorties allocated.

- Upon inflicting mortal damage to the enemy air forces, which was assumed to require about two days, a significant percentage of missions were to be diverted to ground forces support. Until then, the ground forces would enjoy the theater air superiority, i.e., freedom of movement achieved by the air bases attack, and receive occasional support when acutely required, or when free missions were available. 44 Fouga Magister, light jet trainers, were earmarked for ground support. They fought valiantly with insufficient armaments and suffered heavy losses.

- Spread so thin, the only home air defense detail were four Mirage aircraft.

- Losses were calculated to be 3 percent per sortie. The calculations were unfortunately, accurate.

- When the war did break out and the stunning news of the total collapse of the Egyptian Air Force reached the Egyptian GHQ in a quick sequence of disastrous reports, Marshall Hakim Amer, Nasser's deputy and Minister of Defense, ordered a general ground forces withdrawal from the Sinai,[12] be it in order to prevent their eventual total annihilation or in order to achieve a political stalemate. The story of the Israeli outnumbered ground forces' valiant and successful combats in hot pursuit that crushed the Egyptian forces sent to reoccupy Sinai, as that of the battles for the Golan, Judea, Samaria and Jerusalem do not belong to this review, having taken place in the aftermath of decision, that is after a barely cliff-hanging Israel turned the tables by one masterly air strike.

- The elaborated description of the Israeli Air Force's conditions and deeds, is hereby presented for two reasons:

  -To emphasize how dependent Israel's very existence was upon the success of its outnumbered, thinly spread (no reserves) Air Force carrying out a complex, decisive move at a risk as high as to be justified only by mortal danger.

  -To be able to examine, on the basis of this feat, what are the prospects of repeating a similar performance in present day's circumstances.

THE ARABS REMARKABLE RECOVERY

Following the June 1967 debacle, Egypt and Syria did draw the right conclusions:

- The new Soviet re-supplied aircraft were dispersed in hardened, well separated shelters. Additional runways were built.

- Radar coverage gaps were, as a rule, closed also at low altitude.

- Anti-aircraft defense made a quantum jump:

  -In accordance with the Soviet doctrine, Air Defense gained an equal standing to that of the Army, the Air Force or the Navy, enjoying top priority.

-By the outbreak of the Yom Kippur War, in October 1973, a very dense web of then ultra modern SAM-6, SAM-3 and improved SAM-2 anti-aircraft missiles, as well as the efficient Flatdish, radar guided quadruple 37mm anti-aircraft cannon was in place, well coordinated by a Command, Control, Communications and Intelligence (C3I) system and complemented by interceptor-fighters and the ground units' shoulder fired SAM-7 "Strella" anti-aircraft missiles.

-If the writer's findings were correct [13], the Egyptian Air Defense Command consisted, at the outbreak of the Yom Kippur War of an equivalent of about 10 divisions, that is about the same size as the total Egyptian ground forces, to which the Egyptian Air Force interceptors force should be added.

The SAM missiles defenses became the Israeli Air Force's main and most dangerous enemy, whose defeat was the key to achieving an air superiority over an area so as to assure the safe, free maneuvering of Israeli ground forces and to provide the support (fire or assault transport) they were entitled to. When, at the end of the "War of Attrition", Israel and Egypt signed, on August 7, 1970, a U.S. brokered cease fire agreement, the most important article was the one stipulating that Egyptian SAM missiles should be kept out of the reach of the Suez Canal Zone. Unfortunately, the Egyptians moved their SAM's close to the Suez Canal the very night the cease fire had been signed, in flagrant breach of the agreement. Israel, under firm U.S. pressure (again), did not react on time, which it could and should have done before they were reactivated.

"Cleaning" a SAM missile defended area requires an intense one or two days' effort which means a one or two days delay in air superiority and support for the protection of the ground forces at the most critical time, which is that of the outbreak of hostilities, before the Israeli mobilization is carried out. Tolerating the August 7, 1970 arrogant infringement of the cease fire agreement, i.e. allowing the shifting of SAM's to cover the Canal Zone, was tantamount to Israel offering the key for the crossing of the Suez Canal to Egypt, a key used by them three years later. To conclude this paragraph, it may be said that the Arab reaction to the terrible defeat of June 1967 was most intelligent, rapid and efficient, rendering a copied repeat performance of the air victory of June 1967 absolutely impossible. From now on, a relatively slow grinding will become the rule, with the defeat of the SAM cover to precede further operations, if unacceptable losses are to be avoided.[14]

WISDOM ACQUIRED IN THE YOM KIPPUR WAR, OCTOBER 1973

Unfolding

Although enough raw intelligence data was available, Golda Meir, the then Prime Minister of Israel, decided to accept on October 3 and 4, and even October 5, 1973 in the morning, the Israel Defense Forces' Chief of Intelligence assessment that "there is no danger of war in the near future", an assessment shared by Defense Minister Dayan and Chief of General Staff Elazar yet challenged by the "Mossad".

By Friday, October 5, in the evening, there were doubts. By Saturday (Yom Kippur), October 6 in the morning it became certain that war was to start that very evening. It started early in the afternoon.[15] When the certainty of war was unanimous by Saturday, October 6 in the morning, Elazar asked the permission of the Prime Minister and the Minister of Defense to preempt that very day at noon with a full scale air strike. That operation required an immediate "green light". Golda's words were (quote):

> "Dado, I am aware of all the reasons in favor of a preemptive war, but I am against it. None of us knows now what the future has in store for us, but there is always a possibility that we'll need someone's help and if we'll strike first, no one is going to help. I wish I could say yes because I know the meaning of it, but, with a heavy heart, I say no".[16]

Teachings

The combination of the Israeli government's error of August 1970, i.e., of tolerating the deployment of Egyptian SAM missiles on the Suez Canal, which was a blatant breach of the cease fire signed by the Egyptians that same day, with the error of misreading existing intelligence data, especially on October 3,4, and 5, 1973 and the error of not permitting a preemptive strike on October 6, 1973 at noon (out of fear of the U.S.) when the outbreak of war was certain, cost Israel about 3,000 lives.[17]

The obvious conclusions to be drawn from the above paragraph are:

- Even a war wise government like Israel's can err at a crucial moment. Errors are human. The country's defense/deterrence establishment should prevent such a mistake from becoming a death warrant (see para. 2.4).

- Israel has to conduct a sincere, aggressive enlightenment campaign,[18] especially in the U.S., to reduce diplomatic "friendly fire" in crucial moments. Israel has a case. It has never been pleaded with vehemence and vigor.

- Israeli leaders have to learn to live with U.S. pressure when necessary and bear the consequences rather than lose lives or endanger the country's existence. As Allon said, given the circumstances in the Middle East and the danger of extermination if it is going to lose a war, democratic, peace seeking Israel should be free to preempt when war with a neighboring dictatorship is about to break at the dictator's initiative.

- All defense planning in the Middle East [19] has to cater to the "worst case" scenario unless absolutely certain that this is not the case. The Yom Kippur evaluation of the situation did the opposite.

- The improvement in the balance of power between Israel and the Arabs could not compensate for the loss of initiative to the Arabs.

How is it that, in spite of everything, Israel scored a world class military victory (not so in the political field) during the Yom Kippur War?

It takes a long stretch of imagination to believe that an Israel within the pre-June 1967 borders would have committed the errors mentioned above. Possession of buffer zones and the crushing 1967 victory brought complacency. However, were the aforementioned errors to have been committed within the pre-June 1967 borders, it is fairly certain that the State of Israel would have ceased to exist. The facts are that the Golan Heights and the Sinai (where the depth of Egyptian penetration was, in some places, deeper than the whole width of Israel in many places), provided the depth required for the Israeli IDF to "buy" the time necessary for regrouping, reinforcing and re-supplying in view of the coming counterattack. If there was ever a case that proved the vitality to Israel of a buffer, a protection belt, this was the Yom Kippur War, when the "territories" saved Israel from its own government's errors.

The Order of Battle on Israel's Frontiers - Trends[20]

Qualitative Trends (Main Systems Only)

Tanks

- Types upgraded from T.34 and Stalin of WWII vintage, to T.55 and T.62 in 1973 and then, at present, to upgraded T.55, T.62, T.72 and T.72M or the U.S. M1A1.

- Tank cannons grew in caliber from 75mm to high speed 120mm using highly sophisticated ammunition.

- Tank turrets became gyrostabilized to enable firing in movement.

- GPS is being introduced for totally independent navigation and positioning.

- Most important: Passive infrared night vision equipment has converted armor into a 24 hours/day fighting force, thus adding about 30 percent to its war making capability.

- More powerful engines, better armor, better human engineering, more reliability and faster maintenance are to be counted among the added features.

Combat Aircraft

- Types upgraded from MiG-15, 17, 19, 21 or Su-7 of the Six Day War (June 1967) to later types MiG-21, Su-20, etc. in 1973 and MiG-23, MiG-25, MiG-29 or Su-24, etc. that improved the quality of later platforms of Russian manufacture. F-16 A,B,C,D as well as F-15 of U.S. manufacture are top of the line platforms. The top speed bracket remained the same, i.e., around Mach 2 at altitude, clean aircraft, to sonic speed when flying low or subsonic when carrying underslung stores such as bombs or auxiliary fuel tanks.

- One of the revolutionary improvements in air combat technology has been the introduction of the WDNS (Weapons Delivery and Navigation Systems) whose readings are presented on a pilot's HUD, i.e. Head-up Display. An illustration of one of the improvements in aiming achieved through the use of WDNS cum HUD is the accuracy of ("dumb") iron bombs release. While in training, a pilot may achieve, flying over a known firing range, by a fix set of rules, an accuracy of 30 mR C.E.P.[21] when aiming "the old way". In combat, where ranges, speeds, altitudes, dive angles and speeds are played havoc with by anti-aircraft fire or other distractions and the target has to be identified, the 30 mR look more like 300, especially to non-veteran pilots. Equipped with WDNS + HUD, any pilot who operates the system properly, will hit with an accuracy of 6.5-7.0 mR (mili-Radian angular precision). This system alone, is a force multiplier of between 4 and 8 or more, depending on the pilot's experience.

- The second revolutionary improvement is that of passive night, infra-red vision, FLIR (Forward Looking Infra Red). Although some night attacks were carried out by combat aircraft before FLIR, using parachuted flares, this was a complicated procedure, used mostly (if not only) by the Israelis, with the illumination being unsteady, incomplete and uni-directional.

  -FLIR turns a combat aircraft, an attack or an assault helicopter into a 24 hr/day fighting machine which, in order to avoid being in full view of too many preying eyes, will prefer now the relative cover of night. Being a passive system, i.e., that receives and interprets the surrounding I/R radiation but does not radiate itself, the FLIR is discrete.

  -Considering the hours of darkness each day and the edge that FLIR offers at night, this system may be considered to be a further force multiplier of about 2.

- Stand off guided weapons of a multitude of varieties of sizes and ranges and Cluster Bomb Units (C.B.U.) are a quantum jump in armament technology, as are the multitude of short, medium and long range air-to-air missiles.

- The end result of the changes enumerated in above (i) to (iv) is that:

  (1) Payload/range capabilities of modern combat aircraft is in the order of 6 to 10 times that of 1967 combat aircraft (ton-miles).

(2) Where bombing and other weapons' release are concerned, the payload/range capability is further multiplied by a factor of, say, 4 due to the WDNS +HUD and further, by a factor of 2 due to the FLIR.

- Without going into further technical details, it may be safely concluded that one 1997 combat aircraft is, in terms of its strike capability, more than a match to a whole squadron of 1967 or even 1973 vintage combat aircraft - this in a region almost ideal in its geography and climate for the conduct of aerial warfare.[22]

Ground to Air Ballistic Missiles

- The "lonely" SAM-2 of 1967 was joined in 1973 by the SAM-3 high performance medium altitude, by the lethally efficient SAM-6 low and medium altitude, mobile missile and by the "Strella", SAM-7 shoulder fired, infra-red homing infantry missile.

- Later, apart from the improved technology, density, proper positioning and C3I of the above mentioned veterans, the Middle East has received the SAM-5, for extreme range and altitude, the SAM-10, SAM-12 to SAM-17, etc.

- Israel is presently surrounded by the densest most sophisticated and most efficient missile air defense system in existence anywhere.

Ground to Ground Ballistic Missiles

- The by far most dramatic addition to the Middle East arsenal surrounding Israel are the ballistic missiles that "came of age" in grand style, especially since the Gulf War of 1991. During the Six Day War of 1967 there were no ballistic missiles launched. The Egyptian effort of 1962-64 to develop a German V-2 derivative (as is the SCUD) with the help of German rocket scientists withered when thwarted by Israel (which took measures against the scientists) and by other interventions.

- Throughout the Yom Kippur War of 1973, some Frog missiles were launched by Syria and some Frog and Kelt (cruise) missiles were launched by Egypt. Ballistic missiles were hardly mentioned, if at all in IISS 1973 documentation. The scarcity of Western, including Israeli, intelligence on the ballistic missiles development status, quantities and operational readiness in Arab countries was displayed during the Gulf War. Not much is known of about what happened before 1991.

- For instance, IISS data on Syria, 1973, makes no mention of Syrian Frog-2 or Frog-7, although some were launched at Israel during the 1973 Yom Kippur War. It also lacks all information on Egyptian cruise Kelt missiles that were fired at Israel.

- However, the Jaffe Center report of 1994-95, based on 1992-93 data, mentions under the "Defense Production" heading (p. 196), the existence of a SCUD B SSM manufacturing facility in Egypt, operating with North Korean assistance.[23] That same report discloses an intensive manufacturing and inventory build-up effort of ballistic missiles as well as the existence of a conventional, chemical and bacteriological warheads production facility in Syria.

- The present day ground-to-ground ballistic missiles inventory ready to be launched at Israel from Egypt (Iraq?), Syria and Saudi Arabia seems to be about 1,000 to 1,500 SCUDs (or others).

- The TBM (Theater Ballistic Missiles) are, as of 1995 or 1996, considered Main Battle Weapons by Syria and Egypt.

The writer hopes that the qualitative trends roughly surveyed in this paragraph convey the message that today's main weapons are by a few orders of magnitude more potent than those of twenty or thirty years ago, even when no weapons of mass destruction have been considered. This fact should be well comprehended when the quantitative evolution is enumerated.

Quantitative Trends

Egypt

a. Armed Forces personnel, including reserves
   1973 - 898,000 (IISS)
   1996 - 694,000 (IISS)
   1996 - 1,127,000 (JAFFEE)

b. Air Force-combat aircraft, operational (including bombers)
   1967 - 299 (IDF)
   1973 - 409 (IISS)
   1996 - 473 + 89 attack helicopters (IISS)

c. Army - Tanks
   1967 - ?
   1973 - 1,955 (IISS)
   1993 - 2,800 (Jaffe)
   1996 - 3,650 (IISS)

d. Ballistic Missiles
   1967 - nil
   1973 - approx. 35 (IISS)
   1993 - approx. 100 (Jaffe)
   1997 - approx. 500 (local assembly & extrapolation)

Syria

a. Armed Forces personnel, including reserves
   1973 - 344,000 (IISS)
   1993 - 532,500 (Jaffe) + 400,000 "workers militia"
   1996 - 921,000 (including reserves) - (IISS)

b. Air Force-combat aircraft, operational
   1967 - 97 (IDF)
   1973 - 326 (IISS)
   1996 - 468 + 100 attack helicopters (IISS)

c. Army - Tanks, all types
   1973 - 1,300 (IISS)
   1996 - 4,600 (+200 recent improved T.55 from Ukraine) - IISS

d. Ballistic Missiles
   1967 - nil
   1973 - some Frog-2, Frog-7 (Experience)
   1993 - approx. 62 (Jaffe)
   1997 - ~400-600 (North Korean deliveries + production facility)

Other Arab Countries

a. Iraq - still recovering from Gulf War. Data unreliable.

b. Saudi Arabia - the largest arms buyer in the world.

Generally, the trend in the Middle East is that of an "immanent war" arms race. The Middle East, including Iran, imports between 42 percent of the world's arms exports.

Special Remark on Egypt

Egypt is the second largest arms buyer in the Middle East, within the process of westernizing its equipment. Its army is, by now, 65 percent western and its Air Force 85 percent. Its real defense expenditure is estimated to be about 5 times the one openly specified in its budget.[24] It cooperates in defense matters with two "Terror Harboring" countries, in flagrant breach of its defense agreement with the U.S. and the U.S. turns its head the other way. With a GNP stagnant for the last decade, in the order of $50 billion, the Egyptian GNP per capita has not grown in real terms, due to a population growth of about one million a year and the U.S. dollar devaluation.

The obvious questions to be asked are why does Egypt, with no real Sudanese and Lybian threats and having signed a peace agreement with Israel that Israel will certainly be happy to maintain and improve on, need such a rapid build-up of a world class Order of Battle, if it does not harbor any aggressive ideas? If it does - against whom?

How long will it keep on spending at the present rate with the meager GNP per capita (1/20th that of Israel) decreasing? Why? What is the U.S. opinion about it?

Order of Battle - Summary

The Arab Armed Forces around Israel have recently grown at an unparalleled rate, especially since the Six Day War of 1967. Saudi Arabia, Syria, Egypt, Iraq and other Arab countries, as well as Iran, all poor economic performers, all dictatorships of one kind or another, live for the last 30 years on a frantic war footing, with the outside world seeming to be only too happy to oblige and supply. With mass destruction weapons about to be coming of age and a desperate economic situation stirring the masses to move toward Islamic Fundamentalism, or Ba'ath, which is a mirror image of fundamentalism, or any other "ism", 66 percent of this planet's oil reserves are tied to one of the mightiest time bombs ever, yet no one cares... but Israel, which faces at present the highest concentration of military power ever deployed per mile of frontier or square mile of territory.

The Arab Palestinian Angle

- The Palestinian Authority is to include the Arabs of Judea, Samaria and Gaza, i.e. all the Palestinian Arabs that are neither Israeli nor Jordanian citizens.

- Were Israel to shrink to its 1967 borders, with or without any minor modifications, they will become an (extremist) entity bordering with Jordan and, if one remembers 1958, 1968 or 1970, will most probably be out to "unify the country" again.

- If before 1967, the Hashemite throne held the Judea and Samaria Palestinians on a tight rein, unarmed, with no universities and a rudimentary economy to prevent them from overwhelming Jordan, the Palestinian Authority emerging at the end of this century will be well armed, with ten universities or colleges and an economic start-up.

- Were any Arab-Israeli war situation to develop, the Palestinian Authority will certainly pitch in to exact additional concessions from Israel.

- This will complicate matters enormously, like for instance, if Jordan will be occupied by Syrian, Iraqi or Saudi troops, or the three of them,[25] with the Palestinian Authority's help, creating an untenable situation for Israel.

- It may be stated that, while during the 1967 war, the Arabs of Judea and Samaria (and Gaza) were passive onlookers, during a possible war from the 90's on, they should be reckoned with as an active, armed enemy element.

The Israeli Palestinian Arabs

During October 30 and 31, 1994, a symposium was held at the Dayan Center of the Tel-Aviv University[26], its subject being the political line of the Israeli Arabs in view of the pending implementation of the Oslo agreements. About a dozen Arab speakers, covering practically the whole Israeli Arab spectrum, spoke, each one in a manner befitting his political position and temperament. All of them, without exception, declared that with the most probable establishment of a (third) Palestinian State in Judea, Samaria and Gaza, the Arabs of Israel remain the only Arabs under foreign occupation. The demand is, so they said, that Israel sheds its "Jewish State" character[27], agree to a law of return of the Arabs as well as that of the Jews and...please change the anthem, the flag and (as one suggested), the name. "Only then will a Jewish community live in peace in the Arab Middle East". Vox Populi.

The mid-August 1997 Israeli-Arab Assad worshiping dignitaries' visit to Syria (including some Arab members of Knesset), confirms and underlines the symposium's context. It is a surprise why so many were surprised in Israel. The mission's participants spoke their truth in Damascus.

To conclude, one should consider that a fairly sizeable segment of the Israeli Arabs will, once Israel will find itself in a precarious situation in the case of war, side with its enemies.

The Jordanian Palestinian Arabs

As King Abdullah said and repeated during his reign and as King Hussein often stated until about ten years ago, all Jordanians are Palestinians, be they Bedouin or townsfolk, the way all Israelis are Palestinians, be they Jews or Arabs. It is a simple geographic description. However, a large percentage of Jordanians, especially those opposed, for one reason or another, to the Hashemite throne, identify themselves with the Arab Palestinians of Judea and Samaria. Moving cleverly, Arafat adopted (highjacked?) the name of Palestine for his movement (entity in being) which drove King Hussein to denounce the "Jordan is Palestine" slogan that he so proudly proclaimed a decade earlier, and annul, in July 1988, the Jordanian citizenship of the Arab Palestinians of Judea and Samaria.[28]

Not much reading of the Arab mind is necessary to understand that the ruling elites of both Jordan and the emergent Palestinian Authority are on a collision course. How the situation will develop if Israel will withdraw from the buffer it provides in the Jordan Valley is anybody's guess.

Concluding this paragraph, it is evident that Jordan's basic strategic interest, which it certainly cannot proclaim in the circumstances, is to have a strong Israel by its side, which will protect its territorial integrity from neighborly designs and drive a wedge between it and the Palestinian Authority if/when it will emerge as an autonomous pseudo-state. An Israel shrinking to the pre-June 1967 borders will open Jordan to a pincer movement of say, a P.A.-Syrian alliance aimed, for the short term, at usurping the Jordanian throne and, for the long term Syrian design, to take one step further toward the "Fertile Crescent".[29]

Peace Within the 1967 Borders

Definition of Peace

- Dictionaries define peace as:

  a. A state of harmony between people or groups (Collins).

  b. A state of no war.

  These are two distinct, unbridgeable situations that go by the same name.

The prerequisites of a peace of harmony are:

- Commonality of political systems and aspirations, of culture, of Weltanschauung, of style and standard of life, of economic system, etc.
- Free interaction, economic, social, ideological, etc.
- Lack of significant conflicts of interest.
- Total lack of aggressive motivation.

- A peace of "no war" may exist when a factor named "deterrence" re-establishes the balance, preventing war from erupting although all or the major above mentioned factors are in total contradiction of one another.

- There may exist "in between" situations.

- An example of peace of harmony is the peace between the U.S. and Canada or Britain.

- An example of peace of "no war" is the past Cold War situation between the U.S. and the now defunct U.S.S.R.

- An example of a relatively stable "in between" situation is the peace between the U.S. and Mexico, where capital commonality of interests offsets the lack of commonality of other important factors.

When examined realistically, the Middle Eastern circumstances of totalitarianism, internal instability, intra-Arab strifes, deep cultural, economic and emotional fissures, as well as, of course, the inherent conflict of interests (as seen by the Arabs) and the viciously aggressive anti-Israeli motivation, etc. point to a "peace of no war" as the only peace achievable in the Middle East in the foreseeable future, a peace nevertheless, as anticipated at the First Peace Conference at Madrid in November 1991.

Deterrence emerges as the single, vital and sufficient mechanism to prevent war in a "peace of no war" situation. The "components" of deterrence are:

a. Armed forces strong enough to win a war with the deterred, if it breaks out, in all circumstances.[30]
b. A national will to use the force if absolutely necessary.
c. An economy to sustain the force and the will at the proper readiness.
d. The leadership required to do a), b) and c).
e. The proper, unambiguous conveyance of the message of force, will, economy and leadership to the party to be deterred.

The strength of an armed force is measured by the sum total of its capability of exercising a controlled, informed, supplied and otherwise supported manipulation of a triad of:

- Firepower;
- Mobility;
- Terrain.[31]

For the sake of illustration, it may be said that Force = f (Firepower x Mobility x Terrain), since there is a certain measure of cross-compensation among the three. However, if one of the three pillars of strength, Terrain in Israel's case, is reduced ad absurdum, the sum total that makes Force may become insignificant, irrelevant of how great the other two factors are.

Ad Absurdum. The pre-June 1967 Borders - Conclusion

Reverted to its 1967 demarcation lines, Israel will have to back any peace agreements that it might have signed with the deterrence of the threats of:

- The mightiest concentration of forces per mile of frontier or per (its own) square mile the world has ever seen, numerically and even qualitatively superior to the Allied Forces that invaded Normandy in June 1944, as strange as this statement sounds.[32]

- The emergence of a de facto independent Palestinian Authority that, apart from anti-Israeli irrident activities, will most probably be engaged, in alliance/collusion with Iraq or Syria, in the dismembering of Jordan, i.e. the deployment of Iraqi or Syrian (or Iraqi, Syrian, Saudi) forces along the Jordan and then, to be expected, along the Palestinian Authority's demarcation lines with Israel (whose width will be, at critical places, some 9-10 miles in all).

- Egypt reneging on its peace agreement with Israel and joining a Syrian, Iraqi (Iranian) anti-Israeli coalition.

- A degradation of the Middle East political situation toward Islamic fundamentalism or other outcome of an ever-increasing gap between the West's (including Israel's) constantly improving standard and quality of life and the standard and quality of life in the Arab countries, overburdened as they are by defense outlays.

- A degradation of the (conventional) military existing balance with the overtaking of the Israeli technological advantage, as is the case with FLIR, WDNS + HUD or GPS.

- A degradation of the non-conventional military situation brought about by the "nuclearization" of the surrounding dictatorships in addition to the standard inclusion of chemical and/or biological weapons in Arab arsenals.

- A terror situation[33] whose intensity will increase with the deterrence deficiency created by enhancing the Arab forces and by the grossly diminished Israeli force through loss of vital strategic ground.

Constraints

The deterrence, whose main component is the capacity to win the war if it (deterrence) misfires, has to be powerful enough to cater to the teachings of Israel's own (expensive) past experience, which are:

a. Israel cannot afford to lose a war. Losing means for it national and, most likely, personal extermination. Sorry for being blunt.

b. Israel cannot and should not rely on foreign guarantees as components of its deterrence. Foreign guarantees are of very short duration.

c. Israel cannot rely on the presence of U.N. or any other troops to bolster its peacekeeping capability. They are there as long as both parties agree to their being.

d. Israel cannot rely on demilitarization for its deterrence. Like the Rhineland in 1920-1936 or the Sinai 1957-1967, demilitarization is not valid, unless both parties are profiting from it.

e. In view of the above point a), Israel should keep its preemption options open by conducting a continuous, aggressive and powerful enlightenment campaign where it counts, in time of tranquillity as in time of tension (see Golda Meir's deliberations previously mentioned).

f. Israel's defense establishment has to be able to cover for its own government's errors, preventing them from turning into a national disaster.

g. Israel is forbidden to sign any agreements that affect its deterrence/war winning capability without tangible quid-pro-quo collaterals offered by the antagonist, first and foremost being quasi-total disarmament, genuine and under constant surveillance.

h. In the circumstances, Israel is obligated to always plan for "worst scenarios".

A "map in hand" and "feet on the ground", in situ evaluation of Israel's residual deterrence potential, given the enormous Order of Battle facing it and following its withdrawal from the protective high ground of the Golan, Samaria and Judea as well as from the maneuvering area of the Jordan Valley, all of which will subsequently be surrendered to potential enemy forces which will thus gain decisive topographical advantage against Israel and will bring about the dismemberment of Jordan, will confirm that:

> Facing a Middle East that is not a "new one", that is arming faster and better than any other part of this world, making no bones about its non-acceptance of Israel in its midst, that is skidding toward political-ideological-economic chaos, deeply rooted in its hatred of the West and the Jews (who may destabilize the totalitarian ruling elites), the Israeli level of conventional deterrence, within the confinement of the pre-June 1967 war demarcation lines, will be far below that required by the situation in order to maintain a "peace of non-war". That spells war, from a totally inferior position. Given the time/distance considerations within pre-1967 borders, there is a very high probability that the only response Israel may produce to an imminent war situation, will not be a repeat preemption, 1967 style or other, which may be rendered impossible by existent circumstances, but the one desperate option remaining, an eventual "Samson's option".

END NOTES

1 Yigal Allon - the most prominent and successful general of the War of Independence, Commander of the Palmakh, the (pre-I.D.F.) Hagannah elite corps. Itzhak Rabin's mentor. In 1967, Deputy Prime Minister and Minister of Labor Party's Eshkol government.

2 "War and Victory" Album, Mizrachi Publishers, 1967.

3 i.e., Judea and Samaria which were in Jordanian hands at the time.

4 Allon was privy to the Israeli Air Force and other plans.

5 The presence, in Israel, of a large Arab minority, part of which would actively side with their kin, was and is to be considered in case of an Arab-Israeli war, especially when the chips are down.

6 As clearly indicated by all Arab declarations, whether written or verbal, made since the establishment of Israel to this very day. Judging by past experience, the Arab statements should be taken seriously, as should or should have been, Hitler's "Mein Kampf", Nasser's "Philosophy of the Revolution", "The Palestinian Covenant", Arafat's and others "Jihad" (Holy War), inflammatory rhetoric (in Arabic) or Islamic Fundamentalist dictums.

7 During the War of Independence, both sides' air forces were not significant enough to reach firm conclusions.

8 One may assume that, angry or not, the U.S. would not have tolerated a U.S.S.R. nuclear strike against its NATO allies or even Israel. It would have been too dangerous a precedent, however, given the magnitude of the threat, not openly countered by the U.S. at the time, the Anglo-French-Israelis could not but comply.

9 See this writer's, "The Case of the Forgotten War", Society of Experimental Test Pilots - "Technical Review" and "Cockpit", first 1971. (Paper written in 1965 but held back for five years by Israeli Security.)

10 The general runway attack concept, prioritizing and operational requirements deliberations are discussed in "Attacks of Air Bases - 1964/65" (Top secret - now declassified), a paper by Israeli Air Force Planning Dept., May 11, 1964, signed by the writer. Also elaborated on in more general terms in the writer's book "By Day, By Night, Through Haze and Fog (both in Hebrew).

12 See "Nativ", July 1997, "The Six Day War: Why is Israel Abandoning its Gains? (Hebrew), by Dr. Uri Milstein, quoting (pp.75) from a still classified research of the Six Day War made by Brig. Gen. (res.) Abraham Ayalon of the I.D.F. History Dept.

13 As in charge of the Israeli Air Force's post Yom Kippur War study team of air/ground warfare (1973-1974).

14 As Israel learned the hard way, during the first three days of the Yom Kippur War in 1973, when Dayan, the then Defense Minister, personally insisted that Air Force support be given at all cost to the surprised and beleaguered few Israeli troops present in the Canal Zone. The losses were ghastly.

15 "My Life", Golda Meir autobiography (Hebrew), Ma'ariv Publishing, 1975.
pp. 306-309.
qq.

16 Ibid, pp. 309-310.

17 Equivalent to about 300,000 lives in the U.S. or almost five times the total, eight years' U.S. losses in Viet Nam. The number of Israel's inhabitants in June 1967 was about 2.5 million.

18 The presentation of Israel's case before the Administration, Congress, media, academia, public opinion, etc., as if it were before a jury in a Court of Justice, as against propaganda, P.R. or just information.

19 See the "Dhimmi, Jews and Christians under Islam", by Bat Yeor, Cranbury, 1985. See "The Closed Circle - An Interpretation of the Arabs" by David Pryce-Jones, Weidenfeld & Nicholson, Gt. Britain, 1989. See "The Hidden Hand - Middle East Fears of Conspiracy" by Daniel Pipes, St. Martin's Press, U.S., 1996. The Middle East is an unstable area, politically, culturally, emotionally and defense-wise. An explosive mixture of medieval myths, fears and ethics with oil money and state-of-the-art weaponry, with unfortunately, very few exceptions. An inbred hatred of the foreign, especially of the Jews and the West (and Israel represents both).

20 Based on:
- a. 1973 data released by the Israeli Ministry of Defense.
- b. 1973 IISS data.
- c. 1993-95 Jaffee Center for Strategic Studies data.
- d. 1995-6 IISS data.
- e. General, non-classified information handled by the writer as Member of Rafael (Israeli Armament Development Authority) Advisory Board until mid-1995 and other sources.

21 C.E.P. = Circular Error Probability, i.e. the circle around the aiming point where 50 percent of the bombs will hit.

22 The relatively detailed description of the aviation part of "Qualitative Trends" is not due to "professional aberration". It is rather, that aircraft are, by now, the decisive weapon in the Middle East, and they have undergone the most decisive modernization in spite of the less apparent changes in their platforms' performance. The ground forces improvements, too many to enumerate, have an enormous impact of their own.

23 A blatant infringement of the U.S. military assistance agreement providing Egypt with a US$ 2.3 billion yearly aid on condition that it stays clear of terror harboring countries.

24 See "Nativ", July 1997 - "How Much Does Egypt Spend on Weapons of War?" by Sean Pine (pp. 70 - Hebrew).

25 During a conversation between Dr. Martin Sherman, of Tel-Aviv University, with the political officer of the U.S. Embassy in Tel-Aviv, Sherman asked whether, if Jordan is occupied by Syria or Iraq, Israel is entitled to re-occupy Samaria and Judea to establish a defense along the Jordan River. "Of course", was the P.O.'s answer. "See what the Middle East is all about?", said Sherman. "If a fourth country occupies a third country, Israel has the right to take a second country". So much for a third Palestinian state, after Israel and Jordan.

26 See "The Dream of the Israeli Arabs", by the writer, Jerusalem Post, November 16, 1994 (still under Labor Government).

27 According to Israel's Declaration of Independence" of 1948.

28 21 years after the occupation of Judea and Samaria by Israel.

29 Greater Syria, embracing the whole of Palestine and Lebanon, an official Syrian ambition based upon the now defunct Ottoman Empire's administrative regions, where Palestine and Lebanon were part of the Damascus "villayat".

30 See "War and Peace as Rational Choice in the Middle East" by Martin Sherman and Gideon Doron, Tel-Aviv University, Frank Cass Journal of Strategic Studies, Vol. 20, No. 1, March 1997, p. 98, J. Conclusion quote:
"Indeed, the inferences implicit in the internal logic of the models would seem to prescribe the adoption of a robustly assertive defense posture by libertarian (i.e., democratic - the writer) regimes in a predominantly non-libertarian environment such as the Middle East... only if the libertarian regime conveys the perception that should any attempt be made to disrupt violently the prevailing status quo, it has the capacity and resolve to inflict upon the prospective non-libertarian aggressor outcomes significantly more disagreeable than those which suffice to deter an adversary of a more libertarian nature". Unquote.

31 For instance, 1,000 tanks in Tel-Aviv are a display at best and a target at worst. 1,000 tanks, armed, fueled and deployed to make proper use of topography, are a force.

32 While Israel itself is, as mentioned, but a tiny Western beachhead on an Arab continent.

33 Within the general Middle East context, Arab terrorism is but a minor threat to Israel's existence. It can, though, erode will or act as a detonator in a charged situation.

HAS THE PEACE PROCESS REAPED ECONOMIC DIVIDENDS

PRESENTED BY DR. ELIYAHU KANOVSKY

BEFORE THE
JOINT ECONOMIC COMMITTEE

OCTOBER 21, 1997

HAS THE PEACE PROCESS REAPED ECONOMIC DIVIDENDS

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EXECUTIVE SUMMARY

...Shimon Peres, first as Israel's Foreign Minister and later as Prime Minister, assured his people that with so important an economic stake in the "peace process" the Arabs surely would favor continuing peaceful relations with the Jewish state. His calls were echoed by other leaders and diplomats, perhaps most recently by US Undersecretary of State Joan Spero, who said in a speech on 11 October 1996: "Ever since the Camp David accords, the peace process has had an economic as well as a political dimension, with the goal of giving all the parties an economic stake in its success."

Public statements and wishful thinking aside, the Oslo agreements can contribute little or nothing towards the achievement of economic prosperity. Through the following discussion of the Middle East economies, I will demonstrate that economic growth is dependent mainly on the removal of internal social and economic obstacles, and not on international politics.

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INTRODUCTION

More than three years have passed since the Oslo Accords were signed on the White House lawn and acclaimed as the harbingers of peace and prosperity to the Middle East. The prospects for peace have been widely discussed. My focus here is on the promise of Middle East prosperity.

The Declaration of Principles (DOP) was followed by numerous Arab-Israeli meetings and multinational economic conferences (notably in Casablanca and Amman), the purposes of which were to forge and to cement Arab-Israeli economic relations, to attract foreign as well as local investors, and to deliver ever-growing prosperity to the region. Various scenarios were depicted for the future of the Middle East, the essentials of which were as follows:

1. The peace agreements would be followed by a significant reduction in military spending in the Arab countries as well as in Israel. The reallocation of substantial resources from the military to the civilian economy would stimulate and finance greater investment in infrastructure, as well as in educational and health services.

2. Regional infrastructure projects in transportation, communications, water and power, etc. would be supported by foreign aid.

3. Joint Arab-Israeli economic ventures would be fostered especially in industry, agriculture, and tourism

4. A large and growing inflow of foreign private investment would ensue, which would give a strong boost to the regional economies, raise personal incomes, and steadily reduce the high levels of unemployment prevailing in the Arab states.

Shimon Peres, first as Israel's Foreign Minister and later as Prime Minister, assured his people that with so important an economic stake in the "peace process" the Arabs surely would favor continuing peaceful relations with the Jewish state. His calls were echoed by other leaders and diplomats, perhaps most recently by US Undersecretary of State Joan Spero, who said in a speech on 11 October 1996: "Ever since the Camp David accords, the peace process has had an economic as well as a political dimension, with the goal of giving all the parties an economic stake in its success."[1]

Public statements and wishful thinking aside, the Oslo agreements can contribute little or nothing towards the achievement of economic prosperity. Through the following discussion of the Middle East economies, I will demonstrate that economic growth is dependent mainly on the removal of internal social and economic obstacles, and not on international politics.

ISRAEL'S ECONOMY-SUCCESSES AND PROBLEMS[2]

Israel's economic history is varied: a series of major achievements accompanied by serious problems. The 1950s, 1960s and early 1970s were highly successful in terms of economic growth, with the exception of the 1966-67 recession. By the early 1960s the economy had successfully absorbed the mass immigration of earlier years and labor shortages had become the norm. However, balance of payments problems soon became more severe and inflationary pressures grew, although Israel's labor shortages were ameliorated after the 1967 Six Day War. The opening of the pre-war borders brought a growing influx of Arab labor from the areas which came under Israeli control.

The Yom Kippur War of 1973 and the oil shock of 1973-74 greatly aggravated inflationary pressures and balance of payments problems. The second oil shock (1979-80) raised Israel's oil import bill to over $2 billion per annum, a value that exceeded the grants which Israel received from the United States. The oil shock and the huge revenues acquired by the rich Arab states helped to stimulate the Middle East arms race, further straining the Israeli economy. Hyperinflation, amounting to hundreds of per cent per annum, became the norm, with all of its attendant evils. Economic growth slowed to a crawl, dropping from 9-10% per annum between 1953 and 1973 to 3.2% per annum in the decade from 1975-85, and barely exceeded the population growth rate.

In 1985, a national unity government came to power and adopted important economic measures designed to reduce inflation drastically and to put greater stress on economic efficiency. Increased US aid during a two-year transition period facilitated the implementation of the new program. The results were excellent. Inflation, over 300% per annum in 1984 and 1985, fell to 48% in 1986, and continued at a steady decline to less than 20% per annum from 1987-91 and 10-12% from 1992-95. Initially economic growth rates lagged-as is usually the case when drastic anti-inflationary measures are taken-but these policies laid the groundwork for the favorable economic performance of the Israeli economy during the first half of the 1990s.

Based on an international comparison, since 1990 Israel has enjoyed a high rate of economic growth, around 6% per annum. This is three years before the signing of the Declaration of Principles. In fact, the growth rate of GDP, 5.7% per annum from 1993-95 was somewhat lower than in the previous three years, 6.4% per annum in 1990-92. The business sector GDP (i.e., excluding government and non-profit institutions), shows a more significant drop in the growth rate in the latter period, from an annual average 7.8% in 1990-92, to 6.6% in 1993-95.

The high rate of economic growth since 1990 was stimulated, in part, by the large-scale immigration from the former Soviet Union. During the period of mass immigration (200 thousand per annum in 1990 and in 1991) the rate of unemployment rose. But in subsequent years, when immigration was back to a more "normal" 75 thousand per annum, the rate of unemployment steadily declined. The improving state of employment was accompanied by moderating inflation, which by 1995 was down to 10%.

But the good news was accompanied by bad news. In particular, since 1993 Israel experienced a sharp deterioration in the balance on current account of the balance of payments, which worsened in 1994, and even more so in 1995. The balance on current account is defined as exports of goods and services, plus unilateral transfers from abroad (US grants, contributions from world Jewry, German restitution, immigrant and other private transfers) minus imports of goods and services. In 1990-92, as a whole, the balance on current account was positive at $154 million. In the following three years, 1993-95, there was a sharp deterioration with a total deficit of $7.8 billion, of which $4.1 billion was incurred in 1995 alone.[3] This deficit was not the result of arms imports, which actually declined. Estimates for the first quarter of 1996 show a continued deterioration with the deficit in the balance on current account 25% higher than in the same period a year earlier.[4] These deficits were covered, for the most part, by loans and a growing external debt.

If the budget submitted to parliament by the new government in mid-1996, which focuses on cutbacks in government expenditures, is implemented, it should reverse the adverse trends in the balance of payments and reverse the recent up-trend in inflation.

The data do not suggest that the Oslo agreements had any perceptible effect on the Israeli economy. Nor can one "blame" the Oslo accords for the problems which arose since 1993/1994. Israel's recent economic woes are attributable mainly to unwise government economic policies. One example is the unusually large wage increases granted by the government to public sector employees in 1993-96 (soon emulated by other sectors) that stimulated very large increases in private consumption, imports and inflation. A second example is the provision by the government of unusually large subventions to politically-favored groups, aggravating the budgetary deficit and indirectly the deficit in the balance of payments.

What all this tells us is that Israel's economic problems can be addressed only by the adoption and implementation of appropriate economic policies. Israel adopted some important new economic policies in the mid-1980s which fostered efficiency, productivity, and profitability, and the favorable results became very visible in the early 1990s. Wise economic policies underlay Israel's prosperity, and poor economic policies explain the problems that arose in more recent years.

As the rest of this discussion will demonstrate, the same is true of the Arab states where the problems are far more deep-rooted. Wise domestic policies hold out the promise of prosperity. Only basic, fundamental economic changes can significantly improve the performance of the Middle Eastern economies, and provide jobs and decent incomes for the vast army of unemployed and under-employed, the poor and downtrodden-not interstate politics.

4

THE PALESTINIAN ECONOMY-ONE BIG MESS

In the past decade the Palestinians suffered from a series of severe setbacks. The sharp decline in oil prices since the early 1980s, and especially since the mid-1980s, reduced the demand for imported manpower to the rich Gulf states. The Palestinians, as well as others, were adversely affected by the curtailment of job opportunities, and by the depressed wages of those who were fortunate enough to retain their jobs.

The Intifada, which started in 1987, had a depressing effect on the Palestinian economy. The frequent closures following terrorist attacks disrupted trade and other economic relations between Israelis and Palestinians, and accelerated Israel's replacement of Palestinians by laborers from a number of Eastern European, Asian and African countries.

During the Persian Gulf War of 1990-91, Arafat and other Palestinian leaders sided with Saddam Hussein. Following the liberation of Kuwait by the US and allied forces, Kuwait retaliated with a mass expulsion of about 400 thousand Palestinians, including many who had either been born in Kuwait or lived there for decades. The large majority of refugees went to Jordan. Jobs which had previously been open to Palestinians in Saudi Arabia and Kuwait were now closed. Moreover, the large annual financial contributions from these two states to Arafat also came to an end in 1990.

The very sharp curtailment in the number of Palestinian workers given Israeli work permits since the series of suicide bombings in February and March of 1996 has made a bad situation even worse. The estimate of the UN coordinator is that one Palestinian worker in Israel directly and indirectly supports ten people in the Autonomy. Closure had been especially tight since the spate of suicide bombings in late-Winter/early-Spring 1996. Before then Israel had been easing its restrictions and the number of Palestinians working in Israel rose from 30 to 70 thousand, though it still remained far below pre-Intifada levels, when 100-130 thousand Palestinians worked in Israel. But as Fouad Ajami notes "Israel got no gratitude" for the security risks it took.[5]

In a recent interview, the US Consul General in Jerusalem[6] cited World Bank estimates that the Palestinian economy had declined by a severe 8% in 1995 and would probably drop by an even more calamitous 20% in 1996. Helping to rehabilitate the Palestinian economy is, in his view, "the most urgent task." He urged Israel to rescind or at least ease the closure.[7] The American Under-Secretary of Commerce for International Trade, on a visit to the region, said that: "There's a pressure cooker building up in the territories."[8] Because of the poor state of the economy, potential Palestinian investors who had come from abroad to examine investment possibilities have left.[9]

There was near-unanimous agreement that the success of the Israel-PLO accords "rested on advancing the economic situation in the Occupied Territories, and doing it quickly."[10] In the spring of 1994 the vice president of the World Bank, the body charged with implementing the international aid program to the Palestinian autonomy, asserted that: "If the peace process is to have any hope of success, the Palestinians need to see improvements in their living standards quickly."[11]

Arafat's promise of turning Gaza and the West Bank into the "Middle East's Singapore" (other versions spoke of creating the Hong Kong of the Middle East) has left Palestinians feeling cheated.[12] Unemployment in Gaza is variously estimated at a depressing 50-60%. The situation in the West Bank (Judea-Samaria) is less depressing-"only" 24%. According to more conservative estimates, the unemployment rate in Gaza is "only" 40%, but reaches 60% in the refugee camps, where half of the Gaza Strip's population of about one million live. Regardless of the precise figures, it is abundantly clear that the Palestinian economy has deteriorated badly since the Oslo agreements.[13] Despite generous international aid, the two million Palestinians under Palestinian Authority control "have yet to see tangible benefits. For many, living standards have declined."

The Economist[14] notes that the underlying problems stem from gross inefficiency and endemic corruption. One unnamed European diplomat recently described Arafat's administration as, "marked by inefficiency, corruption and cronyism, trying to keep all the power to himself, while juggling various warlords, including half a dozen paramilitary police agencies, the armed Islamic militants, and criminal bands that control their own turf for narcotics and car theft operations [from Israel]."[15]

Because Arafat aims to keep a firm hold on the purse strings, he has set up "three separate economic ministries run competitively by political rivals. [Foreign] donors [of aid to the Palestinians] doubt the PNA's (Arafat's Palestinian National Authority) judgment, suspect that contracts will be given to buddies, and fear that the [aid] money will be swallowed up by running costs." In other words, little of the aid money is available for investment in infrastructure, for developing industry and agriculture, etc. The Oslo B agreement called for a police force of thirty thousand. Recent estimates place the actual figure at least twice that. Here, too, the basic problem stems from very costly duplication and other inefficiencies. According to a report in *Al Ahram*[16], "Arafat has more than five separate security bodies . . . each . . . led by a member of Arafat's entourage competing with each other and sometimes clashing." More recently (August 1996) Arafat established a new security force to contain dissent at Palestinian universities. According to the *Jerusalem Post*, there are at least ten PA affiliated security forces operating in the Palestinian Autonomy areas.[17] The highly-inflated security services and the ballooning bureaucracy absorb a large portion of the aid money. The inefficient and often corrupt administration which has emerged in the Palestinian Autonomy often discourages, rather than encourages, productive enterprise and investment.

JORDAN: FROM PROSPERITY TO CRISIS

The civil war in Jordan between the Jordanian army and the armed Palestinian groups based in Jordan, which broke in 1970, ended one year later. The expulsion of the Palestinian armed groups was followed by the 1972 lifting of the Syrian-imposed embargo on trade and transit, begun as a response to Jordanian support of the PLO. Subsequently, Jordan enjoyed a decade of high-level prosperity. Between 1972 and 1982, real GNP (corrected for inflation) rose by an annual average rate of 9 to 10%, or 5 to 6% per capita, a very noteworthy achievement. Investment was far higher than in earlier decades, and in most sectors production expanded rapidly. However, much of the prosperity was due to temporary external stimuli.

Jordan's participation in the Yom Kippur War of 1973 was peripheral. But the oil shock of 1973-74 and the second oil shock of 1979-80 had powerful indirect effects on Jordan's economy. Financial aid from the oil-rich Arab countries assumed much larger dimensions. More important, the booming Arab economies in the gulf attracted many millions of foreign workers, including hundreds of thousands of Jordanians-Palestinians.[18] The remittances they sent home to their families in Jordan stimulated rising prosperity.

In addition to substantial aid and workers' remittances, the boom in the neighboring Arab oil states opened up markets for Jordanian products, and also benefitted Jordan in other ways-while it lasted. Both because of the exodus of hundreds of thousands of Jordanians to work abroad, and the increasing domestic demand for workers, Jordan reached full employment in the mid-1970s and became a labor importer, mainly of unskilled manual laborers from Egypt and from other poorer Arab countries. The Jordanians-Palestinians working in the Gulf countries were, on average, more educated and more skilled, and hence better paid, than those coming to the Gulf from other Arab countries.

But in 1981 oil profits peaked and in the following years Saudi oil revenues, as well as those of the other Arab oil states, declined rapidly. Saudi Arabia and some other oil states began to incur deficits (both budgetary and in the current account of the balance of payments) in 1983, and these deficits persisted in the following years-until today. One of the first items curtailed was foreign aid from the rich to the poor Arab countries. Budgetary cutbacks in Saudi Arabia and in other rich Arab states, coupled with an overall curtailment of economic activity in the Gulf countries, led to a reduced demand for foreign labor. Those foreign workers who did retain their jobs, including hundreds of thousands of Jordanians-Palestinians, suffered cutbacks in salaries. But even if relatively few Jordanians-Palestinians were fired, few additional ones were hired.

The result of these developments was a deepening recession in Jordan. Between 1982 and 1987 GNP was stagnant as compared with a very rapid growth of 10% per annum in the previous five years. As a result of the recession within Jordan and in the Arab Labor-importing countries, rising unemployment took hold in Jordan, in sharp contrast with the labor shortages which had prevailed between the mid-1970s and mid-1980s.

The plethora of foreign aid, as well as income from other sources, had made the government lax in its spending habits and large budgetary deficits emerged during the 1970s and even more so during the 1980s. The subsequent decline in foreign aid after 1982 was not matched by substantial budgetary cutbacks. But while in the 1970s Jordan was able to cover its deficits mainly by concessional (long term low interest) loans, during the 1980s more and more of the deficits were covered by high-interest commercial loans mainly from external sources. The result of these policies was a growing balance of payments deficit, declining foreign exchange reserves and a much larger and more onerous burden of foreign debt.[19]

The crisis came to a head in 1988. Amman began to default on its external loans. This was soon followed by a sharp devaluation of the Jordanian dinar, in order to reduce imports and stimulate exports. The so-called Paris Club of lenders to Jordan rescheduled the debts. An agreement with the International Monetary Fund was concluded which called for an austerity program, including sharp cutbacks in food subsidies. Eleven people were killed in rioting triggered by the steep rise in food prices.

Things were going from bad to worse. Living standards which had risen strongly in 1972-1982 dropped sharply during most of the 1980s. But possibly the most severe problem was rising unemployment, especially among the more educated, in particular university graduates. Until the mid-1980s Jordanian university graduates, in growing numbers, had no problem finding lucrative jobs in the Arab Gulf countries. But when oil incomes declined sharply in the neighboring Arab states during the 1980s, and budgetary cutbacks were imposed, the demand for Jordanian university graduates fell drastically. What emerged was an incongruous situation in which educated Jordanians looked for work at home, while large numbers of foreigners were working in Jordan. They viewed jobs involving manual labor as demeaning. In 1989 and in early 1990 there were an estimated 100-120 thousand unemployed Jordanians-about 20% of the labor force-and some 175-200 thousand foreigners working in Jordan. The latter were mainly manual laborers in agriculture, industry, construction and some services. The number of Jordanians working in the Gulf states in 1989 was estimated to be 328 thousand, aside from accompanying family members.

A British economic journal summarized the situation in Jordan in early 1990 (before the Iraqi invasion of Kuwait) as follows: "The economic situation is so bad . . . that renewed and spontaneous outbreaks of popular unrest cannot be ruled out . . . Jordanians are. . . faced by rising unemployment, high inflation and frozen salaries. There is still bread to eat (due to subsidies), but a few other comforts . . . for the majority there is little prospect of a change . . . for the next five or probably ten years. With popular resentment over past corruption still acute, and with little prospect of a substantive economic improvement, the political situation remains explosive."[20]

THE GULF WAR AND THE JORDANIAN ECONOMY

The immediate aftermath of the Gulf War of 1990-91 was an even more depressed Jordanian economy. Jordan made the costly mistake of siding with Iraq. The consequences were dire: Saudi Arabia and Kuwait cut off all aid to Jordan, which, although reduced to $500 million in 1989 from its early 1980s high of $1.2 billion, was still substantial. The US also suspended its aid program to Jordan, while UN-imposed sanctions on Iraq had an adverse effect on Jordan's economy as well. Jordan had been an important route for the transit of goods to and from Iraq, and Iraq was also a major buyer of Jordanian products. The UN sanctions sharply reduced Iraqi oil revenues, forcing the latter to cut back drastically on all imports, including those from Jordan. Tourism was also adversely affected. But possibly the most difficult blow, in the short run, was the mass expulsion of Palestinians from Kuwait and to, a smaller extent, from Saudi Arabia.[21]

As to the number of refugees who settled or resettled in Jordan there are differing estimates. One source states that about 300 thousand Palestinians-Jordanians expelled from Kuwait settled in Jordan.[22] Another source gives an estimate of 350 thousand Palestinians-Jordanians, noting that this added about 10% to Jordan's population.[23]

Another source states that before the Iraqi invasion there were an estimated 450 thousand Palestinians-Jordanians in Kuwait. Following the expulsion only 32 thousand were allowed to remain. Despite the post-liberation policy of Kuwait's rulers of holding down the number of foreigners, by 1994 there were more foreign workers in Kuwait than Kuwaiti nationals. The Palestinians had been replaced mainly by workers from the Asian countries as well as by Egyptians.[24]

Regardless of the precise numbers of expelled workers, it is clear that Jordan had to cope with difficult problems. The outlook was grim before the Iraqi invasion of Kuwait, and the massive influx of refugees (officially called returnees), concurrent with a cessation of aid from the richer Arab countries and from the US, only made matters worse. However, by 1991 the US announced its resumption of aid to Jordan. Moreover, aid from Japan and from a number of European countries, amounting to over one billion dollars, came to the rescue at a critical time.[25]

The immediate impact of the austerity program adopted in the later 1980s was recessionary. Between 1987 and 1991 GDP (corrected for inflation) fell to a disastrous 13%, and on a per capita basis by 21%. But this was followed by four years of rapid growth, with GDP increasing by 38% between 1991 and 1995, or 13% per capita, over the four-year period.[26] An IMF report (1996) states that Jordan had begun to move in the right direction in terms of economic policies. The report notes that budgetary deficits had been cut back very sharply, mostly through curtailing spending rather than by imposing higher taxes. The report also notes that economic policies have been adopted which foster investment and growth. The finance minister was particularly optimistic, asserting (in January 1996) "Jordan has reached a stage of sustained growth."[27]

Paradoxically, one of the important reasons for the sharp turnaround in the Jordanian economy since 1991 was the large influx of Palestinians-Jordanians expelled from Kuwait. In many cases the new refugees came with their savings, skills and entrepreneurship, giving a powerful boost to Jordan's small economy, both through a massive expansion of housing construction and investment in new or existing businesses. According to one report, the refugees brought in about $1.5 billion, much of it for housing construction. This was a massive infusion into an economy with a GNP of $5 billion in 1992.

But while the above-mentioned IMF report gave very good grades, overall, to the new economic policies, it also noted that between 1991 and 1994 there was a major increase (15%) in public sector employment and

a 40% rise in the real (inflation-adjusted) wage bill. Padding the public payroll can only be detrimental to longer term economic growth.

Despite the relatively strong rate of economic growth since 1992, unemployment is still inordinately high, ranging between 15-20% according to various official estimates, and far higher according to unofficial sources.[28] Another source of concern is the "growing social disparity, with a tiny rich elite living in enormous new mansions, surrounded by increasing poverty."[29]

The very wide and growing gap between the few rich and the many poor may well foster revolutionary unrest and political instability. IMF pressures on Jordan's government to cut back sharply on food subsidies, in order to curtail budgetary deficits, raised the prices of basic foods and especially of bread. The reaction was severe rioting in southern Jordan in August 1996, which was suppressed by the regime. In many respects it was a repetition of the riots in 1988-and for similar reasons. The widening gap between rich and poor, high rates of unemployment, inflation, and other socio-economic ills may well be exploited by the Islamists and others who oppose the regime and the peace agreement with Israel. In the fall of 1996 the prime minister stated in parliament that there had been thirty-six attempted terrorists incidents in Jordan in the past six months, and King Hussein accused Syria of trying to destabilize the country.[30] Rising unemployment and inflation, and falling living standards for the large majority, while a small minority engages in conspicuous consumption, can only add fuel to the terrorist fire.

THE ISRAEL-JORDAN PEACE AGREEMENT OF 1994: THE ECONOMIC DIMENSION

It was widely believed that, in the aftermath of the Jordan-Israel peace agreement concluded in 1994, there would be economic cooperation yielding substantial economic benefits to all participants. It is well to recall that the Israel-Egypt agreement of 1979 was also expected to be followed by economic cooperation in many fields, to the benefit of both sides. In reality economic cooperation between Israel and Egypt was, and is, hardly significant. But, in 1994, many believed that with Jordan things would be different.

Three international conferences have taken place, designed to foster economic cooperation and investment in the Middle East, in Casablanca in 1994, Amman in 1995 and Cairo in 1996. However, as The Economist noted, the conferences "produced a rash of high-minded proposals . . . which did not happen." The article is entitled, "Middle East Economic Integration? You Have to be Joking."[31] The Cairo conference was hardly different in this respect from its predecessors.

What economic gains did Jordan obtain from its peace agreement with Israel? Mainly the cancellation of the $705 million debt to the US which was followed by the UK's cancellation of debts totaling $90 million, Germany $53 million and France $4.5 million.[32] Jordan also gained from an influx of Israeli tourists, and there are some joint Israeli-Jordanian projects related to tourism which may be implemented. Insofar as the main goal of the conference is concerned, namely attracting substantial foreign private investment, there are very few results.[33] The feeling of many in Jordan seems to be that "they are no better off today because of peace and may even be worse off."[34]

Why has there been so little in the way of Arab-Israel economic cooperation, including with Jordan, which normally has a much better relationship with Israel than other neighboring Arab state? There seems to be a fear that Israel's larger and far more developed economy will give Israel all the advantages. An Egyptian economist, Mahmoud Abdel Fadil, speaks of the "hegemonic dominance" of Israel's economy.[35] Taher Masri, a former prime minister of Jordan stated: "Israel has a huge economy, compared to Jordan's, and it (Israel) does not have to bargain so hard."[36] In other words, Israel should make all of the concessions.

What about the disarmament which some envisioned would follow the conclusion of Arab-Israel peace treaties? As one military analyst has phrased it, "No sooner had Jordan signed a peace treaty with Israel in 1994 that its wish list of US military equipment was dispatched to Washington."[37] This was the pattern set by Egypt following its peace agreement with Israel in 1979. Actually, there had been a De Facto peace between Israel and Jordan for at least twenty years prior to the conclusion of the formal peace agreement in 1994. The king candidly explained his country's request for US arms: "Our problem is not one of particular frontier . . . but all of them."[38] In other words, Jordan fears Syria, Iraq and the new Palestinian entity.

Following the conclusion of the Israel-Jordan peace agreement in 1994, an unnamed "economist based in Amman" commented as follows: "Jordan will have a couple of good years (due to foreign) aid. Then it will have to depend more on its own resources. They are busy trying to milk the cow of peace, but they also have to streamline their own economy."[39] Jordan must take more drastic measures internally to improve its economy. The peace agreement can contribute marginally to economic improvement. However, the crucial economic issues and problems facing Jordan are largely of domestic origin and therefore require, more than anything else, far-reaching changes in domestic economic policies.

EGYPT'S ECONOMY-PERPETUALLY IN RUINS?

Egypt is a prime example of an economy ruined largely by its own self-destructive policies. As alluded to above, back in 1979 with the conclusion of the Israel-Egypt peace treaty, there were predictions and expectations of large scale Middle East trade, multinational infrastructure projects, joint ventures involving Egyptian, Israeli and American or European investors, technology transfers, and a reallocation of resources from the military to civilian pursuits. But the reality was entirely different, and for various reasons unrelated to Camp David, the Egyptian economy has stagnated.

One *New York Times* correspondent gives the following dismal description: "Egypt's [economy under Mubarak] remains perpetually in ruins, and a breeding ground for fundamentalism. Its attempts to industrialize are a shambles, its government bureaucracy legendary for sloth and inefficiency. Its schools spew out . . . poorly educated, into a non-existent job market . . . Its Islamic fundamentalists periodically shoot up tourists, the police, Coptic Christians, or government officials, and are shot up in return." [40] An American economist who has studied the Egyptian economy over many years concluded that since the mid-1980s "the Egyptian economy has essentially stagnated." The growth rate of GDP per capita has been approximately zero.[41] Estimates for 1990-95 indicate that the average annual growth rate of the economy was a miserable 1.6%, while population grew by 2.4% per annum. In short, GDP per capita was declining.[42] This implies fewer job openings and even higher rates of unemployment, and lower incomes for the large majority.

The poor performance of the economy, especially in the first half of the 1990s, is particularly disconcerting in view of the massive financial aid which Egypt has received in recent years. Since the 1970s Egypt has been a recipient of large-scale aid from the US and from other industrialized countries. Aid rose to higher levels following the conclusion of the peace agreement with Israel in 1979, despite the cutoff of Arab aid, in retribution for Egypt's signing a peace agreement with Israel. However, the assistance Egypt received following the Persian Gulf war has few, if any, parallels.

President Bush was anxious to obtain Arab support for the war against Saddam Hussein and rewarded Mubarak handsomely for joining the coalition by canceling Egypt's $7 billion debt to the US. Bush also urged other creditors, Arab and European, to follow suit as well as offer substantial additional aid. US influence was also brought to bear on the World Bank and the IMF to help improve Egypt's economic performance and to offer financial aid and guidance. All in all, a major part of the $50 billion debt owed by Egypt was canceled. Interest rates were lowered and payments were stretched out on the remaining debt. In addition, "Official Development Assistance" from various industrialized countries was raised from $1.8 billion in 1989 before the Gulf War to $5.7 billion in 1990 and $10 billion in 1992. These figures exclude the annual $1.3 billion military grant from the US.[43]

Egypt's current economic problems stem largely from the legacy of "Arab Socialism," instituted by President Nasser in the 1960s. The state-owned industries, especially in manufacturing, suffer from gross inefficiency, over-manning and very low productivity and profitability. The loss-making state-owned firms are a serious drain on the treasury. Nasser guaranteed jobs to all university graduates, as well as demobilized soldiers, in the civil service or state-owned enterprises-a policy continued by Sadat, and by Mubarak during the 1980s. Subsidies were expanded under Sadat and maintained, for the most part, by Mubarak. Price controls, foreign exchange regulations, including multiple-exchange rates, wage policies, and other measures added more distortions to the economy. Egyptian corruption did not begin with Arab socialism, but Nasser's policies multiplied the opportunities and inducements. And, the wide gap between the few rich and the many poor widened to dangerous dimensions, fueled by widespread corruption.

Since 1991, under IMF and World Bank guidance, Egypt has made some important monetary and fiscal changes in addition to alterations in its foreign exchange controls-for example eliminating multiple exchange rates. But the recommendations to embark on a large scale privatization program in order to get rid of the unwieldy and very costly public sector enterprises, have been strongly resisted. Well-connected individuals who gain enormously, often illegally, from "milking" the public sector oppose the privatization plans. The public sector workers and managers are fearful that privatization would be followed by massive dismissals. As a result, about two thirds of industrial production remain in hands of the public sector, as are oil extraction and refining. As a result, Egyptian efforts to privatize the economy have been of very minor dimensions.

This was a phenomenon in the Soviet Union as well in other formerly socialist countries. Another problem which seems to be intractable is the massive public payroll, literally millions of employees with little or nothing to do. Egypt has four million public servants, 23% of the labor force according to official estimates. Another 8% of the labor force is employed by public sector enterprises. These figures do not include the armed and other security forces. In the public sector it is "virtually impossible to sack anybody" and labor laws also make it very difficult to dismiss private sector employees.[44] Low productivity, financial losses, and depressed incomes are the inevitable result.

In the seventeen years that have passed since the conclusion of the peace agreements between Israel and Egypt, it is hard to discern economic progress. Nor is there any indication of any cutback in Egyptian military expenditures. As one analyst has phrased it: "It might be assumed that peace treaties will neutralize external threats to security and lead inevitably to a reduction in defense outlays. However, the experience of the peace between Israel and Egypt suggests greater spending on defense rather than less."[45] According to the US Arms Control and Disarmament Agency, Egypt's armed forces numbered about 450 thousand in 1978-79. They number about the same today. An additional 250 thousand serve in the National Guard. Given the job market in Egypt, the government is wary of demobilizing large numbers. Unemployed army veterans could pose a serious danger to the regime which already has enough troubles. Insofar as military equipment is concerned, the American arms which have replaced inferior Soviet equipment are far more expensive than their Soviet-made predecessors.

SAUDI ARABIA-A GIANT ON CLAY FEET

A recent report in *The New York Times*[46] describes the Saudi economy as being "near collapse." There is probably an element of journalistic hyperbole in the description, but it is abundantly clear that disruptive forces, economic and other, are becoming stronger in Saudi Arabia. Amongst other things, the report notes the high rate of unemployment and other problems which make the situation "ripe for unrest." A *Reuters* dispatch[47] asserts that the challenge faced by the Saudi leaders is to find more jobs and maintain the generous welfare system. The Saudi princes, estimated to number between five and ten thousand, "are immune to the hardships faced by others." A report in *The Financial Times*[48] states that the annual allocation from the treasury to five thousand Saudi princes is $8 billion, absorbing about one fifth of Saudi Arabia's annual oil export revenues. In other words, the extended royal family, and others close to the royal family, continue to enjoy very high incomes, while many or most Saudis are suffering from declining living standards. The report quotes an unnamed "senior government official" to the effect that "most of the extremists . . . now come from poor families." Presumably they are recruited by organizations opposing the regime, including those responsible for the bombing of the American bases in Saudi Arabia in November 1995 and in June 1996.

Between 1982 and 1989, and again since 1992, the population has grown faster than the economy, i.e., the growth rate of GDP per capita has been zero or negative. The almost inevitable result is increased unemployment and depressed incomes. The authorities are encouraging the private sector to hire more Saudis since the government cannot afford to continue financing more make-work jobs in the bureaucracy. However, university graduates and other Saudi youth expect the government to continue with its long-time policy of providing them with white collar office jobs as it has done for the past twenty years, if not longer.

Few Saudis have the necessary skills to replace foreign technicians, mechanics, and other skilled workers. There are also many millions of unskilled workers in Saudi Arabia from various poor Arab and Asian countries. But menial jobs for Saudi university graduates, and even for high school graduates, are considered demeaning. The result is rising unemployment for Saudis, especially for youngsters just entering the job market. According to some estimates, unemployment among Saudis has reached 20% and is climbing as the economy stagnates.[49] These high unemployment levels stand in sharp contrast to the three million foreigners employed in Saudi Arabia, many skilled and professional, but about half unskilled.[50] These expatriates are employed overwhelmingly by the private sector, and despite strong official pressure to hire Saudis, only 7% of private sector employees are Saudi nationals.[51]

In order to understand the current state of the Saudi Arabian economy, it is first necessary to review quickly its status since the late 1960s. Saudi Arabia incurred deficits (both budgetary and in the current account of the balance of payments) in the later 1960s and, again, in the later 1970s. But these were relatively short term, each period lasting about two years. The deficits were readily covered by the utilization of previously accumulated reserves; no debts were incurred. Each time exogenous events extricated the Saudis from their financial embarrassment. Both in the early 1970s and again between 1979-81, a sharp rise in the demand for Saudi oil combined with far higher world oil prices. As a result, Saudi oil export revenues skyrocketed from a "mere" $4 billion in 1972 to $111 billion in 1981. As a result of these two factors, Saudi deficits were soon forgotten-viewed as a temporary aberration. As revenues went up, the authorities sharply increased public expenditures, inevitably raising imports of both goods and services. In the Saudi case, imports of services means primarily payments to foreign workers and to foreign contractors operating in Saudi Arabia.

OPEC surpluses disappeared almost as quickly as they appeared. Oil prices peaked in 1981, eroded and then fell sharply, especially when measured in constant (inflation-corrected) dollars. Oil discoveries outside the Middle East raised non-OPEC oil supplies almost steadily, helping to depress oil prices. In 1983, Saudi Arabia incurred a deficit (both budgetary and balance of payments). In response, however, the authorities did little to cut public spending, seeing the deficit as a temporary aberration. They believed that they could easily cover the anticipated deficits by utilizing part of the financial reserves accumulated during the "Years of Plenty". But contrary to expectations, deficits persist to this day, and by 1987 most of the financial reserves had been exhausted in order to cover the deficiencies.

Subsequently there were sharper cutbacks in the "projects" budget, basically investment in infrastructure, as well as for housing, health and educational facilities. Since construction was mainly done by foreign contractors with a labor force that was almost completely foreign, the authorities felt that cutbacks in the projects budget would have only a minor effect on Saudi nationals. They also severely cut back aid to the poorer Arab states from seven to less than one billion dollars per annum by the later 1980s, and even less by the mid-1990s. But military outlays and various current expenditures, including a wide range of free health and educational services, and numerous other subsidies, as well as the burgeoning and bloated civil service, were hardly touched for fear of public reaction. The authorities were politically unable to impose more drastic cutbacks, especially in view of the large allocations to the royal family (as noted above). Further tying the hands of the regime were a host of "commissions" collected by the royals and those close to them, for their services in obtaining government contracts, especially on behalf of foreign companies.

The Gulf War and its aftermath made a bad financial situation even worse. Budgetary as well as balance of payments (current account) deficits, which had persisted in every year since 1983, rose sharply during 1990-91. Thus the cumulative budgetary deficits for the years 1983 through 1994 were $165 billion, of which $38 billion was incurred during the Gulf War. The cumulative deficits since 1983 greatly exceed the cumulative budgetary surpluses between 1971 and 1982: about $100 billion. The trends in the balance of payments are similar. Since 1987, Saudi Arabia has been borrowing heavily, mainly domestically, in order to cover the deficits.

The projected budgets for 1995 and 1996 indicate that the authorities are trying to muddle through without taking any drastic measures to cope with the deficits. According to an IMF report, the domestic debt as of the end of 1994 was almost $100 billion, the equivalent of 77% of the Saudi GDP. The IMF mission projects that by the year 2000 the deficit will rise to the equivalent of 110% of GDP. This would crimp the ability of private commercial banks to lend to the private sector.[52]

The Saudis appear to be praying for higher oil prices and increased demand for Saudi oil in order to extricate themselves from their financial dilemma. However, longer term trends indicate lower oil prices, especially when measured in constant dollars.[53] This does not rule out temporary fluctuations due to weather, as was the case in the winter of 1995-96, or the current uncertainty regarding the resumption of Iraqi oil shipments. Indeed, although there may be digressions from the trend due to wars, revolutions, weather, etc., the underlying trend of real oil prices is constant at most, and more probably trending downward.

If significant growth in oil export revenues is not in the cards, what about the chances for significant cutbacks in expenditures in order to balance the budget? The constraints the Saudis face are formidable, including their fear of their two powerful neighbors, Iraq and Iran; it is this security concern which underlies the drive to acquire more and more sophisticated and expensive military equipment. The fear of internal revolution-possibly aided by external enemies-explains why Saudi Arabia maintains what amounts to two parallel armies, the regular armed forces, under the command of one prince, and the National Guard, under the command of another. Such duplication is highly costly. The Persian Gulf War of 1990-91, and the imminent threat to the Saudi regime, provided an additional stimulus to the Saudi drive to expand and modernize its armed forces. But there are other factors accounting for the huge orders of military equipment mainly from the US and also from the UK. The *New York Times*[54] reported that "Prince Abdullah has been struggling to rein in military spending . . . [but] his efforts have alienated family members aligned with

[Prince] Sultan, who have much to lose financially if new projects do not go forward." The commissions and kickbacks earned by those near the seat of power are a powerful deterrent to cutbacks in military spending. And this is also true of civilian expenditures.

Thus, Saudi ability to cope with the financial crisis is greatly inhibited by: (1) the drive to increase military spending; (2) the opposition to sharper cutbacks in subsidies (which entail higher prices for water, fuel, electricity, etc., and fewer government handouts such as free health care and educational services); (3) the pressure to create more make-work jobs for Saudi graduates and reduce their high level of unemployment; and (4) the voracious financial demands of the royal family.

Will Arab-Israeli peace agreements attract foreign investors to Saudi Arabia? Hardly. Other than the oil sector, including petrochemicals, there has been little foreign private investment in Saudi Arabia. In fact, total foreign private investment in Saudi Arabia fell sharply from $1.9 billion in 1990, to only $106 million in 1994. Trends were similar in other Arab oil states.[55] Unofficial estimates of Saudi private wealth held abroad are about $100 billion-not including the royal family.[56] This probably indicates a lack of faith in the stability of the regime. Given the magnitude and nature of their problems and the political, social, and economic constraints, one can understand the skepticism of the potential Saudi and foreign private investors with respect to investment in Saudi Arabia.

While Arab-Israeli peace is desirable in its own right-even without economic benefits-such an eventuality will hardly affect the Saudi economy. What the financial crisis in Saudi Arabia has done is cause the state sharply to reduce its aid to poor Arab countries as well as reduce the job opportunities available to the nationals of the poor Arab states. What the financial crisis has also done is compel the Saudi authorities to stretch out payments to American and British arms suppliers. No new arms orders of significance have been placed in the US in the last few years.[57] Three cheers for lower oil prices.

How Well (or How Poorly) is the Syrian Economy Doing?

Syrian merchants and entrepreneurs have a reputation for astuteness and diligence. And, indeed, for about twenty years before 1958, i.e., before Egypt united with Syria under the "United Arab Republic" and imposed Arab Socialism, the Syrian economy was doing very well, led by agriculture and light industry. GDP rose by an annual average rate of 7-8%, or about 4-5% per capita-respectable by any standards.

Private enterprise was dominant with the government confining itself to basic infrastructure investments, education, tariff protection for industry, and other aid to the private sector.

In 1961, after the Egyptians left, there was a short-term reversal of some socialist measures, but this was soon followed by a takeover of the regime by the leftist Ba'ath Party in 1963, and a more intensive and extensive imposition of socialist measures. The results have been, and continue to be, catastrophic despite some "corrective measures" taken by Assad after his rise to power in 1970. Assad's modifications made few changes to the basic socialist structure he inherited, however his regime did give greater leeway to private enterprise in some sectors of the economy.[58]

A bright spot on the horizon surfaced in the mid and late 1980s as foreign oil companies discovered large deposits of better quality oil. For the past forty years, oil has been a major factor in the gyrations of the Syrian economy. Output rose strongly from a low of 160 thousand barrels per day in 1985 (about the lowest level in the 1980s), to 610 thousand barrels per day in 1995.[59] Oil exports rose, even after the cutoff of Iranian oil shipments when the Iran-Iraq war ended in 1988. Oil was of key importance to the balance of payments. In 1995 oil export revenues were $2.4 billion, 60% of Syria's total export earnings, while all other exports-industrial plus agricultural-amounted to $1.6 billion.[60]

What does the future look like? In the summer of 1996 the Syrian oil minister was dismissed after being blamed for the "mass exodus" of international oil companies, which had ceased or sharply reduced their exploration activities in Syria. According to Shell, "If no significant oil discoveries are made in the next few years, Syria could become a net oil importer by the year 2005."[61] No one can be certain regarding future oil discoveries, but less exploration reduces the chances of new discoveries, without which production inevitably falls.

Another major factor, temporary but important, was Syria's "reward" for joining the anti-Saddam Hussein coalition. The magnitude of Assad's reward is not clear from official sources. According to one unofficial source, Syria received some $4 billion in concessional loans.[62] Another unofficial source states that Syria received "almost" five billion dollars in grants from the Gulf states, the West, and Japan,[63] much of which was spent on arms purchases-mainly from Russia.

Between 1981 and 1988, there were persistent current account deficits. The authorities cracked down strongly on imports, although illegal imports inevitably rose. The severe compression of imports affected the whole economy, which is dependent on imports of machinery and equipment, spare parts, and raw materials for industry, agriculture, transportation, construction, and other sectors. Soon thereafter, large oil export revenues and very generous foreign aid changed the whole economic situation. In 1989 the current account balance was a positive $1.2 billion, rising to $1.8 billion in 1990. However, by 1993 the current account balance was again negative (over $600 million), and the deficit was even higher in 1994.[64] Unofficial estimates for 1995 and projections for 1996 and 1997 point to even larger deficits.[65] The record of the past tells us that persistent and growing balance of payments deficits are a harbinger of future trouble. This might not be the case if there were large-scale foreign private investment. However, whatever foreign private investment has taken place has been almost solely by expatriates and other Arab investors, mainly in short-term commercial ventures rather than long-term investment in industry.

Unlike other countries in trouble (usually meaning falling behind in debt payments and other balance of payments problems), who call upon the International Monetary Fund and the World Bank to help straighten out their economies, the Syrians have steadfastly refused to take such steps. It may be a matter of pride, or that some of the decision-makers may find the current situation to their liking. These international institutions usually prescribe privatization, something resisted by highly-placed public officials who find it is easier to corrupt the public sector. Privatization usually means large-scale dismissals and a host of other problems. In short there are no real prospects of basic economic reforms.

The Syrian economy, as it has evolved in recent years, is described by one account as "strongly centralized, characterized by public sector predominance, administered prices, import compression, foreign exchange rationing [and] a system of multiple and generally overvalued exchange rates." This same analysis also quotes an estimate of the amount of Syrian capital which has fled to safer havens: a "massive" $25 billion.[66] In the absence of basic economic reforms, the Syrian economy will continue to be dependent on exogenous factors, as it has since the 1960s-most importantly oil. The possibility of foreign aid, as in the past, is a second important factor. A third factor is Syria's effective control of Lebanon.

Syria sent its army to Lebanon one year after the eruption of the civil war in 1975. Intuitively one might assume that this is a negative factor for the Syrian economy. One would assume that keeping an occupation army of 35,000 in Lebanon exacerbates Syria's already heavy military burden. But as things have developed, the occupation appears to benefit the Syrian economy in various ways, and may, in fact, be a net gain rather than a loss. There are no reliable figures, but the following description from *The Wall Street Journal*[67] should give us some clues:

Three years after Syria was supposed to withdraw its troops from Lebanon [according to an inter-Arab agreement], it was still tightening its grip .... The army that came in to make peace [among the various Lebanese factions] has dug in to make money .... Lebanese rich and poor, Muslim and Christian, resent heavy handed Syrians, whose 35,000 troops and pervasive secret police control everything. Syrian companies are building roads, renovating buildings, trucking freight and supplying much of Lebanon's cement and electricity. An estimated one half million to one million Syrians ... work in Lebanon, sending home annually between one and three billion dollars. For Syrian workers Beirut is heaven, salaries are about double [those prevailing in Syria]. Before the civil war [which began in 1975] Syrians did manual labor in Lebanon. Now with the Lebanese government powerless, Syrians are working in factories, ports, farms, and construction ... Lebanese Shiites and Palestinian refugees are especially hard hit by the influx of Syrian workers .... Lebanese merchants say that 'rackets run by officers in Syria's army and secret police control thriving trades in vegetables, cigarettes, clothing and others. There is large scale smuggling from Lebanon to Syria...'

Lebanese merchants complain that their costs have increased due to the "Syrian component"-payments to various Syrian army officers.

One of Syria's economic benefits, direct and indirect, from its occupation of Lebanon is employment for a half million to one million Syrians. Even the lower estimate implies jobs for about one seventh of the Syrian labor force. This is a far greater number than before the civil war and Syrian occupation. These jobs reduce unemployment in Syria and the remittances of these workers to their families back home, estimated at one to three billion dollars per annum, also bring in foreign exchange earnings. In addition, there are the profits of Syrian businessmen operating in Lebanon and the substantial payments Lebanese businessmen make to Syrian army officers. The foreign exchange earnings help to finance the large-scale illegal imports smuggled into Syria with the connivance of the Syrian armed forces. Officially, annual trade between Syria and Lebanon has been about $90 million in recent years. But it is estimated that unofficially- including smuggling-it is ten times that figure. Lebanon is the source of many of the consumer and other goods sold in Syria.[68] One can well understand the desire of Syrian army personnel to be stationed in Lebanon; it can be quite lucrative. The Syrian forces do not meet with any physical resistance to their occupation of Lebanon and the tribute they collect is substantial-why move?

Of possibly greater importance from the point of view of financial rewards is the army's involvement in the flourishing and lucrative drug trade in Lebanon. *The Economist*[69] quotes from an unpublished report of the US Drug Enforcement Agency, which details the close liaison between the Syrian forces in Lebanon and drug dealers. The Bakaa Valley, the center of the drug trade, is under the control of the Syrian army, as are most of the ports from which the narcotics are shipped to Europe and the US. The report states that Syrian forces have escorted drug convoys to the ports.[70]

The failure to implement basic reforms means that the outlook for the Syrian economy is poor, especially if, as expected, oil revenues fall. Syria has moved into a deficit position in its balance of payments (current account) since 1993, and the outlook is for more, and probably larger, deficits in the coming years. The large-scale payments Syria received for its political stance in the Gulf War are not likely to be repeated. This means continued or intensified balance of payments problems, with a consequent compression of imports, with adverse effects on the economy, as was the case during most of the 1980s. Barring the unforeseen, oil will probably not come to the rescue again, nor will the various aid givers.

Will Syria significantly reduce its military outlays? Not very likely. Syrian relations with Turkey are aggravated by the issue of water supplies and the Kurdish rebellion which affects both countries as well as Iran and Iraq. Relations with Jordan have, at times, been bitter. In any event, Assad requires a large army to quell internal dissension. Even a full-fledged peace treaty with Israel will not bring about any significant reduction in the armed forces of either side. The examples of Egypt and Jordan discussed above are instructive. With the signing of the peace treaties, each demanded, and received, more and more sophisticated military equipment from the US as a reward for their peace signature. This was in addition to large or larger-scale economic aid and the cancellation, or at least the easing, of the burden of all kinds of debts.

FOOD FOR THOUGHT

The analysis of economic developments during the last few years, in both Israel and its neighboring Arab countries, leads to some important conclusions.

1. Military Expenditures

Will Israeli-Arab peace agreements significantly reduce Middle East military expenditures? All the evidence points to the conclusion that the era of beating swords into ploughshares has not yet arrived in the Middle East. Israel has been reducing its military outlays since the early 1980s. But this has been largely unilateral. One of the conditions of the Egyptian peace agreement in 1979 was that the US would reward Egypt with sophisticated military equipment, which the US has been doing through a $1.3 billion per annum military grant, aside from civilian aid. There is no indication that Egypt has reduced its military outlays. Jordan's signing of the peace treaty with Israel in 1994 was accompanied by a request for more and better arms from the US.

What many tend to forget is that the Israel-Arab dispute is by no means the only dispute, or even the main dispute, in the region-though it does receive the most headlines. The longest and costliest war in the region in recent years was the Iran-Iraq War of 1980-88. Saudi Arabia and Kuwait fear Iran and Iraq. Syria fears Turkey and Iraq. Jordan fears Syria and Iraq, and so on and so on. In addition, there is another important factor which impedes a movement towards disarmament. In democratic countries, the armed forces serve to protect against foreign enemies and the police deal with criminals. In autocratic regimes, the armed forces serve to protect the regime from its internal as well as external enemies. Egypt, Syria, Iraq, and Saudi Arabia serve as good examples.

Aharon Yariv, a former head of Israeli Military Intelligence, said: "We are living in a dangerous neighborhood." Oslo's promises of prosperity have not changed the fundamental structures of Arab economies, nor have they stopped the flow of weapons. Israel must consider both of these realities in taking every necessary step to provide for its own security and economic prosperity.

2. Joint Projects and a Common Market-Risky Ventures

Israel suffered some serious setbacks as a result of the Khomeini revolution in Iran in 1979. In earlier years, Israel and Iran had cooperated in building an oil pipeline from Eilat to Ashkelon. This pipeline not only provided Israel with its own oil needs, but also enabled Israel to earn transit dues from shipments of Iranian oil to Europe. There were other joint projects in agriculture and in other sectors, as well as expanding trade, aside from oil. All of this came to a halt with the Islamist revolution of 1979. The new Iranian regime put an abrupt end to all economic or any other relations with Israel. Iran lost out as a result, but that did not deter the revolutionary regime. No one can be certain regarding future revolutions when, where, and if they take place, and what will be the policies of the revolutionary regime. But what the Iranian experience should teach Israel is to go slow, and be wary about larger joint projects which might make Israel, or important parts of Israel, subject to a sudden cutoff, or subject Israel to blackmail. In some cases backup systems might be feasible, such as imported coal substituting for a sudden cutoff of imported natural gas, but in that case, as well as in many others, the economic feasibility of the project might come into question.

This analysis is not meant to rule out all joint projects. Rather, it merely points out that before initiating a project, Israel should consider the possibility that the other country or countries involved may at some future date undergo revolutionary change and adopt policies inimical to Israel. This consideration is, of course, in addition to rigorous economic feasibility studies to which all proposed projects should be subjected.

Patrick Clawson, an American economist, relates from his experience at the World Bank that: "Financial disputes have been an irritant in joint international projects around the world, even when the countries involved are on good terms; they are likely to be all the worse when the partners start out being suspicious of each other." With respect to Middle East projects currently under discussion, such as a canal from the Red Sea to the Dead Sea, he argues that "such projects will not cement the recent peace accord. They are almost sure to be accompanied by dispute-provoking cost overruns which will strain relations between the partners."[71]

As demonstrated by the experience of the World Bank, joint projects often lead to international disputes. International financial disputes, for example between Argentina and Uruguay, may become vociferous. Similar disputes between Arabs and Israelis may become dangerous. The Israeli-Arab relationship is made even more complicated by the sentiment, popular in the Arab World, that Israel is giving up on political-military hegemony in favor of economic domination. They fear, as a former director-general of the Israel Foreign Ministry has phrased it, "Israeli Economic Imperialism".[72] A British publication notes that "Egypt's enthusiasm for global economic cooperation . . . is tempered by fear of regional economic domination [by Israel], including the concern that Egypt will merely become a source of cheap labor."[73] Similar views have been expressed by Palestinians, Jordanians,[74] and other Arab states.

Whether this sentiment has a basis in reality is irrelevant. What it tells Israelis is that they should be particularly wary of joint projects, especially large scale, long-term projects. Those interested in long-term peace should endeavor to minimize points of friction, rather than create new ones.

This analysis does not rule out ordinary trade by the private sector, where both sides feel they are gaining from the transaction. But it does rule out a Middle East Common Market or any similar multinational organization, the likes of which was proposed by Shimon Peres. His vision had no support in the Arab world, and, in fact, was even perceived as another indication of Israel's drive for economic hegemony.

Israel cannot base its economic future, or even a major stake of it, on economic relations with its neighboring Arab states. Even if they opened up their markets to Israel on an equal footing with that of other sources of supply, the fact remains that they have very limited purchasing power and their economies appear to be stagnant. Israel's markets-and the same is true for the Arab states-are mainly in the advanced industrialized countries, and, to a lesser extent, in the newly emerging countries in South and East Asia, as well as some of the advancing Latin American states. Inter-Arab trade has been minuscule.

3. The Importance of Good Government

All of us desire peace so that each man "can sit [in peace] under his vine and under his fig tree." We all desire a cessation of hostilities, whether of terrorism or open warfare. But an end to conflict alone is certainly not a sufficient condition for prosperity. What is abundantly clear from the experience of Israel in the past ten years, and of many other countries, especially in the Far East, is that economic growth and development are crucially dependent on "good governance," i.e., honest and capable government which provides the legal and infrastructure framework necessary for private enterprise to develop the economy.

Recent World Bank studies have come to the not very surprising conclusion that good governance is a prerequisite for rapid economic growth. This implies that government leaders have the wisdom, strength, and integrity to adopt and implement often very unpopular policies, and to wage a continuing battle against corruption, sloth, and inefficiency. Government must foster openness of trade, privatization, and convertible currencies. It must favor export industries and hold down government spending in order to increase domestic saving and investment.[75]

The failure of Egypt's economy, especially in the past decade, despite massive foreign aid and a peace agreement with Israel since 1979, is due to poor governance and policies adverse to economic growth and development. No peace agreement, even when associated with joint regional projects, free trade, etc., can substitute for wise economic policies.

4. Socio-economics and Islamic Militancy

Included in the many factors affecting regime stability is socio-economics. In some cases it is even the dominant issue. Although varying in significance from state to state, providing jobs and decent incomes is critical, while the failure to do so is destabilizing. In the Arab Middle East, regime changes often involve armed rebellion. Many analysts believe that "Islamic militancy, like the earlier nationalist [Arab] militancy, is linked inextricably to poverty and deprivation."[76] The continued economic failure of various Middle Eastern countries (as is evident from their longer term zero or negative economic growth rates per capita) may lead to revolt, especially where corruption enriches a select few who flaunt their growing wealth while the large majority suffers from falling incomes and poverty.

5. The Palestinian Economy and Closure-an Alternative Solution

Because of the frequent closures, there has been a large increase in the number of foreign workers coming to Israel from Eastern Europe, Africa, and other regions. They have taken over the jobs of the Palestinians. Given the sorry state of the Palestinian economy and the poor prospect of improvement without far-reaching changes in the Palestinian Authority and in its policies, there is no short-term solution other than finding outside jobs for tens of thousands of unemployed Palestinians. Israel is being pressured by the US and others to expel a large number of foreign workers, many of whom infiltrated illegally into Israel, and expand job opportunities for Palestinians. Israel has countered that such a step might endanger the security of its citizens, arguing that it must severely limit the number of Palestinians working in Israel because of the possibility that some may commit terrorist acts, or provide aid to those who do.

But there is an alternative solution-jobs in Saudi Arabia, Kuwait, and other Gulf states. Despite much lower oil revenues since the mid-1980s, the number of foreign workers in Saudi Arabia is enormous. The Saudis, Kuwaitis, and other Gulf Arabs shun manual labor as demeaning. As noted earlier, there are some three million foreign workers in Saudi Arabia, including a small number of Palestinians. Kuwait, following its liberation in 1991 by the US and the coalition forces, expelled some 300 to 400 thousand Palestinians-Jordanians. Many of the Palestinians living under the Autonomy previously held jobs in Saudi Arabia and Kuwait.

Israel has every moral right to put forth that Saudi Arabia and Kuwait must now again give work permits to the Palestinians and share the burden. An estimated one half of the foreign workers in Saudi Arabia are unskilled manual workers. Most of the Palestinians who worked in Israel held unskilled or semi-skilled jobs. Most of the foreign workers in Saudi Arabia are from the poor Asian countries. Even a small fraction of those jobs would more than satisfy the needs of the Palestinians. According to official figures, as of the end of 1995 there were almost two million foreigners in Kuwait and 707,000 Kuwaitis.[77] It can be assumed that of the two million foreigners in Kuwait, about one half were workers, the others being accompanying family members. The Kuwaitis, like the Saudis, have been importing labor mainly from the Asian countries.

The US and other states who saved Kuwait and Saudi Arabia from the clutches of Saddam Hussein should be able to persuade them to forget the past and hire Palestinians. In the long run, the Palestinians will have to develop their own economy. But that will take time, a revolutionary change in economic policies, and proper implementation.

6. Lebanon-the Economic Factor in Syrian-Israeli Peace Negotiations

Syria has been by far the most difficult of Israel's peace process partners. One of the motivating factors behind Syrian policy may be the significance of the Lebanese economy to that of Syria. With this important stake in the continued occupation of Lebanon, one can better understand why the Syrians may actually prefer the status-quo, including Israel's possession of the Golan Heights, to a settlement that would require it to relinquish control over Lebanon. What this may imply is that Syria may prefer, for this and other reasons, a non-belligerency pact which implicitly sanctions Syria's continued occupation of Lebanon, or of most of Lebanon, in favor of a full-fledged peace pact with Israel. According to the Taif inter-Arab pact, Syria should have withdrawn from Lebanon in 1992. Lebanon has no independent voice and this modus operandi will continue apparently into the indefinite future.

CONCLUSION

Economic history teaches that countries which adopt and efficiently implement wise economic policies prosper. Those that do not, more often than not, are failures, including those with an abundance of natural resources, such as the former Soviet Union or the oil-rich Arab countries.

This has been true irrespective of the significant costs of a heavy military burden. For example, in two of the East Asian "tigers," South Korea and Taiwan, military expenditures rose sharply over the past decades, however, their economies grew so rapidly that the relative burden (military expenditures as a ratio of GNP) fell, despite the high absolute level of military spending. South Korean military expenditures rose very sharply from $4.6 to $10.6 billion between 1981 and 1991, while the military burden fell from 6.2% to 3.8%.[78] During the same period, Taiwan sharply escalated its military outlays from $3.7 to $9.7 billion, however, the relative burden fell from 6.4% to 5.2%. In the case of Israel, military expenditures fell from $6.5 billion in 1981 to $5 billion in 1991, while the ratio of military expenditures to GNP fell far more rapidly: from 22.5% to 8.1%.

Achieving prosperity in the Middle East is dependent primarily on the removal of internal social and economic obstacles. The Oslo agreements can contribute little or nothing towards the removal of the impediments to economic growth and prosperity. They may have engendered false expectations and dangerous disappointments.

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THE CUSTOMS UNION BETWEEN ISRAEL AND THE PALESTINIAN AUTHORITY: A CRITICAL ANALYSIS

PRESENTED BY TALIA EINHORN
BEFORE THE
JOINT ECONOMIC COMMITTEE
OCTOBER 21, 1997

EXECUTIVE SUMMARY

The Israel - PLO Protocol on Economic Relations reflects the schizophrenia that afflicts the Agreement as a whole. Is it an agreement to separate Israel from the Palestinians, politically and economically, or is it an agreement of cooperation that will bring about an integration of their economies? These questions can hardly be answered before the parties have reached a shared clear view of the final status. Whatever political options may be under consideration, the provisions of the Protocol have created a dangerous situation, more of an invitation to a trade war rather than economic cooperation. The Protocol should have been designed to provide the economic foundation for an improved standard of living and for social progress. Instead, it has contributed to the impoverishment of the Palestinian population.

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THE PROTOCOL ON ECONOMIC RELATIONS

The establishment of an Israeli-Palestinian customs union.

The Protocol on Economic Relations (hereinafter - the "Economic Protocol" or "Protocol"), signed between Israel and the PLO,[1] reflects the schizophrenia that afflicts the Agreement as a whole. Is it an agreement to separate Israel from the Palestinians, politically and economically, or is it an agreement of cooperation that will bring about an integration of their economies? These questions can hardly be answered before the parties have reached a shared clear view of the final status.[2] In the meanwhile, the economic interim solution may dictate the political result. Whatever political options may be under consideration, the provisions of the Economic Protocol have created a dangerous situation, more of an invitation to a trade war rather than economic cooperation. This is a harsh statement requiring explanation, especially in view of the Preamble to the Economic Protocol, which reads:

> The two parties view the economic domain as one of the cornerstones in their mutual relations with a view to enhance their interest in the achieving of a just, lasting and comprehensive peace. Both parties shall cooperate in this field in order to establish a sound economic base for these relations, which will be governed in various economic spheres by the principles of respect of each other's economic interests, reciprocity, equity and fairness.

Neither the Protocol nor the preceding Gaza-Jericho Agreement make express mention of the type of arrangement chosen for the interim period, yet the provisions make it clear that this is a customs union.[3] A customs union entails a common level of external tariffs and application of the same regulations of commerce to substantially all imports from nonmembers, combined with elimination of all duties and other restrictive regulations of commerce with respect to substantially all imports from members.

Regarding external tariffs, the Protocol stipulates that 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 importation of most goods imported into the Palestinian Authority (article III.5(a)). Three lists of goods, attached to the Protocol, have been excluded. It has also been agreed to apply the Israeli system of importation to almost all goods imported into the PA (with the exception of the goods mentioned in the above three lists) (articles III.5(b), III.10). This includes the application of Israeli standards, licensing, country of origin, valuation for customs purposes, etc. The freedom of the PA to carry out an independent importation policy is restricted, with respect to the first two lists of excluded goods, to the quantities specified therein. With respect to the third list, on the other hand, the PA has been given full authority to independently determine and change from time to time the rates of customs, purchase taxes, levies, excises and other charges on those goods. This list includes basic food items and other goods for the Palestinian economic development program. It seems to have been understood that should the PA choose to reduce customs tariffs, or other duties levied on these goods, Israel would have to follow suit, in order to prevent its own imports from being first assigned to the territories controlled by the PA.[4]

The Protocol further provides that "there 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" (article IX). There is also free movement of agricultural produce (with a few exceptions, to be eliminated by 1998), subject to Israel's veterinary and phytosanitary requirements applicable to similar imports to Israel. According to the Protocol, the Israeli requirements follow international conventions and standards.

With respect to indirect taxes on local production, each party levies and collects VAT and purchase taxes on local production, as well as any other indirect taxes (article VI.1); the purchase tax rates must be identical for imported and domestic [like] goods (article VI.2); whereas Israeli VAT rate is 17%, the PA may choose to levy a VAT rate of 15%-16% (article VI.3). With respect to direct taxation, Israeli and the PA have remained free to determine and regulate their tax policies independently (article V). It has however been agreed that Israel would transfer to the PA 75% of the income taxes collected from Palestinians employed in Israel, and the full amount of income taxes collected from Palestinians employed in the Jewish settlements.[5]

In line with this Protocol no customs checkpoints exist between Israel and the Territories. Israeli customs officials, present at the Palestinian customs points of the Jordan River and the Gaza Strip, should receive from the Palestinian customs officials a copy of the relevant documents related to each shipment (article III.14).

The troublesome features of the customs union

Two aspects of this customs union are especially troublesome: the competition between the PA and Israel over import revenues and the absence of rules prohibiting unfair competition.

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

The Protocol provides (article III.15) that the clearance of revenues from all import taxes and levies, between Israel and the PA, will be based on the principle of place of final destination. Tax revenues are allocated to the PA even if the importation is carried out by Israeli importers, provided that the final destination stated in the import documentation is a corporation registered by the PA and conducting business activity in the territories under jurisdiction of the PA. Whereas the Protocol refers only to import taxes, article III.15 was probably meant to relate also to the purchase tax collected from imported goods upon their clearance from customs, notwithstanding its classification as an internal tax imposed on domestic as well as imported goods. In practice, Israel remits to the PA both customs duties and the purchase tax collected from imports with final destination in the autonomy.

This means that Israel and the PA are competing for the revenues from imports. The gain of one is the immediate loss of the other. The method adopted by the European Community, when faced with the same problem, is instructive. In the EC, following the completion of the customs union in 1968 and the adoption of a common customs tariff, customs duties and agricultural levies (collected upon importation of agricultural products from non-members) were designated as a source of Community revenue.[6] It has been noted that this designation follows logically from the nature of the customs union, since in effect goods are imported into the customs union rather than into any of its members.[7] Whatever their port of entry, the goods are then in free circulation throughout the territory of the customs union. The import duties and agricultural levies are transferred by the Member States to the Community budget, less 10% allowed to cover the costs of collection by the national administrative authorities.

The Protocol makes it clear that as soon as the documentation indicates that the final destination of the imported goods is a corporation registered and conducting business in the autonomy, all import taxes (including purchase tax) will accrue to the PA. There is no need for them to be sold in the PA. The free circulation principle ensures their free movement in Israel. In fact, they need not reach the Palestinian territories at all. Following clearance by the customs authority, they may lawfully reach the Israeli market directly. The Protocol thus creates a clear incentive to divert trade of goods subject to a high rate of purchase tax.

It may as yet be too early to assess to what extent imported goods with final destination in the Palestinian territories, according to their documentation, end up being sold on the Israeli market, and all data collected so far must be treated with caution. Yet, complaints that diversion of trade is in fact taking place have already been sounded by the Israeli Ministry of Trade and Industry, the Association of the Chambers of Commerce and the Association of Manufacturers.[8] Furthermore, a report made by the Economic Department of the US Embassy in Israel notes that, "both PA and GOI [Government of Israel] Ministry of Finance have revealed to us that statistics on customs and VAT clearances (for Palestinian purchases "cleared" through Israeli collections) confirm the counter-intuitive conclusions from the CSD [the PA Ministry of Planning's Central Statistics Department] figures: imports are indeed on the rise in spite of the very real economic woes ... In looking at Q/3/96 [3rd quarter of 1996] statistics compared with Q/3/95 numbers only, imports rose across the board in all categories (at least slightly) except in building materials".[9] The increase in imports has taken place in spite of the repeated closures imposed by Israel on the Palestinian Territories and despite the economic depression, with real GNP falling some 18%.[10]

One may only speculate what the reasons might have been for not creating a joint budget for the Israeli-Palestinian customs union. One reason may be that there seemed to be no need for a common budget in the absence of common projects that might be financed from that budget. Another reason may be that, as mentioned in the Preamble, "this Protocol lays the ground for strengthening the economic base of the Palestinian side and for exercising its right of economic decision-making in accordance with its own development plan and priorities". Strengthening the Palestinian economy is indeed a very important goal, yet any solution which puts the parties at odds with each other, rather than enhance cooperation between them, may end up causing more damage than benefit to both.

This problem is aggravated by yet another factor. Whereas purchase taxes on PA-destined imports are directed to the PA, purchase taxes on Israeli domestic products accrue to the Israeli budget. The PA has thus a clear incentive to prefer the purchase of imported goods over Israeli domestic products. This has already caused anxiety to Israeli producers, and caused the Israeli

Association of Manufacturers as well as the Israeli Minister of Trade and Industry to demand that purchase taxes be transferred to the PA also in respect of Israeli products.[11] The Israeli finance ministry has not yielded to this demand. It is not difficult to imagine that, had it agreed, Israeli products might have first been sold to corporations conducting business in the territories subject to the PA, and then resold on the Israeli market, the PA having collected the respective purchase tax. The danger is real, in view of the systematic monopolization of trade with the PA, as explained hereunder.

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

(a) The need to prohibit anticompetitive practices

The second fault of the Economic Protocol is due to the absence of any rules regarding competition. Agreements that provide for the free movement of goods must take into account the inseparability of "domestic" anticompetitive behavior, motivated by industrial policy considerations, from international trade policy. Therefore, customs union agreements, and even free trade area agreements, include provisions prohibiting anticompetitive behavior.[12] Thus, article 12 of the previous FTA between Israel and the EC, as well as article 36 of the future Association Agreement with the EC, declares as incompatible with the proper functioning of those agreements:

> (i) all agreements between undertakings, decisions by associations of undertakings and concerted practices between undertakings which have as their object of effect the prevention, restriction or distortion of competition;
>
> (ii) abuse by one or more undertakings of a dominant position in the territories of the Community or Israel;
>
> (iii) any public aid which distorts, or threatens to distort, competition by favoring certain undertakings or the production of certain goods.

The Association Agreement further requires the Parties to ensure transparency in the area of public aid.

Articles 85-90 EC Treaty provide even more stringent rules regarding competition. Being aware that Member States are in a position to insulate public undertakings from market forces, finance them out of taxes, protect them from domestic or foreign competition, and favor their interests over those of consumers, the EC Treaty provided that special and exclusive rights, granted by Member States to public undertakings, are to be abolished if they prove to be incompatible with the free movement of goods and services. These provisions enabled EC law develop a level playing field for private and public undertakings, and implement an economic order based upon open markets and undistorted competition.[13]

Such provisions are missing from the Economic Protocol. Article IX.3 includes a rather vague and very soft undertaking, providing that "each side will do its best to avoid damage to the industry of the other side and will take into consideration the concerns of the other side in its industrial policy". This provision is no replacement for proper rules regarding anticompetitive behavior.

(b) The regulation of distribution in the Palestinian territories through "direct agents"

The impact of the absence of competition rules was soon to be learnt by the Israeli side. On July 26, 1995, December 18, 1995 and January 6, 1996 the Palestinian Ministry of Economy and Trade issued circulars, informing all international companies that they may operate in the Palestinian Territories only through a direct importer, agent or distributor registered with the Palestinian National Authority.[14]

On March 16, 1996, a communication was issued by Palestinian Ministry of Economy and Trade, reading as follows:[15]

> The Palestinian Authority's Ministry of Economy and Trade wishes to present the following explanatory remarks on the issue of commercial representation in the West Bank and the Gaza Strip. While we are actively involved in the organization of our domestic market and the establishment of our regional and international trade relationships, the following remarks are the Ministry's guidelines in its efforts to promote Palestine and the Palestinian business community as business partners in this region:
>
> 1. The West Bank and the Gaza Strip have always and continue to be a separate territorial and political entity.
>
> 2. The West Bank and the Gaza Strip maintained their distinct legal jurisdiction, since they were never annexed to Israel even when Israel administered the West Bank and the Gaza Strip, as an occupier, between 1967-1994.
>
> 3. While Israel was administering the West Bank and the Gaza Strip, existing laws continued to apply in this area distinct from laws applied in Israel. The court systems were also different and decisions were rendered independently. Thus, two parallel legal structures existed.
>
> 4. Contractual agreements were entered into by and between Israelis and Palestinians, each of which had their own binding effects. Agreements made with third parties, which applied in Israel, did not necessarily apply to the West Bank and the Gaza Strip and vice versa.
>
> 5. In 1993, the Declaration of Principles was signed between the PLO and Israel followed by several Agreements. As a result, Israel has ceased its administration of the West Bank and the Gaza Strip.

6. The essence of the Agreements is rooted in the establishment of a Palestinian self-government authority leading to the establishment of an independent Palestinian State.

7. Pursuant to the Agreements, the Palestinian Authority has assumed full responsibility and control over legal and civil matters in the West Bank and the Gaza Strip. These include, but are not limited to, economic spheres, such as taxation, trade, industry, banking, commercial and corporate transactions and the judiciary.

8. The Palestinian Authority is now responsible for the regulation of all commercial and corporate activities including representatives to foreign companies and businesses in the West Bank and the Gaza Strip.

9. A corporate entity cannot function as a representative to a foreign company in the West Bank and the Gaza Strip unless it is registered in the Companies Register of the Palestinian Authority which is separate from the Israeli register. Intellectual property can only acquire protection in the West Bank and the Gaza Strip if it is also registered in the Palestinian Authority registers.

10. Each corporate representative has to comply with Palestinian Authority regulations in the sale and distribution of products within the West Bank and the Gaza Strip including matters of labeling, health and safety regulations.

11. Foreign citizens, companies or other entities can only operate in the West Bank and the Gaza Strip if they have an explicit authorization and/or registration with the relevant Palestinian Authority department according to prevailing laws and regulations.

We trust these explanatory points can help in clarifying the distinctions between the Palestinian and Israeli markets and hope that the necessary steps will be taken by your company to appropriately adjust to the changing political, economic and legal realities in light of the recent Palestinian-Israeli peace agreements.

We also trust that supporting a viable Palestinian economy, competent and strong Palestinian business community, in full cooperation with the regional and international partners, would be the cornerstone for a sustainable peace in Palestine and the Middle East.

Thank you in advance for your cooperation.
(-) Samir Huleileh
Assistant Under Secretary
Ministry of Economy & Trade

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Following this communication, the PA Ministry of Economy and Trade issued a notification, reading as follows:

Preamble

Pursuant to the Commercial and Business Laws applied in Palestine, the Ministry of Economy and Trade (the Ministry) announces the instructions for the registration of commercial agents and agencies and its measures for the protection of their rights. The issuance of these instructions constitutes part of a campaign undertaken by the Ministry to regulate the internal trade in the Palestinian market and to enforce and protect the rights of agents and agencies.

In its implementation of such laws, the Ministry has opened the Registers for (1)agencies, (2) agents and (3) distributors and middlemen, which were suspended during years of occupation.

Implementation and Compliance

Beginning October 1, 1996, the Ministry will implement the laws and regulations; full compliance must be adhered to no later than January 1, 1997.

Instructions

First: Individuals and companies that have obtained direct agency agreements for the Palestinian National Authority (PNA) areas must register as agents (individual and/or company) and register the agency agreement itself with the Ministry of Economy and Trade.

Second: The direct agency rights are deemed to cover the entire areas of the Palestinian National Authority (West Bank and the Gaza Strip).

Third: Foreign companies distributing goods in the PNA areas, must appoint a direct agent who is to register with the Ministry in compliance with prevailing laws and regulations.

Fourth: Foreign companies distributing goods in the PNA areas, where agents are not required or used in the ordinary course of business, must qualify for an exception from the Ministry whereby they may distribute through distributors and middlemen.

Fifth: Distributors and middlemen who distribute goods for foreign companies, as mentioned in Fourth above, must register at the Registrar of Distributors and Middlemen at the Ministry.

Sixth: Those agents having agencies for special category goods, including cigarettes, electrical appliances, pharmaceuticals, cars, certain food stuffs and agricultural items, must attest to compliance with the technical requirements of the concerned ministries and departments of the PNA before registering with the Ministry.

Seventh: Direct agents may authorize primary, sole or more distributor(s) in the PNA areas in order to facilitate delivery of goods to and between the West Bank and the Gaza Strip.

Eighth: To protect the direct agency rights, the Ministry will prevent the import, the entry and distribution of goods into the Palestinian market unless authorized by the agent.

(-) The Minister
Ministry of Economy and Trade

1 October 1996

It has correctly been pointed out that the communication and notifications issued by the PA reflect a practice that will lead to economic secession rather than a customs union.[16] Indeed, following the introduction of these rules, Israeli importers and producers have sounded complaints that whereas Palestinian importers are free to import goods directly into the Israeli market, a de facto boycott exists on importation of goods from Israel into the Palestinian territories.[17] It may have been expected that this would especially affect goods subject to high purchase tax rates. In this respect however one more factor has come to play a decisive role. The PA has set up its own agencies, or monopolies, to import goods from Israel as well as from third countries. Reportedly, the monopolies in Gaza are dominated by Arafat's financial consultant and the Head of Arafat's Bureau in Gaza.[18] From Arafat's offices they run Al-Bahar, a commercial company granted a licence by the PA to be the sole importer of some of the most important commodities from Israel, including petroleum, cement, electric appliances and equipment. In the West Bank the monopolies are dominated by a senior financial advisor to Arafat.[19] Other monopolies have been set up to handle the imports of flour, cigarettes, meat, paint, construction materials, televisions, VCRs, computers etc. Reportedly, more than 100 exclusive importing agencies have been created.[20] They are controlled by persons with close contacts to the PA Chairman, some of them serving simultaneously as officials of the PA. It has been maintained that the monopoly for the importation of gravelstone is controlled directly by the security services, and the income derived finances their activities.[21] The monopolies enhance the trade with Israeli and foreign manufacturers linked to them. Other Israeli and foreign firms have been excluded from the Palestinian markets. Israeli importers have been excluded altogether. Goods imported by the monopolies as Gaza or West Bank-bound are sold on the Israeli market. It has been maintained that the structure of the monopolies, controlled by senior PA officials, has enabled the PA to share with them some of the revenue taxes that it collects from Israel upon clearance of the goods. The purchase tax is thus shared between the PA and the PA importer.[22] Some of it may even be passed on to the Israeli consumer, thus giving these imports a competitive edge. Moreover, independent Palestinian entrepreneurs have lost a substantial share of their Palestinian market.[23] According to a report published by the IMF (International Monetary Fund) in 1997, "the PA has undertaken to dismantle import monopolies (notably on petroleum products, cement, tobacco, and some electronic products) by end-1998."[24]

The Israeli side has claimed that the Palestinian regulations are in violation of the Paris Agreement, which in Article IX of the Protocol provided that "there will be free movement of industrial goods free of any restrictions". The Palestinian side has responded that according to that same Article IX the freedom of movement of goods has been made "subject to each side's legislation". The PA has claimed that its regulations are in accordance with the Jordanian "Commercial Agents Law" of 1967, requiring all agents of foreign companies to be Jordanian citizens or companies registered in Jordan with the majority of their shareholders being Jordanian as well. The Israeli occupation having come to its end, it is the old Jordanian law which should now be used as the basis for Palestinian legislation.[25]

The Israeli side may be right that the proviso included in Article IX was meant to cover only such legislation as may be needed to protect public interests, such as health, security and safety, yet article IX makes no specific reference regarding the contents of such legislation. Be that as it may, the resulting situation is contrary to the most basic tenets of a customs union. This calls for an assessment of the various options available to remedy the current state of affairs.

THE ECONOMIC DEVELOPMENT OF THE PALESTINIAN TERRITORIES

The evaluation of the different options for an economic arrangement between Israel and the Palestinians requires some understanding of the economic development of the Palestinian Territories, in view of the political and social problems encountered both before and during the Israeli occupation. The present situation, since the territories have come under the control of the PA, is covered as well. This study is limited to the most pertinent points.

The status of the occupied territories under public international law

The West Bank formed part of the Palestine British Mandate until 1948. Following the 1948 war with Israel, it came under Jordanian control. Jordan attempted to annex the West Bank in 1950. The annexation was not recognized under public international law, Britain (with an exception regarding East Jerusalem) and Pakistan being the only states to recognize the annexation, which was also vehemently opposed by the Arab states.[26] In 1967, following the Six Day War, it came under Israeli control. Israel has not annexed the West Bank, to the exclusion of East Jerusalem. The annexation of Jerusalem has not been recognized under public international law.[27] In 1988 King Hussein declared that Jordan severed its legal and administrative ties with the West Bank.

The Gaza Strip was also part of the British Mandate until 1948. Following the war with Israel, it was administered by Egypt from 1948 until its occupation by Israel in 1967. Egypt has never claimed title to it.[28] The peace treaty between Israel and Egypt specifies in article II, that "the permanent boundary between Israel and Egypt is the recognized international boundary between Egypt and the former mandated territory of Palestine ... without prejudice to the issue of the status of the Gaza Strip".[29]

The Economy of the West Bank and the Gaza Strip Prior to the Israeli Occupation

Prior to their occupation by Israel in 1967, the economies of the West Bank and the Gaza strip were underdeveloped and fragmented. There was no exchange between the West Bank and the Gaza Strip.

(1) The Economy of the West Bank

The West Bank had economic ties to Jordan, and therefore its economy was comparatively stronger than that of the Gaza Strip. Yet, the West Bank remained underdeveloped. Jordan gave preferential treatment to Transjordan, that had most investments directed to it and experienced a large increase in the urban population, in contrast with the West Bank with its mainly rural society.[30] This preference was also reflected in the Jordanian budget. The high rates of full and seasonal unemployment (estimated at more than 50% of the labor force[31]) caused a high rate of emigration from the West Bank mainly to the East Bank of Jordan. As a result, the population in the West Bank changed little between 1952 and 1967, rising according to some estimates, from 742,300 in 1952 to 803,000 on the eve of the 1967 war.[32] In 1966 agriculture contributed 27% of the GDP and employed about half the labor force (as compared with 7% of the labor force in Israel), this seeming discrepancy due to low productivity as well as concealed unemployment. To an extent, this resulted from the fragmentation of farm units, the small size of the agricultural units not unique to the West Bank, but rather typical and the result of Muslim inheritance patterns.[33] Furthermore, West Bank agriculture was heavily dependent upon rainfall with only 5% of the cultivated land being irrigated. Olives constituted the main crop in the West Bank. Scarcity of water prevented the expansion of agriculture. Primitive methods were employed; sowing and harvesting were done manually by the farmers, using antiquated tools such as sickle and scythe, and animals rather than tractors.[34]

Industry and mining contributed 8.8% of total GDP. Most of the manufacturing was carried out by small and medium workshops. 90% of them employed less than 10 persons and two thirds of those employed even less than 5. Most of them processed primary products, such as food, beverages, tobacco, textile and clothing.[35] Construction contributed 6.4% to total GDP. The services sector was dominant, contributing more than 56% of the GDP. This was partially due to the significant role of tourism, mainly from Arab countries.[36]

(2) The Gaza Strip

Following the 1948 war, the Gaza Strip constituted a separate economic unit administered by Egypt. Whereas some links with the Egyptian economy were maintained, many restrictions limited economic exchange.[37] The population, which was approximately 280,000 in 1948, increased steadily to 288,000 in 1950, 373,000 in 1960 and around 400,000 in 1966.[38] The labor force represented only a small percentage of the total population. Thus e.g. just prior to its occupation by Israel in 1967, the labor force was estimated at 19% of the total population.[39] Female participation in the labor force has been negligible.[40]

From 1948 to 1967 agriculture (including fishing) was the main economic activity in the Gaza Strip. In 1965 a third of the work force was employed in agriculture, which provided about 36% of the GDP, and 90% of all exports, citrus being the main source of income.[41] Nearly half the cultivated area was under irrigation. Before 1967 withdrawals from Gaza aquifers exceeded average renewable recharges by some 50%.[42]

Industry contributed about 4% of total GDP.[43] In the whole area of the Occupied Territories there was only one modern factory.[44] It was in Gaza and produced soft drinks. The rest of the industrial production was concentrated in small workshops, that used manufacturing methods and tools even poorer than those prevailing in the West Bank. Immediately after 1948 weaving was the most important of the small industries. About two thirds of all industrial firms produced textiles and carpets.[45] The weaving industry declined rapidly, however, because looms could not be replaced or maintained and because lower priced textile imports came to dominate the local market.[46] Industrial firms included flour mills, olive presses, ice factories, soft drinks and sweets manufacturers, cigarette and tobacco processors and organic fertilizer plants, woven and spun textile and production of soap. Some workshops engaged in the maintenance and repair of agricultural and irrigation equipment and manufacture of packing crates. The overall manpower employed in industry has in fact decreased from 2500 in 1953 to 1782 in 1960.[47]

Trade and personal services contributed 28% to the GDP.[48] Foreign trade was of great importance due to the need to import most raw materials. About 50% of the raw materials came from Egypt.[49] However, the imports into Gaza served not only the local market. Gaza merchants imported also 'luxury' goods, such as whisky, radios, china and silverware and, thanks to relaxed border controls, smuggled them into Egypt.[50] It has been estimated that only 10% of the goods imported into Gaza were purchased for local consumption. 70% were smuggled into Egypt, and 20% were consumed by tourists.[51] Citrus exports comprised 70% of the Gaza Strip total export in 1954, and this figure increased to 90% by 1966. The Gaza Strip suffered of a steadily growing trade deficit, which was covered mainly by remittances from UNRWA (United Nations Relief and Works Agency for Palestinian Refugees in the Near East) and, to a lesser extent, by other public transfers, as well as remittances from relatives abroad.[52]

Construction, mainly of private housing, contributed 6% of the GDP and provided employment for 4000 workers before 1967.[53] During the '50s and '60s Egypt has forbidden UNRWA the building of any permanent housing and the casting of concrete foundations. These restrictions were intended to ensure that the refugees retain their refugee status.[54]

The services sectors in the Gaza Strip provided most of the remaining employment and accounted for over a half of the GDP before 1967. Its income was derived from tourism, public services, transportation and services given to Egyptian, Palestinian and United Nations forces stationed there. UNRWA employed a large staff to run its refugee camps, schools and clinics.[55] The collection of taxes throughout this period was only marginal, and accounted for only 2-3% of GNP. Customs duties on imported goods, on the other hand, provided an important source of income due to the smuggling of goods into Egypt.[56]

The Economy of the West Bank and the Gaza Strip under Israeli Occupation prior to the Intifada

In view of the weakness and problematic structure of the West Bank and Gaza Strip economies prior to the 1967 war, Israel could hardly be blamed for having distorted the Palestinian economy. In fact, no Israeli government formulated a well-defined economic policy regarding the territories occupied in 1967.[57] The Israeli occupation has however created problems of its own.

In the end of June 1967, less than three weeks after the end of the Six Day War the walls separating East Jerusalem from West Jerusalem were demolished. On the next day hundreds of Palestinians reported to work, offering their labor to Israeli employers. By then Israel had suffered two years of economic recession and tens of thousands of Israelis were still serving in the military reserves. Israeli employers were thus inclined to hire the Palestinians to work, mainly in construction. From the Palestinians point of view, the sudden war had taken place amidst the agricultural season in the West Bank. The bridges connecting the West Bank to Jordan had been bombed and there was danger that most of the 1967 crops, that should have been exported to Jordan, would be lost. Tourism was in danger of a crisis in the West Bank, and the public sector employees were concerned that their salaries would no longer be paid by Jordan.[58]

The Israeli administration helped transport the West Bank crops to Jordan, and to that end even rebuilt the bridges on the Jordan River. The interest of Jordan and other Arab countries in purchasing the crops induced them to disregard the rules of the Arab Boycott prohibiting such exchange. Many Israelis, while touring the West Bank, also bought goods on sale there, due to their competitive prices. By August 1967 many Palestinians from both the West Bank and the Gaza Strip were willing to explore the opportunities opened to them to work in Israel in building, industry and agriculture; the Palestinians working in the Gulf states renewed their remittances to their family members in the Occupied Territories; and Jordan continued the payments to its former teachers and policemen.[59] The money thus accumulated by the Palestinians helped them renew their inventories by purchasing goods from Israeli dealers and manufacturers. Payment in cash, rather than by arrangements of credit, common in Israel, made Israeli manufacturers offer them substantial rebates. When it turned out that they were willing to compromise the quality of products, Israeli manufacturers established special production lines for cheap merchandise sold to the Palestinians. By 1986 the number of Palestinians employed in Israel was estimated at 94,700, which amounted to 36% of the total labor force in the West Bank and Gaza Strip.[60] In 1987 109,000 Palestinian workers, constituting almost 40% of the labor force, were employed in Israel.[61] Employment in Israel has been very meaningful from the point of view of the Palestinians: the income from Israel equaled a quarter of the GDP; most persons employed in Israel had no other source of income; more than half were sole providers of large families. Work was especially important for the residents of the Gaza Strip, where most of the population was urban, the economy less developed, the per capita GDP smaller, and rate of population growth - faster. From the Israeli point of view, the importance of the economic connection was much smaller. The 109,000 Palestinians working in Israel in 1987 constituted only 7.2% of the total labor force.

Agriculture in the Occupied Territories has undergone significant changes since 1967. The Israeli Ministry of Agriculture provided technical assistance and agricultural education services that introduced technologically advanced methods of agricultural production, mainly more efficient methods of irrigation, especially drip irrigation; the production of protected crops in polyethylene greenhouses or through polyethylene mulch combined with drip irrigation; the use of fertilizers and pesticides; careful selection of seeds and kinds of stock and seedlings; and enhanced mechanization.[62] As a result, some yields have doubled or tripled since 1968.[63] Although productivity levels have remained well below those in Israel, the USA and selected Western European countries, they have nevertheless been comparable to or exceeded those prevailing in neighboring Arab countries.[64] In the Gaza Strip Israeli assistance also helped farmers shift from citrus to intensive agriculture focused on the production of vegetables. Improvement of cultivation methods decreased the number of persons needed in the orange groves. Whereas citrus groves required substantial investments, and only few had the required capital, the shift to vegetables better suited the social and economic needs of the rapidly growing number of residents of the Gaza strip.[65] With the increase of employment opportunities in Israel, fewer persons were inclined to work in the agricultural sector in the Occupied Territories. As a result, agriculture became a secondary source of income for many families, employing also women, children and old persons.

During the first years of occupation the West Bank and Gaza Strip attained a relatively high rate of growth. The average annual growth of agricultural productivity was 12% in each of the first six years; average annual growth of industrial productivity - 15% (reaching 10% of GNP in the West Bank and 6% - in the Gaza Strip, the level being nevertheless comparable to that of developing countries); the share of building, which in the first years declined from its pre-1967 rate of 6% of GNP to 3% of GNP, then recovered and reached 6% in the West Bank and 9% in the Gaza Strip.[66] When Israel plunged into recession and high rates of inflation in the late 1970s, GDP in the Territories grew at only 5.3% per annum. With economic growth in Israel slowing down even further, GDP in the Territories grew at 2% per annum in the early 1980s.[67] Following economic recovery in Israel in the mid-1980s, GDP once again increased rapidly at a pace of 5.6% per annum.[68]

The first 20 years of occupation have brought about a pronounced improvement in the standard of living of the Palestinians. Private consumption per capita rose during 1969-1986 at an overall rate of 5% per annum.[69] This is evidenced by economic indicators, such as increase and improvement of quality of the food consumed; housing conditions; ownership of private cars, refrigerators, television sets, cooking appliances, sewing machines, etc.[70] According to the World Bank Report, 95% of the Households in Gaza had running water and 100% had electricity (compared with 3 percent for water and 14% for electricity in 1974). This does not relate to the disadvantaged refugee camps. However, the quality of water in Gaza is far from satisfactory and electric shortcuts occur all too often. In the West Bank 79% of the households have running water and 75% - electricity, compared with 24% with water and 46% with electricity in 1974.[71]

The rate of growth of population has also moved upwards since 1967, from around 2.2% in 1968 to 3.6% in the West Bank and 3.8% in the Gaza Strip in 1987.[72] The increase in birth rate was accompanied by a decline in infant and child mortality. The growth of the population has since the 1950s been mitigated through negative migration. However, in 1983 Jordan forbade emigration of Palestinians to Jordan, and emigration declined to 4000 from both the West Bank and the Gaza Strip in 1983; 8000 in 1985; and 9000 in 1986.[73] Life expectancy increased by a decade, from 56 in 1970 to 65 in 1987 (and 66 in 1991).[74] Population in the West Bank increased from almost 600,000 in 1967 to 837,000 in 1987, and in the Gaza Strip - from almost 400,000 in 1967 to 545,000 in 1987.[75] As a result of the high birth rate the population in the West Bank and Gaza Strip is very young. In 1986 Persons under 24 years of age constituted 69% of the population, whereas persons over 65 years were only 3% of the Territories population.[76] Education has also developed significantly. The percentage of persons with at least 9 years of education has risen from 22% in 1970 to 46% in 1986 in the West Bank, and from 32% to 54% in the Gaza Strip during the same period. There has also been an increase of students enrolled in universities and academic institutes of higher education.[77] Nevertheless, women illiteracy has remained a serious problem.[78]

However, the story of the Palestinian economy under occupation is not just bright, as manifested by the following problems encountered:

1. The agricultural sector suffered from Israeli restrictions on the importation of agricultural products from the Occupied Territories into Israel. In addition to that, policies of the Arab League Boycott have restricted the flow of farm products from the West Bank and Gaza to the Arab world. Over pumping in Gaza caused salination of the water, which in turn damaged the quality of Gaza's agriculture. This prompted the Israeli civil administration to restrict water usage. The same restrictions were not applied to Israeli settlers inside the Gaza Strip. Their annual per capita consumption of water has been more than 10 times that of the population of Gaza.[79]

2. The composition of the industrial sector has remained largely unchanged since 1967. Israeli business arrangements have been created with firms inside the Territories either for the purchase of goods or for subcontracting of work. Israeli construction firms purchased nearly 50% of the building materials manufactured in the West Bank.[80] The same was true for workshops in the Gaza Strip manufacturing shoes and cloths for Israeli firms.[81] In general, industrial goods from the West Bank and Gaza Strip were permitted entry to Israeli markets, provided that they complied with Israeli rules regarding labeling, standards, hygiene regulations etc. Nevertheless, Israeli manufacturers enjoyed benefits not extended to Palestinian manufacturers, such as access to private and public sources of credit, tax benefits and investments, as well as a larger capacity, enhanced technological sophistication, and higher level of training of their employees.[82]

3. Arab manufacturers were obliged to obtain licences for industrial projects from the Israeli officer in charge of trade and industry within the Civil Administration. Thus, at least some projects have not been approved, as Israel had no interest in the development of an industry that will compete with its own. Those included a cement factory and a poultry hatchery.[83] The cement factory was not approved to ensure the continued monopoly position of the single Israel Cement Corporation (Nesher) also over the Occupied Territories. As a result of the denial of licence to the poultry hatchery, poultry raisers were obliged to procure baby chicks from Israeli hatcheries. Rigid quotas placed on the number of chicks forced Palestinians to buy a substantial proportion of the end products (meat and eggs) from Israeli producers. Exports from Israel to the West Bank constituted 89% of the its total industrial imports in 1986, and 92% of the total industrial imports of the Gaza Strip in that year.[84] In the same year, exports to Israel constituted 62% of the total exports from the West Bank and 85% of the total exports from the Gaza Strip. In trading with Israel the Occupied Territories suffered a continuous trade deficit, which has been financed through exports to Jordan, wages obtained in Israel, and capital remittances from abroad.[85]

4. The local industry in the Occupied Territories further suffered from the lack of investment. This was due to the political instabilities and uncertainties that made any form of investment very risky. The low level of development of the financial system inhibited the transfer of private savings into productive investment.

5. The Arab League's Boycott of Israel has been applied to the Occupied Territories, thus depriving them access to the markets of the Arab countries.. Industries established in the West Bank since 1967 and not licensed by Jordan have not been allowed to export at all to Jordan. This meant that the production of major Palestinian exports, such as soap, had to use raw materials and new equipment imported via Jordan, usually at relatively high costs. Until 1979 only pre-1967 factories were allowed to export to Jordan. In 1979 the Jordanian Government awarded licences to a number of relatively large factories.[86]

6. Wages paid to Palestinian workers in Israel were subject to the same deductions as wages paid to Israeli employees. These included income tax and contributions to social security. There are no available statistics on these fiscal transfers. Regarding income tax, it is the usual international practice for income tax to accrue to the treasury of the territory in which a person works.[87] Regarding social security, however, Palestinian employees did not qualify for most of the benefits for which the social security deductions were supposed to pay. The excess of these deductions was thus used to create a "deduction fund" remitted to the Civil Administration. The Civil Administration used the money to finance general expenditure. The report of the World Bank has concluded that Israeli spending on public services has been somewhat low for the income level of the population and that development spending has been extremely low, as evidenced especially by the poor economic infrastructure in the Occupied Territories.[88]

7. The functioning of the Israeli Civil Administration in charge of the Territories has been severely criticized. Shortly after the occupation it had been staffed with persons belonging to the elite of the Israeli society. The long duration of the occupation has brought stagnation coupled with the problematic features of an administration that is not subject to any effective criticism by the recipients of its services. Such conditions would probably make any administration inefficient and careless. Working conditions in the Civil Administration became increasingly difficult and dangerous. The decision of the Government of Israel to operate the Civil Administration as a "closed economy" had especially harsh results. The Civil Administration has thus been charged with financing itself from the remittance by Israel of the Palestinian contributions to social security mentioned above, as well as from levies and charges for the Civil Administration services, such as the issuing of various licences and certificates. Thus, simple certificates as a permit to exit the State of Israel, or to receive visits of relatives from Arab countries were made subject to expensive charges.[89]

8. The settlement of Jews in the Occupied Territories, whether for security and strategic purposes, or due to the will to realize the original ideal of establishing a "national home for the Jewish People" in the whole of the Land of Israel, has met with substantial criticism for the use made by Israel of the land and natural resources, mainly water, of the West Bank and Gaza.[90]

The trade relations between Israel and the Palestinians prior to the Intifada could be thus described as a trade of Palestinian labor for Israeli goods.[91] The number of industrial establishments has grown since 1967 thanks to the generation of capital from wages in Israel and remittances from Palestinian workers abroad, as well as the opportunities opened to Palestinian firms to subcontract to Israeli firms. However, the higher wages earned by Palestinians inside Israel were not invested in the economy of the Territories. The money was used for increasing consumption of Israeli products. Labor opportunities were not created in the Occupied Territories. This was partially due to restrictions imposed by the Israeli Civil Administration. The Government of Israel could have created incentives for investment in the Territories. However, the Israeli Government itself was uncertain whether the occupation would end with economic and political separation, or whether all of the Land of Israel west of the Jordan River would end up being integrated into one economic unit.[92] Another factor inhibiting economic development and making almost any investment futile was the very large rate of growth of the Palestinian population. The birth rate raises doubts regarding the viability of any program for economic rehabilitation. The Palestinian economy and welfare has become dependent on the Israeli economy.

The Economy of the West Bank and the Gaza Strip under Israeli Occupation since the Intifada

Broadly speaking, the pattern of economic growth of the Occupied Territories since 1967 can be broken into four phases: very rapid growth until the mid-1970s; slightly less rapid growth until the early 1980s; stagnation until the onset of the Intifada (uprising) in December 1987; and decline thereafter.[93]

The Intifada involved a general deterioration in security and led to disruptions in the economic relations with Israel. Since the beginning of the Intifada, data collection in the West Bank and the Gaza Strip has been disrupted.[94] All information should therefore be treated with caution. Existing reports seem to indicate that both employment and trading activity have been adversely affected by both periodic border closures and curfews (imposed by Israel) and strikes and shop closures (imposed by the Palestinians). Exports from Gaza fell by 37.5% between 1987 and 1988 and have not recovered since. There was also a 20% decline in Palestinian employment during that year, both within the Territories and in Israel.[95] Whereas the number of Palestinians employed in Israel has remained at about 109,000 during 1988, hours worked dropped significantly.[96] Transportation costs to work in Israel increased as time to get to work increased mainly due to imposed road checks.[97] This led to a decrease in the wage of Palestinians employed in Israel relative to that of Israelis and an increase in employers' costs. Strikes and demonstrations imposed work interruptions and these may have dominated the net effect on both employment and wage.[98] Altogether, the Intifada contributed to reduced labor demand in Israel (construction being the only exception) as well as to reduced labor supply and economic activity.

Four subsequent events influenced the Palestinian economy significantly:

1. Following King Hussein's declaration in 1988, that Jordan severed its legal and administrative ties with the West Bank, Jordan withdrew the public sector payments. In addition, the devaluation of the Jordanian Dinar during 1988-1990 hit hard many Palestinians, who used Jordanian Dinars for savings.[99]

2. Yasser Arafat's proclaimed support of Iraq during the Gulf war led to the expulsion of Palestinians from several Gulf states and to the loss of their substantial contributions to the economy of the Occupied Territories prior to the Gulf war. The war led also to the loss of Arab grants and reduced transfers from a cash-starved PLO, having lost direct aid from Gulf sources. The workers expelled returned to the Territories, increasing the Palestinian labor supply (especially that of skilled labor).[100]

3. A mass wave of migration to Israel from the Soviet Republics, starting at the end of 1989, and reaching more than 410,000 by the end of 1992, created a demand for labor in the construction sector.[101] On the other hand, the proportion of workers from the Occupied Territories employed in the industrial sector, and trade and services industries, has declined. This made the Palestinian labor market dependent almost entirely on construction. The increased demand for housing created high demand for Palestinian workers.[102] This factor affected a surge in the Palestinian labor force employed in Israel in 1992, with 112,000 workers employed, predominantly (84,300) in the construction sector.[103] The rise was followed however by a sharp decline in 1993.[104]

4. In March 1993, following a four-month period of the most violent incidents since the beginning of the Intifada, Prime Minister Rabin sealed off the West Bank and Gaza Strip, and announced that Israel would have to be less dependent on Palestinian labor in the future. In March alone twenty eight Palestinians and fifteen Israelis were killed. The Israeli Government reacted especially to the stabbing to death of Israelis by Palestinians in the Tel-Aviv area. While these were not the first times for such attacks to take place, the incidences of March nevertheless signified a turning point. Central leaders of the Labor Party and its important coalition partner, the left-wing party Meretz, demanded that Israel adopt a regular policy leading to total separation of the Territories from Israel.[105] Israel could no longer be counted upon to provide permanent employment to a large number of Palestinians. Accordingly, the number of laborers permitted to work in Israel has sharply declined, falling from a monthly average of 116,000 in 1992 to about 50,000 in 1993, This number has further declined to 32,500 in 1995.[106]

One indicator of the economic changes that have taken place in the occupied territories is the number of families in need of emergency food relief to avoid hunger. According to UNRWA, that number has increased from about 7500 in 1986 to 120,000 in the Gaza Strip and to 165,000 families in the West Bank by June 1991.[107] Unemployment has thus risen to its pre-1967 level. Birth rate has nevertheless continued to grow, to about 50 per 1000 residents.[108] The loss of purchasing power resulted with a decline in the production of goods for the local market. Local wages plunged. The public sector, i.e., the employees of the civil administration and of UNRWA, have become the main providers of income. The closures were coupled with export restrictions that created agricultural surpluses, which the local markets could not absorb despite very low prices. Due to the closures, Gaza's smaller subcontractors working for the Israeli textile industry faced substantial difficulties in importing raw materials and exporting finished goods.[109] To pay for food, electricity and water bills it became necessary to convert private savings and assets into cash.[110] At the same time, Israel has allowed workers from third countries, e.g., Romania, Thailand and South America, to come on a temporary basis and replace the Palestinian workers.[111] The dependence of the Israeli economy on Palestinian labor has thus diminished considerably, and so were also the chances for Palestinians to regain employment in Israel.

The economy of the West Bank and the Gaza Strip following the Interim Agreement with Israel

It might have been hoped that the Agreements entered into between Israel and the PLO might improve the economy of the Palestinian territories and enhance security and peace in both Israel and the Palestinian territories. Unfortunately, to date such a development has not taken place.

In the aftermath of the agreements, more violent incidents have taken place than ever before. On February 25, 1994 a Jewish settler from Kiryat Arba massacred at least 30 (about 50, according to the PLO) Palestinian worshipers in Hebron. This incident was the culmination of a long series of clashes between the Palestinian population and the Jewish settlers in Hebron and nearby Kiryat Arba.[112] Suicide bombings struck central locations inside Israel in 1994 and 1995. The suicide attack of January 1995 prompted the Government to establish a committee, assigned to plan the separation of the Israeli economy from the Palestinian economy.[113] The plan, presented to the Government in March, included the erection of an electronic fence as well as the establishment of industrial parks on the borders of the West Bank and the Gaza Strip. The investment needed for the separating devices alone was estimated at half a billion US dollars, which seemed prohibitive. This kind of separation required also very substantial annual maintenance costs. Eventually, an electronic fence has indeed been built around the Gaza Strip.[114]

Since the establishment of the PA, Israeli citizens, especially those living in areas near the Palestinian territories, have been suffering from numerous thefts and from deliberate sabotage of equipment, as well as a deterioration of their personal security.[115] Thefts of cars transferred from Israel to the areas controlled by the Palestinian Authority were estimated at more than 40,000 in 1995. The Palestinian police has been reported to be among the users of the stolen cars.[116] The economic implications of these problems cannot be ignored.

Terror has reached its peak in February 1996, when a series of terror bombings, mainly in the city centres of Jerusalem and Tel-Aviv, killed over 60 Israeli citizens and permanently maimed scores of others. An almost permanent comprehensive closure has been applied to the West Bank and the Gaza Strip since then. A relative relaxation of the closure (with over 45,000 Palestinians allowed to work in Israel) during the second half of 1996 ended when a terror bomb killed civilians in a cafe in centre Tel-Aviv in March 1997. Following that attack a comprehensive closure has been reinstated. Aside from the loss of jobs in Israel, the closures and security controls have caused serious delays in the importation and exportation of goods into the territories, especially the Gaza Strip, and made them substantially more expensive. Delays in deliveries have reduced client confidence in Palestinian suppliers.[117] The closure and separation policy resulted with sharply declining private investments and exports, making the four years 1992-1995 the worst in recent history.[118] Real GNP has declined by 18.41%. At the same time, the population increased by 27.8%. GNP per capita has thus declined by 36.16%. The West Bank and even more so the Gaza Strip have been struck by poverty and economic distress.[119]

The security problems and the ensuing closures resulted with a change of attitude within Israel. Whereas before the March 1996 terror attacks Israeli employers pressured the Government to grant more work permits to Palestinians, they now demanded an increase of permits issued to workers from third countries.[120] The number of such workers has already reached 70,000 in 1995, and to about 100,000 in 1997.[121]

Other factors affecting the economic relations between Israel and the Palestinians in the aftermath of the entry into force of the agreements could be summarized as follows:

1. The first manifestation of legal independence was a decree by Arafat, according to which the 1300 military orders, enacted by Israel during the period of occupation, were abolished. Instead, the Egyptian law prevailing in the Gaza Strip and the Jordanian law prevailing in the West Bank before 1967 have been reinstated pending the unification of the two separate legal systems.[122] This

proclamation was made in contravention to the provisions of the Gaza-Jericho Agreement, that "laws and military orders in the Gaza Strip or the Jericho Area prior to the signing of this Agreement shall remain in force, unless amended or abrogated in accordance with this Agreement" (Article VII.9).[123] A new set of laws has not yet been enacted, and the Palestinian Legislative Council has to a large extent been neutralized by the Palestinian Authority. Since any private investment would require an adequate legal infrastructure, its absence has created one more obstacle to the development of the economy.

2. Before the establishment of the Autonomy, Israeli judgments and dishonoured cheques could be enforced directly through the Israeli execution office. Furthermore, the Israeli law that prevents under certain conditions a person from opening bank accounts and drawing cheques after ten of his cheques have been dishonoured, was adopted by the military authorities in the territories shortly after its introduction in Israel.[124] Since the transfer of powers to the PA, there seems to be no legal way to enforce the payment of debts owed by Palestinians to Israeli citizens. Judgments given by Israeli courts cannot be enforced in the Palestinian territories, and dishonoured cheques cannot be executed.[125] Debts incurred by public authorities to the Israeli public utilities companies, such as the electricity, water and telecommunications companies, as well as to Israeli hospitals, could only be collected through deductions made by the Government of Israel from payments due from Israeli to the PA, in accordance with an Agreement on Economic Issues signed on 14.2.1997.[126] According to the Annex to that Agreement, the undisputed debts to the Bezek telecommunications co. alone amounted to 50 million NIS (some 16 million US dollars). This however means that it is the general public that has ended up paying the bills. Foreigners conducting business with Palestinians may encounter similar problems.[127]

3. From the outset it was clear that changing the structure of market opportunities was essential to economic reorientation, and that structural changes were dependent upon increased investment levels by the private sector.[128] The World Bank Report emphasized in particular that, "any involvement by the public sector in directly productive ventures or interference in the marketplace by propping up unviable private sector activities (e.g., through price controls and by limiting competition) would retard economic development and, therefore, should be resisted ... Economies that have prospered in the past have relied primarily on the private sector, working in undistorted markets, as the primary engine of economic growth."[129] The World Bank Report further cautioned against enlargement of the bureaucracy of the public sector, since it must not act as the residual employer, but rather have its role restricted mainly to provide basic infrastructural and social services, including a limited and well-targeted safety net for the poorest segment of the population.[130]

It is true that border closures have had a severe impact over the economy of the West Bank and Gaza. The PA, with the help of the donor states, implemented a series of short-run measures, including the provision of temporary employment through public works to 40,000 workers.[131] Civilian employment rose from 34,800 in December 1995 to 39,000 in September 1996, while police employment increased from 24,000 to 33,000 in the same period.[132] Yet, it seems that Arafat's style of governance, characterized by lack of transparency and accountability, has been more than questionable.[133] It has been alleged that corruption, favouritism and state-run monopolies are choking development and intimidating investors. Further complaints alleged that the whole bureaucracy is dominated by "the Tunisians", officially known as the "returnees", who returned with Arafat from Tunis, who run the economy in a fashion that enriches themselves as it further impoverishes society at large.[134] The exclusive importing agencies caused a substantial rise in prices; during 1995 the price of flour has risen by 18% in Israel, but by 27% in Gaza; margarine has been subject to a price rise of 7% in Israel compared with 20% in Gaza; eggs - 26% in Israel and 41% in Gaza; soft drinks - 6% in Israel and 20% in Gaza; fish - 12% in Israel and 51% in Gaza.[135] The price increase was more significant in the Gaza Strip than in the West Bank due to the tight closure imposed on Gaza.[136]

The PA-controlled monopolies generate considerable revenue. It seems, however, that the profits have served to transfer income from the poorer classes to a new economic class that uses the money to pay its bureaucracy and enrich itself.[137] In May 1997 the Budget Committee of the Palestinian Legislative Council issued a report according to which funds from foreign donors were channeled through personal accounts of Palestinian officials. The report named officials who had awarded contracts to certain companies because of "personal interests".[138] Members of the Palestinian Legislative Council claimed that $326 million, or 37% of the PA's annual budget, were wasted or misused by ministries during the past year, and that taxpayers' money was used to buy cars and villas for ministers and officials.

According to the International Monetary Fund Report (February 1997), the PA has undertaken to dismantle import monopolies by the end of 1998, and to encourage private sector investment through the strengthening of financial intermediation.[139] The PA has also undertaken, according to the same report, to bring all revenues and expenditures, including revenues from PA commercial activities (particularly import monopolies), under the control of the Ministry of Finance by March 1, 1997.[140] The IMF Report emphasizes that this is a crucial decision, as up to one-fourth of domestic revenues are currently being diverted to accounts outside of the Ministry of Finance. This has been putting pressure on the liquidity position of the Ministry of Finance. Lack of control by the Ministry of Finance (and the resulting incomplete data) has also impeded fiscal analysis.[141]

THE NECESSARY INTERNATIONAL TRADE LAW RULES: PROS AND CONS OF THE VARIOUS OPTIONS

The above study portrays a difficult situation which does not lend itself to any easy solution. Still, it seems worth the effort to assess the interests of the peoples involved from an economic point of view, since, it is believed, good economics could contribute to the peace process and, so it must be hoped, to the success of peace.[142]

A FREE TRADE AREA

A free trade area means a group of two or more customs territories in which duties and other restrictive regulations of commerce are eliminated on substantially all the trade between the constituent territories in products originating in such territories (Article XXIV.8(b), GATT). Thus, in free trade areas the members remove the barriers to trade among them, yet maintain their separate national barriers against states that are not parties to the free trade area. This means that there is need to prevent non-members from taking advantage of the free trade area by entering it through the territory of the member that levies the lowest tariff on the product in question. Therefore only products originating in the territory of the member states should benefit from the abolition of trade restrictions. To that end every free trade area agreement includes detailed rules of origin. Customs inspectors must police the borders to ensure that only those goods originating in the other parties move freely, while other goods are properly taxed.

It has been suggested that a free trade area is more advantageous to the PA, since it allows the Palestinians to choose a suitable external tariff.[143] However, even if the PA had wanted to set the Palestinian tariff lower than the Israeli tariff, budget financing constraints might have made such a policy difficult to implement.[144] The most important objection to a free trade area stems from the fact that it is practically impossible to establish customs borders between Israel and the West Bank due to the "leakiness" of such borders.[145] The idea of having one arrangement (an FTA) with the Gaza Strip, where borders already exist, and another (customs union) with the West Bank, does not seem plausible, since that would entail different political results for the two regions.[146] It may be concluded that the decision to abandon this solution was a correct and wise one.

A CUSTOMS UNION

A customs union means the substitution of a single customs territory for two or more customs territories, so that: (i) duties and other restrictive regulations of commerce are eliminated with respect to substantially all the trade in products originating in such territories, and (ii) substantially the same duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union (Article XXIV.8(a) GATT). The common external customs and commercial policy eliminates the need for customs borders between the members. The character of a customs union dictates that it is not only products originating in the members that benefit from the rules regarding free movement, but also products from third countries, which have already been imported into the territory of one of the members. Once they enter the customs union they are in free circulation in the members.[147]

It has been noted that the implementation of such an arrangement between Israel and the PA has the advantage of administrative simplicity.[148] A customs union could provide the Palestinian territories with access to the Israeli market, which is the largest market in the region. This is vital for their economic growth, as a small economy does not allow for economic development if it attempts to rely on the domestic markets. Even the Israeli economy, far larger than the Palestinian, is dependent upon its foreign trade.[149] However, access to larger markets is often difficult for third world entrepreneurs. While there may have been nothing economically wrong with the export of labour services from the densely-populated West Bank and Gaza Strip, terror and insecurity have rendered this arrangement implausible. It therefore seemed desirable and more promising to rely on an expanded production of exportable goods rather than labor services.[150]

A report prepared by a team of experts at the Harvard University endorsed a long-term goal of establishing a customs union between Israel, the West Bank, Gaza and Jordan. According to that report, Israel and the Palestinians should start immediately implementing a customs union, and Jordan should join within five years.[151] Studies have been carried out noting the comparative advantages, as well as shortcomings, of Palestinian economy.[152] In particular, it was noted that water shortages, growing salinity and low citrus prices in Europe have made Gaza's traditional agriculture unsuitable. Modern horticultural industry, on the other hand, involving a more versatile basket of products and advanced facilities could provide families in Gaza with an opportunity to engage in trade, their comparative advantage being based on the low cost of labour there as well as on the capability of Palestinian farm families to mobilize much labour input that has low or no opportunity cost (women, children, old family members, and the spare time of the family workers).[153]

Since even the Israeli market is limited in its capacity to absorb goods produced in the Palestinian Territories it has been maintained that, from an economic point of view, the most viable opportunities, should be created by joint ventures between Palestinians, Israelis and Jordanians.[154] Such joint ventures could include the outsourcing by Israeli enterprises in the clothing industry to Palestinian operators. Such arrangements accounted for almost half of the Palestinian exports of goods in the mid 1980s, and those exceeded, by far, levels accomplished in the neighboring countries.[155] They could also take a more favourable and more advanced relationship, as exists with respect to strawberries and cut flowers grown in Gaza and exported to Europe through the forwarding facilities and marketing channels already created by Israeli entrepreneurs.[156] The establishment of industrial parks near border areas could provide a continuous flow of income and durable employment for the Palestinian population.[157]

A COMMON MARKET

A common market entails the free movement of all factors of production, namely goods, services, labour and capital. From an economic point of view, it does not matter much whether the capital goes to the labour, or the labour goes to the capital. Theoretically, the result would depend, inter alia, on the economic and legal infrastructure provided by the economies involved. For the Palestinians, the ability to seek employment opportunities outside the West Bank and Gaza Strip has been, and still is, critically important, as their economy is not yet capable of providing enough opportunities for employment. However, the security concerns of Israel have made the free movement of workers into Israel impossible in the past years. Unfortunately, so far the security concerns could not be alleviated. The closures have exposed the vulnerability of the export of Palestinian labour services to Israel. Therefore, a common market with free movement of workers has so far not seemed to be an option.[158]

SEPARATE MARKETS

It is not only economics that may dictate the solution chosen for the Israeli and Palestinian economies. Political and emotional considerations play a significant role as well. Lingering hostility may engender a pressure to restrict economic relations to a minimum; political ambitions and national pride may result with the building of high protective walls against Israel, being the more developed neighbour as well as the former occupier and enemy; finally, threats to the security of Israeli citizens may make the closure policy a permanent one, thus stifling any chance for cooperation and free movement.[159]

For Israel, separation would mean loss of benefits that could be attained by an integration of the economies. However, due to the small size of the Palestinian economy, compared with the Israeli economy, the losses will not be very significant. Israel has undergone a process of adjustment to decrease labour from the territories relatively quickly and easily, since the workers could be replaced from third countries.

For the Palestinian economy, the results may be extremely harsh. Limited natural resources make the Palestinians dependent upon imports. The funding of the imports should come from exports, since otherwise capital has to be imported, through grants or loans, to make up for the indispensable foreign currency expenditure. International trade is necessary for the development of economies of scale. Besides, small economies cannot develop in reliance on their domestic market. Large scale is essential for the industry to be competitive, efficient and able to reap the benefits of expertise and specialization. This is true also for the much larger economy of Israel. Yet, western markets do not offer easy access to third world entrepreneurs, and the process of learning and adjusting to the demands of those markets may be slow and painful. The opportunities provided by integration with the neighbouring Israeli market seem to be critical for the development of the Palestinian economy.[160]

CONCLUSIONS

From an economic point of view, the customs union with the PLO is indeed the preferable and more viable solution. It does not entail the burdensome, and costly, administrative measures needed to monitor the origin of goods in a free trade area. The need of the Palestinian economy to be integrated with an advanced economy could be satisfied. In the long run this is the most important factor for Palestinian economic development. Mainstream economic theory argues that the greatest gains in efficiency and growth tend to come from linking economies that differ in their labour skills and productivity levels, as such economies are expected to have different comparative advantages.[161] The benefits to the Palestinian economy have been further enhanced by the US and the EC. The Declaration of Principles caused, unintentionally, Palestinian goods the loss of benefits accruing from the US-Israel Free Trade Area Agreement. This was rectified by the US extending, through a presidential proclamation, the duty-free treatment to items originating in the West Bank, Gaza Strip and qualifying industrial zones. Following the proclamation, duty-free treatment has been accorded since November 1996. It also allows for the cumulation of Israeli and Palestinian inputs in establishing product origin.[162] The EC has also signed a Euro-Mediterranean Interim Association Agreement on Trade and Cooperation between the

European Communities and the PLO. The EC has provided for a free trade area with the West Bank and Gaza Strip.[163]

The promotion of regional infrastructural networks in electricity, transport, telecommunications, petroleum and gas pipelines and water could offer more opportunities for strengthening interdependence and benefiting from complementarities and economies of scale.[164] Especially for the West Bank and the Gaza Strip, their small size, the landlocked location of the West Bank and paucity of natural resources, would make separate infrastructure services very costly. The scarce water resources, common to Israel, the West Bank and Gaza, necessitate a joint effort to reach equitable solutions, that will make use of the existing resources; plan the construction facilities for sewage treatment, making reclaimed sewage a major source for irrigation and agricultural usage; plan desalinization plants; and even consider water importation to the extent that it may be needed.[165] Tourism offers one more domain for cooperation.

The success of the customs union depends on the commitment of both parties to the mutual opening of their markets and to the adoption of rules and policies that will enhance the creation of trade rather than trade diversion. It seems very important to determine a mode of sharing the revenues from imports rather than have Israel and the Palestinians compete for them. The monopolies must likewise be dismantled and state intervention in the economy minimized. International experience has shown that protection, activist industrial policy and public channeling of money into unviable enterprises lead to economic disaster. For economies to prosper they have to rely primarily on the private sector, operating in undistorted markets. It has been noted that reliance on the private sector is especially important in the case of the Palestinian economy, since public sector resources are likely to be very scarce.[166] They should thus be spent prudently.

THE REQUIRED DOMESTIC LAW RULES

The successful establishment of a customs union is dependent upon the implementation of an economic order based upon open markets and undistorted competition. One is tempted to think that free trade may be attained in a passive manner, that would let the market forces work. Quite the opposite is true. It is planned economies that require only one simple legal principle: the plan is law. Market economies must be based upon a sophisticated and a differentiated system of private and public law.[167] Attaining international free trade requires not only cooperation on the international level, but also the implementation of domestic rules that would make the authorities of both Israel and the Palestinians support the rules rather than bend them in favour of local interest groups. Only through such rules would citizens be free to enjoy their rights to pursue international trade activities and explore the advantages conferred on the public at large. Whereas the establishment of a customs union is a matter of public law, its functioning has to be guaranteed by the commitment to private law rules of competition mandated by an open market economy.[168]

Private sector initiative requires legal rules that govern property rights, their transfer and the settlement of disputes. The rules should be transparent, stable and enforceable in a fair and efficient manner.[169] At present, the legal system in the West Bank is based mostly on the continental system with Jordanian influence, whereas in Gaza it is based more on common law from the time of the British Mandate. In most business areas there are separate laws in force in each of these territories. The duality in the legal system renders the system inadequate, complex, uncertain and leads to higher transaction costs. Thus, the companies law prevailing in the West Bank is the Jordanian one of 1964, whereas in the Gaza Strip it is the British Mandate Law of 1929 and 1930; there is no comprehensive law that governs contracts; commercial law in the West Bank is essentially the same as in Jordan; labour law has to be developed; the protection that the Landlords and Tenants Law gives the tenants resulted in a tendency to own property rather than rent it. There is need to enact laws regarding, inter alia, unfair competition, monopolistic and oligopolistic behaviour, safety, and consumer protection. Some of the areas for review and revision include the commercial code, company law, bankruptcy law, securities and intellectual property.[170] According to the World Bank Report, the system of taxation lacks transparency and due process and is administered arbitrarily.[171]

One of the first initiatives taken by the Palestinian Authority was to prepare a Law on the Encouragement of Investments. The Law has been subject to much criticism regarding the guarantees and protection granted to investors; the scope of investment incentives; and mainly regarding the High Commission established under the Law for the promotion of investment.[172] The administrative framework of the Commission lacks transparency, its guidelines are ambiguous and its discretionary powers far too wide. Another manifestation of the administrated control is the right to appeal decisions of the Commission to the President of the PA. It has been noted that such a process is both highly irregular and inadvisable. The head of the executive is not a proper arbiter of a conflict between an investor and an administrative agency.[173]

Economic activity and investment necessitate a strong, independent and effective judiciary. There is also a lack of coordination between the two court systems. The rules of procedure are antiquated. As a result, Palestinians usually use mediation, informal arbitration, and self-help to enforce their contracts.[174]

THE CRITICAL ROLE OF INDIVIDUAL RIGHTS

The objectives of a customs union can be achieved only when supported by an adequate legal system that would ensure transparent rules, abided by private citizens and public authorities alike. This requires a system that protects individual rights and subjects its authorities to open criticism.

The European Community has inserted into its Europa Agreements with the Central and Eastern European States provisions that would ensure their respect for human rights. Even the Euro-Mediterranean Agreements with Israel and with the PLO, which entail less integration than a customs union, include a provision (article 2) stating that "relations between the Parties, as well as the provisions of the Agreement itself, shall be based on respect for human rights and democratic principles [as set out in the universal declaration on human rights - according to the EC-PLO

Agreement], which guides their internal and international policy and constitutes an essential element of this Agreement".

In the Interim Agreement, Israel and the Palestinian Authority have undertaken to "exercise their powers and responsibilities pursuant to this Agreement with due regard to internationally-accepted norms and principles of human rights and the rule of law" (article XIV).

To be sure, violations of human rights took place during the Israeli occupation.[175] The violations were reported extensively by the electronic media and the daily newspapers; three extensive reports and many more newsletters were made by the Israeli Center for Human Rights in the Occupied Territories; Members of Knesset brought up the violations in parliamentary debates; and petitions regarding the violations were brought to the Israeli High Court of Justice. The acknowledgment that occupation entails violation of human rights resulted with disenchantment of many Israelis with the occupation.

It could have been expected that with the transfer of powers to the Palestinian Authority the situation would improve significantly. Instead, it seems that a grave deterioration has taken place. Human Rights Watch and Amnesty International have both been very critical of the PA's repressive regime.[176] Human Rights activists and journalists were arrested for criticizing the PA. Both Dr. Iyad al-Sarraj, the commissioner of human rights, and Bassem Eid, head of the Jerusalem-based Palestinian Human Rights Monitoring Group, have been arrested and threatened to cease their activities. Daoud Kuttab, a well-known Palestinian journalist and broadcaster, winner of the 1996 International Press Freedom Award of the Committee to Protect Journalists, was kept under arrest from 20.5.1997-27.5.1997, for broadcasting sessions of the Palestinian Legislative Council. The session broadcast on 19.5.1997 apparently contained particularly severe criticism of alleged corruption in the PA.[177] Other transmissions have been jammed. A Palestinian human rights group charged that Arafat's security forces systematically tortured and mutilated detainees.[178] According to the report, Arafat has established eight separate security forces. It has also been charged that the Chief of the Preventive Security Service has exercised censorship over the Al-Quds newspaper through almost daily contact with the managing editor, who seeks approval for all articles critical of the Palestinian Authority.

This is clearly not an atmosphere that encourages accountability and transparency. Such curtailment of the freedom of expression and freedom of the press may allow the PA to avoid public criticism, yet it would hardly encourage private investors, or donor states, to contribute towards economic growth. Moreover, it seems impossible to have a customs union with an entity that does not observe adequate standards of human rights. The lack of accountability allows for the creation of distortions that frustrate the very basic tenets of a free market.

Peace Through Trade: Conditions For A Viable Customs Union

The agreements entered into between Israel and the PLO reflected "their determination to put an end to decades of confrontation and to live in peaceful coexistence, mutual dignity and security".[179] Understanding that poverty and misery are enemies of coexistence, the parties regarded the economic domain a cornerstone in the mutual relations. The economic protocol of the Interim Agreement was a step in the right direction on the road to peace. It created a customs union between Israel and the West Bank and Gaza Strip. This choice was the best of the available options. It had the advantage of administrative simplicity while allowing the Palestinian territories access to the largest market in the region, a factor vital for their economic growth. A new economic order should have been established, enabling each party, but especially the small Palestinian economy to make the most of its comparative advantage. Cooperation in regional development of infrastructure, such as electricity, transport, telecommunications, gas and water could be envisaged. Tourism and other joint ventures could create more opportunities for cooperation and cohesion of the economies.

So far the results have been disappointing. A main obstacle has been the deterioration of the state of security after the signing of the agreements, proving the interdependence between economic cooperation and peaceful coexistence. Sound economics may be capable of generating peace, yet no sound economic achievements can be attained in the absence of peace and security. There have been other obstacles as well. The Interim Agreement and Economic Protocol did not provide the conditions necessary for a rule-oriented customs union. To begin with, the parties were put at odds competing for the revenues from imports. This arrangement should be replaced by either creating a common budget to finance joint projects, or otherwise, by equitably sharing those revenues.

The success of a customs union depends on the commitment of both parties to the mutual opening of their markets and to the adoption of rules and policies that will enhance the creation of trade rather than trade diversion. To that end a legal environment has to be created, that will support a private sector operating in an undistorted market. Such a legal infrastructure involves a sophisticated system of private and public law, both in Israel and in the Palestinian Authority. There is need for legal rules that govern property rights, their transfer and the settlement of disputes. The rules should be transparent, ascertainable and enforceable in a fair and efficient manner. There is also need for rules that will prohibit anticompetitive behaviour.

The objectives of a customs union can be achieved only when the legal system is abided by private persons and public authorities alike. This requires a system that protects individual rights and subjects its authorities to open criticism.

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

END NOTES

1 Annex V of the Israeli-Palestinian Interim Agreement on the West Bank and the Gaza Strip, Kitvei Amana (Israel Treaty Series) 1071, pp. 281-384. According to its preamble, the Interim Agreement replaced the three preceding agreements signed with the PLO: the Gaza-Jericho Agreement signed in Cairo, May 4, 1994; the Agreement on Preparatory Transfer of Powers and Responsibilities signed at Erez, August 29, 1994; and the Protocol on Further Transfer of Powers and Responsibilities signed in Cairo, August 27, 1995. Article I of the Protocol however reads: "This Protocol, including its Appendixes, will be incorporated into the Agreement on the Gaza Strip and the Jericho Area (in this Protocol - the Agreement), will be an integral part thereof and interpreted accordingly. This paragraph refers solely to the Gaza Strip and the Jericho Area."

2 The agreements signed between Israel and the PLO and their background are analyzed by Y.Z. Blum, "From Camp David to Oslo", 28 Israel Law Review 211 (1994); E. Podeh, "The Arab-Israeli Peace Process", 18 Middle East Contemporary Survey (MECS) 46, 46-52 (1994); for an insight into the events leading to the signing of the first step taken in the Declaration of Principles, cf. Y. Carmon, "The Story Behind the Handshake", 98(3) Commentary 25-29 (March 1994).

3 Cf. Y. Gabai, "The Agreement on Taxation and Tariffs between Israel and the Palestinians", in: State Revenue Administration Report 1994 No. 44, pp. 261-273 (in Hebrew).

4 E. Kleiman, "The Economic Provisions of the Agreement between Israel and the PLO", 28 Israel Law Review 347, 359 (1994); cf. also the analysis of the rules by S.S. Elmusa, M. El-Jaafari, "Power and Trade: The Israeli-Palestinian Economic Protocol", 24(2) Journal of Palestine Studies 14 (Winter 1995).

5 It is noteworthy that according to the usual international practice, income tax accrues to the treasury of the territory in which a person works. Cf. Developing the Occupied Territories: An Investment in Peace (The World Bank, Washington D.C., September 1993), a six-volume series communicating the results of a study of the Multilateral Working Group in Economic Development, supported by the World Bank, at the request of the sponsors and organizers of the Middle East Peace Talks (hereinafter - World Bank Report), vol. 2: The Economy, p. 33.

6 Council Decision 70/243 of 21.4.1970, subsequently replaced by Decision 85/257 of 7.5.1985, which was in turn replaced by Decision 88/376 of 24.6.1988, OJ L 185/24 (articles 2(1)(a), 2(3)).

7 A.J. Easson, Taxation in the European Community, London: Athlone 1993, pp. 3-4.

8 S. e.g. A. Avneri, "An Autonomy of Smuggling", Yedi'ot Aharonot Daily Newspaper (hereinafter - Yedi'ot Aharonot) 6.2.1996.

9 USDOC, "Gaza Trade Statistics Show Drop in West Bank-Gaza Turnover and Increased Reliance on Israeli Supplies and Markets", December 1996. The report makes it clear that not all of the products supplied by Israel are "Israeli-produced", but may just be imported via Israel.

10 United Nations Office of the Special Coordination in the Occupied Territories (UNSCO), Economic and Social Conditions in the West Bank and Gazas Strip: Quarterly Report Winter Spring 1997, Gaza: UNSCO 1.4.1997 (hereinafter - "UNSCO Report"), p. 50

11 Cf. e.g. O. Koren, "The Manufacturers, the Chambers of Commerce and the Ministry of Trade and Industry Request Peres to Discuss the Palestinian Boycott on Israeli Goods", Globes Daily Newspaper (hereinafter - "Globes") 29.3.1996; "The Israeli Iron Manufacturers are concerned: The Palestinians are Starting Independent Importation", Ma'ariv Daily Newspaper (hereinafter - "Ma'ariv") 16.4.1997; O. Koren, "The PA will prohibit the distribution of Israeli cigarettes as of January 1996", Globes 5.12.1995.

12 Cf. E.-J. Mestmaecker, "Providing Fair Conditions of Competition Under the Free Trade Agreements of the European Economic Community", 3 Northwestern Journal of International Law and Business 296 (1981).

13 S. further E.-J. Mestmaecker, "Can There be a European Law?" 2 European Review 1, 11-12 (1994); E.-J. Mestmaecker, "Staat und Unternehmen in Europaeischen Gemeinschaftsrecht: Zur Bedeutung von Art. 90 EWGV", 52 RabelsZ 526 (1988); R. Whish, Competition Law, 3rd ed., London: Butterworths 1993, pp. 330-346.

14 The contents of the circular dated 6.1.1996 are brought by M. Wertheim, "Can the Law Survive a Change in Political Sentiments?" Justice No. 12, March 1997, 22, at p. 24.

15 The text is brought by Wertheim, ibid., at pp. 24-25.

16 Cf. Wertheim, ibid., p. 26.

17 Cf. S. Salomon, "The Palestinians to international trade companies: Do not operate through Israeli agents", Telegraph Daily Newspaper 11.1.1996; O. Koren, "Palestinian importers are replacing Israeli importers on the Israeli market: Israeli importers of automobile spare parts warn against decrease of State revenues", Globes 5.2.1996; G. Eshet, R. Shaked, "The Separation Policy", Yedi'ot Aharonot 24.9.1996; S. Hametz, "The Ministry of Trade and Industry and the Chambers of Commerce: The Trade Regulations of the PA - A Serious Blow to the Paris Agreement", Ha'aretz Daily Newspaper (hereinafter - "Ha'aretz") 24.9.1996.

18 Cf. R. Bergman, D. Ratner, "The man who swallowed Gaza", Ha'aretz Friday Supplement 4.4.1997, at 18-27; J. Dempsey, "Poor pickings in Gaza for Palestinian entrepreneurs: Monopolies are stifling small businesses", Financial Times 3/4.5.1997.

19 I. Lotenberg, O. Koren, "Mr. five percent", Globes 16.2.1996. The article relates how former Deputy Director, Israeli GSS [General Security Services] has become chief middleman for

monopoly transactions entered into between Israeli companies and PA agencies dominated by that senior financial advisor; Bergmann, Ratner, ibid.

20 S. Moshavi, "You call this a free market?" Business Week 7.4.1997; G. Dachs, "Staat der Staatenlosen: Arafats Cliquenwirtschaft hemmt die Entwicklung von Markt und Demokratie", Die Zeit 16.5.1997.

21 Bergman, Ratner, supra n. 18.

22 Bergman, Ratner, ibid.; N. Arad, "Three tons of cheese were caught on their way from the autonomy", Yedi'ot Aharonot 2.6.1996. In this case, tens of tons of "La Vache Qui Rie" cheese were imported as Hebron-bound. They were reported to have been lost in a fire, a claim against the insurers accordingly brought, yet seem to have surfaced in Israel later on.

23 Dempsey, supra n. 18; A. Hass, Drinking the Sea at Gaza, Israel: Ha'Kibbutz Ha'Meuchad 1996, pp. 358-362 (in Hebrew).

24 M. Zavadjil, N. Calika,O. Kanaan, D. Chua, Recent Economic Developments, Prospects, and Progress in Institution Building in the West Bank and the Gaza Strip, Washington D.C.: International Monetary Fund 1997, p. 17 (hereinafter "IMF Report").

25 Regarding the legislation in the Palestinian territories cf. part 4 of this article hereunder.

26 P. Malanczuk, "Israel: Status, Territory and Occupied Territories", 12 Encyclopedia of Public International Law 149, 170-171 (1990); cf. also Y.Z. Blum, "The Missing Reversioner: Reflections on the Status of Judea and Samaria", 3 Israel Law Review 279, 288 (1968).

27 P. Malanczuk, "Jerusalem", 12 Encyclopedia of Public International Law 184, 193 (1990).

28 Malanczuk, supra n. 26, at p. 165.

29 18 ILM (International Legal Materials) 362 (1979).

30 A. Mansour, "The West Bank Economy: 1948-1984", in: The Palestinian Economy (G.T. Abed (ed.)), London: Routledge 1988, pp. 71-99; S.M. Roy, Development under occupation: A study of United States government economic development assistance to the Palestinian people in the West Bank and Gaza Strip, 1975-1985, unpublished doctoral dissertation submitted to Harvard University, 1988 (UMI - University Microfilm International), pp. 21, 263-264; A. Bergmann, Economic Growth in the Occupied Territories 1968-1973, Jerusalem: Research Department, Bank of Israel 1974 (in Hebrew), p. 86; H. Awartani, "Israel's Economic Policies in the Occupied Territories: A Case for International Supervision", in: International Law and the Administration of Occupied Territories (E. Playfair (ed.)), Oxford: Clarendon 1992, p. 399.

31 Bergmann, supra n. 30, p. 47.

32 Mansour, supra n. 30, pp. 71-72.

33 Bergmann, supra n. 30, p. 47; cf. also Z. Abu-Amr, "The Gaza Economy: 1948-1984", in: The Palestinian Economy (G.T. Abed (ed.)), London: Routledge 1988, p. 106.

34 Cf. Bergmann, supra n. 30, pp. 46-48; cf. also Roy, supra n. 30, pp. 264-265.

35 Mansour, supra n. 30; Bergmann, supra n. 30, pp. 57-58.

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41 Abu-Amr, supra n. 37, pp. 105-107.

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117 UNSCO Report, supra n. 10, p. 56; The issue of building a new port in Gaza, to alleviate the problems created by the closure, is outside the scope of this article. The port would facilitate direct import and export to the Gaza Strip, yet pose serious security problems for Israel (control of the direct import of armaments). The port would also aggravate the problems caused by the competition between Israel and the Palestinian Authority over the revenues from imports. It is noteworthy that the World Bank Report raised doubts regarding the economic viability of such a new port, and suggested that the issue be assessed in the regional context. Cf. World Bank Report, supra n. 5, vol. 5: Infrastructure, p. 76.

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Private Sector Development, p. 3; cf. Levine, supra n. 118, p. 1400.

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179 The Preamble to Interim Agreement.

Commerce *and* Security in the Middle East: An Action Agenda

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COMMERCE *AND* SECURITY IN THE MIDDLE EAST: An Action Agenda

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EXECUTIVE SUMMARY

This report is based on a two-day meeting on "Trade and Security in the Middle East," hosted by Harvard University's Institute for Social and Economic Policy in the Middle East (ISEPME) in Cairo on November 10-11, 1996. The meeting was designed to explore ways to enhance the flow of goods and persons in the Middle East without undermining the security of the parties involved. The basic premise of the meeting was that economic prosperity is an interest shared by Arabs and Israelis alike and that the free movement of goods and labor increases such prosperity. While the meeting was devoted to examining security considerations that affect the economic interactions among Israel, the Palestinian Authority (PA), Egypt and Jordan, this conference report focuses especially on the manner in which these considerations affect the bilateral relations between Israel and the PA.

The Declaration of Principles on Interim Self-Government Arrangements, signed in Washington, DC in September 1993 and the Protocol on Economic Relations, signed in Paris in April 1994, envisaged a high degree of interaction between the Israeli and Palestinian economies. Unfortunately, recurring acts of terrorism against Israeli citizens have led the Israeli government to implement prolonged and repeated closure of Israel to Palestinian goods and labor. Other tough security measures implemented at the crossing points also constrain Israeli-Palestinian trade and the Palestinians' ability to work in Israel. In turn, these measures have resulted in a significant deterioration in the economic conditions in Gaza and the West Bank, threatening the stability of the PA and the parties' ability to make further progress in the peace process.

This report concludes that enhancing economic prosperity requires Israel and the PA to act upon a pact already codified by policymakers, through various agreements between the parties, but insufficiently implemented at an operational level. The PA would take all measures necessary to prevent the planning and execution of terrorist acts against Israelis, inside Israel as well as in the West Bank and Gaza Strip. In addition, the PA and its security services would refrain from any acts that might undermine the confidence and trust of the Israeli government in the PA's willingness and ability to prevent violence against Israelis. If fully implemented by the Palestinians, such measures would make Israeli security far less dependent on the arrangements adopted at the checkpoints between the PA and Israel. In order to be effective, these security measures must remain classified; therefore, this report does not provide a detailed list of these steps.

For its part, the Israeli government would relax significantly arrangements that hinder the free movement of Palestinian labor, Palestinian-Israeli trade, and the Palestinians' ability to trade with other parties within and beyond the Middle East.

This requires that closure be abandoned as a semi-reflexive policy; that investments be made by Israel in manpower and technologies that allow efficient but rapid security checks of workers, goods and transport vehicles; that privatizing the implementation of these measures be considered seriously; that VIP cards be provided to Palestinian business people, permitting them easy and rapid access to their Israeli counterparts; and that Israel minimize its intervention in the trade between the PA and other countries. These and other operational measures that would allow greater Israeli-PA economic interaction and enhanced Palestinian economic prosperity are listed in this report.

The report neither denies that the Palestinians also have legitimate security concerns, nor does it ignore the possibility that the relaxation of some security measures by Israel might involve a measure of risk. However, our considered estimate is that the danger to Israelis and Palestinians entailed in the current deterioration of economic conditions in the West Bank and Gaza Strip is far greater. In order to increase economic prosperity without undermining immediate security concerns, the Israeli government and the PA should both take bold measures. Past practice must be re-examined and new steps must be implemented to enhance economic interaction and prosperity as well as short- and long-term security for Israelis and Palestinians alike.

COMMERCE *AND* SECURITY IN THE MIDDLE EAST: An Action Agenda

Introduction

Economic development *and* physical security are both indispensable if the peace process is to continue and progressively bring ever more tangible benefits to the residents of the Middle East. We, therefore, propose in this report the enactment of a powerful pact among Israel, the Palestinian Authority (PA), Jordan and Egypt: more individual security *and* more commerce to the lasting benefit and general well-being of citizens throughout the area.

Without systematic progress on *both* fronts across the region and especially between Israel and the Palestinian Authority, the domestic political bases for continued progress toward peace cannot be maintained and expanded. Over the long run, ordinary Israelis will not support a peace process that does not lead to a reduction in the level of terrorism in Israel. Average Palestinians will not back in a sustained way President Arafat's peace effort in the face of increasing economic deterioration and cruel and endemic family hardship in the West Bank and Gaza Strip (WBGS).

Thus, the Israeli government has a profound long-term stake in facilitating increased prosperity on the West Bank and in the Gaza Strip if, by easing restrictions on the passage of goods and people and thus improving economic prospects in the WBGS, it can reduce the appeal of violent extremism among the populace there. Because Israel's responsibility for crossing points and other matters related to movement into and out of the WBGS is clearly established in the September 1995 Interim Agreement on the West Bank and Gaza Strip, it follows that the obligation for undertaking most of these operational measures lies ultimately with the Israeli government. At the same time, the Palestinian Authority undoubtedly has a vital interest in working hard to decrease—even end—violence against Israelis both in the WBGS and in Israel, in order to build confidence with the Israeli public at large that typical Palestinians, despite their sometimes acute frustrations regarding the pace of the peace process, can be trusted to reject terror as an instrument for achieving their tactical and strategic political objectives.

Tragically, however, during the past year the negotiations regarding the implementation of the Oslo agreements, and increasingly the agreements themselves, have been widely associated for many Israelis with an increase in terror that has personally and painfully touched every corner of that small society. According to the Israeli Ministry of Foreign Affairs, there were 13 violent incidents launched from the West Bank and Gaza Strip against Israeli civilians between January and September 1996 with 86 men, women and children losing their lives and scores of others injured.

In reaction to these terrorist incidents, Israel decided to curtail severely the movement of goods and people between the WBGS and Israel. As a result, this same interval has been connected in the minds of most Palestinians with a precipitous decline in economic opportunity and well-being for themselves and their families. According to the United Nations, during the past year overall economic performance in the Gaza Strip as measured in real GNP has fallen 5.6 percent. Palestinian Census Bureau figures document a rise in unemployment over the same period from 31 to 55 percent. Crucially, these unemployment figures are higher among young males who make up the pool from which the shock troops of Palestinian terrorism are recruited. The analogous figures for the West Bank are 11.2 percent and 13 to 45 percent.

In addition, economic engagement between Israel, Egypt and Jordan has been disappointing. Despite the two peace treaties, political and security preoccupations on the part of these governments have largely stifled free market enterprise and prospects for economic cooperation that could enrich all three nations, improve the standards of living for their citizens, and begin to create patterns of openness and mutually beneficial commercial behavior that are an important ingredient of long-term peace in the region.

An agreed framework in which to address these multifaceted and interlocking issues related to commerce and security has been created in a number of agreements between the Government of Israel and the Palestinian Authority. This framework is embodied not only in the September 1993 Declaration of Principles on Interim Self-Government Arrangements and the September 1995 Interim Agreement (which superseded the 1994 Protocol on Economic Relations), but also in the 1995 and 1996 Tripartite Action Plans on Revenues, Expenditures and Donor Funding for the Palestinian Authority. At least as early as April 1995, when the first Tripartite Action Plan was signed in Paris, representatives of the Israeli government and the Palestinian Authority stated that the two had to work together to safeguard the security of the Israeli people and the economic well-being of the Palestinians. This aim has been repeated by officials from both parties on various occasions. There has been considerable difficulty, however, in finding operational measures that translate these principles into action.

Thus, it is the aim of this report to offer specific means by which the parties can make greater progress in realizing these bilateral and multilateral commitments, in order to boost economic activity among these four parties and especially between Israel and the Palestinian Authority (which is in the most economic difficulty), while protecting the security of all the people of the region and particularly the safety of Israeli citizens (who are under the greatest terrorist threat). We wish to stress that this commerce/security initiative, meritorious though we believe it is, cannot substitute for progress in the peace process writ large. But expanded economic enterprise among these parties can serve as one pillar of a cooperative effort to create a new, safer and more prosperous reality in the Middle East.

Economic interaction and security are both desirable goals but in the short term unfortunately one of these goals sometimes comes at the expense of the other. Completely preventing the movement of goods and people is certainly one way to minimize security risks but it could produce unacceptable economic costs. Conversely, allowing complete freedom of movement of goods and labor would maximize trade but could entail intolerable security risks. Policy choices must therefore settle somewhere between these extremes. It would be both presumptuous and inappropriate for us to prescribe exactly where this choice should be made. The leaders and citizens of the region must decide how to manage these tradeoffs. But all who are concerned about the area can play a role in seeking measures to achieve given security goals more efficiently—in particular through methods which maximize regional economic interaction.

The specific prescriptions contained here all relate to improving the flow of commerce between Israel and its neighbors. We do not suggest new and improved cooperative measures regarding security collaboration among Israel, the Palestinian Authority, Jordan and Egypt. This is not because we regard goods and workers as more important than security. Indeed, the contrary is the case. In an economic sense, without adequate security regimes in place in the area, commerce will not thrive. But far more important, in moral terms the sanctity of innocent human life must always transcend the search for commercial advantage.

Therefore, the far-reaching list of possible commercial improvements contained in this report must be accompanied by an equally long inventory of new cooperative actions undertaken by security professionals in the region to combat terrorism. Indeed, it seems highly unlikely that comprehensive improvements on the commercial side will be implemented in the absence of much closer security cooperation among the parties, especially between Israel and the Palestinian Authority. Nevertheless, it seems obvious that such possible detailed security precautions against real and potential terrorists should not be specified in a public document. We, therefore, leave that indispensable work to the appropriate authorities and experts.

The views expressed here are those of the authors but we take no credit for originality regarding the specific suggestions that are enumerated below. Most of these ideas have been around in public discussion for some time. Many of the prescriptions which follow were put forward at a November 10-11, 1996, ISEPME Conference on this subject we co-chaired in Cairo that was attended by security experts, other government officials, business people, and academic specialists from Israel, the Palestinian Authority, Jordan and Egypt. What has been lacking, however, has been the political will of the parties to put recommendations such as these into practice. We hope that the publication of this report will encourage political leaders in Israel, the Palestinian Authority, Jordan and Egypt to work together to implement urgently the general thrust of our action agenda, along with parallel cooperative security measures. Time is of the essence. If this situation does not soon get better, it will get worse.

Background

In April 1994, Israel and the PLO signed an impressive Protocol on Economic Relations which provided for free trade between the Palestinian Authority and Israel, as well as between the WBGS and its Arab neighbors. If this agreement and the subsequent Interim Agreement were implemented under the right conditions, they could dramatically improve economic conditions in the WBGS. When these agreements were signed, Palestinians looked forward to opportunities to supplement the incomes their workers earned in Israel with expanded domestic possibilities for production and trade.

But terror has shattered these hopes. A series of violent actions, which have resulted in the loss of many lives in Israel, has been followed by increased security arrangements imposed by Israel's government. Commercial conditions in the WBGS have consequently become exceedingly difficult, and living conditions are becoming increasingly unsustainable. Israel has erected trade barriers far more draconian and pervasive than would be associated with a stringent regime put in place to protect the internal market. Moreover, frequent changes in Israeli security practices have led to great uncertainty on the part of business people throughout the area. Firms cannot be sure whether their imports will arrive or their exports will exit. Transportation costs are extremely high and delays are prohibitively long.

With restrictions on their own travel, and that of their products, Palestinians are severely hampered as both laborers and contractors in the Israeli market. The movement of people and goods between the West Bank and Gaza Strip has also been restricted; even within the various parts of the West Bank, travel is often impossible. Indeed, Palestinians have sometimes found it easier to visit Israel or foreign countries than to move between the West Bank and Gaza Strip. Finally, the transport of goods to and from the WBGS, from both Israel and the rest of the world, has been severely curtailed.

Security concerns have therefore created a crisis in the West Bank and the Gaza Strip. According to United Nations estimates, the private sector has been particularly adversely affected—the number of employers fell by about twenty-five percent in the first half of 1996 alone. Declining worker incomes, which dropped from $740 million (in 1995 dollars) in 1992 to $70 million in 1995, reflect the impact of both the border closures, which reduced the number of days movement was allowed, and the decline in the number of Palestinians permitted to enter Israel. In addition, exports from the WBGS have fallen in the same period by 53.8 percent, from $280 to $129 million. The public finances of the WBGS are in disarray. Donor money, intended for long-term projects, is being diverted to current operating budgets. The economy is being maintained by donor transfusions of public works money and infrastructure projects, and many workers have turned to the agricultural sector.

Implications

The economic impact of the closures and other restrictive security measures highlights the crucial role that commerce with the outside must play in the sustained effort to create a decent standard of living in the West Bank and Gaza Strip. The Palestinian economy is simply too small to be self-sufficient. The Palestinians have been extremely dependent on Israel for employment. If they are to be partially or largely denied these critical opportunities within Israel, the only viable alternative is a dramatic increase in domestic employment in Palestinian farms and firms that export. But as indicated above, this substitution is also undermined by Israeli security measures that persistently cause delays and commercial uncertainty.

While increased employment is provided by infrastructure and other construction projects, these are mostly financed by external donors, whose funds are increasingly used to mitigate the costs of closures. In addition, domestic industry and services have some scope for import substitution and growth. But the income generated by all these activities will inevitably spill over into an increased demand for imports. To pay for these, the Palestinian economy will have to export. If it is to succeed economically, therefore, the WBGS must have access both to neighboring and global markets. The key question is how this can be done without jeopardizing security.

As noted above, the mutual interest which both parties have in commerce and security cannot be overemphasized. Each side has a strong stake in the internal security and economic development of the other. *It is imperative that the economic development of the WBGS become a high policy priority of the Israeli government.* The Israeli public in general and officials who come into daily contact with Palestinians in particular need to appreciate Israel's interest in a prosperous WBGS economy. It will provide Israel with markets, products and workers. More important, the creation of wealth in the WBGS is a necessary—although not sufficient—factor in boosting the desire for peace with Israel and decreasing the appeal of violence throughout the West Bank and Gaza Strip; the peace process must, of course, make progress over the long run as well. Israel's political leadership should stress to ordinary Israelis the benefits of Palestinian economic development.

Similarly, *it is essential that maintaining the security of ordinary Israelis becomes a predominant policy objective of the PA and that President Arafat and his colleagues make that point frequently and publicly to their constituents.* Palestinians must come to understand and accept that terrorism against Israelis undermines their cause over the long term and dramatically reduces the likelihood that Israel will agree to adopt cooperative measures such as those recommended in this report.

Considerations

Before considering concrete suggestions regarding the improvement of commercial interaction among Israel, the PA, Jordan and Egypt, two fundamental points should be made.

Incentives and Implementation. Israeli officials dealing with security and commerce will reflect the incentives systems that they discern from the top of their government. Consistent with the thrust of this report, these individuals should be rewarded when they facilitate economic interaction without compromising security, and penalized when they do not. Such a change in the standard operating procedures and behavior of these Israeli security personnel would require strong and tough-minded leadership from the senior ranks of the security agencies and authoritative guidance from the Prime Minister and appropriate Cabinet Ministers. Indeed, even good intentions of political leaders can be thwarted by those actually making decisions on the ground. Efforts at improvement should be closely monitored, with effective feedback mechanisms to detect implementation failures.

Cooperation. This is a pivotal factor, necessary both between each of the party's public and private sectors and among them all. The previous Israeli system in the WBGS worked through unilateral action and this tradition continues to a considerable extent. However, in some cases it has become self-defeating.

First, joint teamwork between security forces on the two sides has been initiated and it is vital to improve further such collaboration. Second, Israeli and Arab businesses are critically affected by security measures. These entrepreneurs must make positive decisions if their respective economies are to benefit and ultimately, they bear many of the costs imposed by delays, inspection requirements, closures, etc. It is therefore important that the relevant business communities be consulted and involved (naturally without veto power) both with respect to the design of security systems and their implementation. The commitment of the business community is necessary also to ensure that the costs associated with adhering to security regimes do not undermine the economic rationale for trade.

For their part, businesses need to provide specific feedback to governments on how their commercial activities are being affected by security measures.

Economic interaction must be kick-started, but once firms identify and enjoy the tangible benefits from cooperation through trade, subcontracting, and joint ventures, they will in turn have a greater interest in lobbying their respective governments to both facilitate trade and ensure the security necessary to keep it thriving.

Action Agenda

This action agenda is not meant as a precise and definitive enumeration of what needs to be done. Rather, it is an illustrative starting point and a challenge, designed to stimulate governments to implement briskly measures in the spirit of those we advocate here.

A) End the Closure Policy

The effect of Israel's closure policy on the Palestinian economy has been devastating. Closure days totaled 28 in 1992; 91 in 1993; 77 in 1994; 125 in 1995; and 1996 will surpass last year's number. If it is true that there is no known case of a Palestinian laborer who entered Israel with a work permit and subsequently engaged in terrorist activity, Israel should end closure as a reflexive response to acts of terrorism inside Israel.

B) Oversight

Establish a joint Israeli-Palestinian "Security and Commerce Advisory Board," comprised of eminent economic, business and security experts charged with systematically exploring methods for improving coordination and cooperation regarding these and other similar measures.

C) Crossing Point Infrastructure and Procedures

The following recommendations are designed to allow a marked increase in the number of individuals and vehicles that can be processed for transit at the crossing points between the Palestinian Authority and Israel:

1) Open additional crossing points between the PA and Israel.
2) Increase significantly the security personnel checking permits and cargo at the crossing points.
3) Deploy a sufficient number of state-of-the-art devices for detecting weapons and explosives carried by individuals or hidden in cargo or luggage.
4) Extend hours of operation of border facilities to 24 hours per day.
5) Authorize private security firms to conduct security checks at the crossing points.
6) Review all fees charged at crossing points and provide for accelerated inspection procedures for vehicles and goods on a per-fee basis.
7) With the above changes in place, expand considerably the volume of traffic permitted to cross borders daily.
8) Provide officers and officials at crossing points immediate access to senior decisionmakers in case of unexpected situations and developments.
9) Establish clear criteria and standard operating procedures for inspections to reduce arbitrary decisions made by junior officials at the crossing points.
10) End petty enforcement of regulations not related to genuine security concerns.

D) Entry of Palestinian Workers

11) Increase significantly the number of Palestinians provided with permits to work in Israel beyond the current levels.
12) Make criteria clear for obtaining permits to enter to work in Israel.
13) Provide extended multi-day permits to workers with long-time employment records.

E) Entry of Business People

14) Increase the number of Palestinian business people allowed to enter Israel.
15) Adopt procedures that allow rapid processing of applications by business people requesting entry permits.

16) Provide business people and their passenger cars extended period, multi-entry permits.

17) Allow business people overnight stays in Israel, perhaps with registration requirements.

18) Engage the security services of the PA in assisting the process of clearing Palestinian business people for extended period, multi-entry permits.

F) Providing Enhanced West Bank - Gaza Strip Interactions

19) Provide facilities and procedures for safe passage between the West Bank and the Gaza Strip.

20) Until 19 is fully implemented:

   a) Permit escorted, sealed convoys of buses and trucks.

   b) Allow West Bank business people with permits to enter Israel entry into the Gaza Strip as well, and vice versa.

G) Trade Among WBGS, Jordan and Egypt

21) Increase opportunities for the movement of goods and business people both to and through Jordan and Egypt.

22) Lessen security inspections of goods moving out of the WBGS that are destined for Jordan, Egypt and/or points beyond.

23) Improve the operation of visa, permit, border, transportation and transit facilities between the WBGS, Jordan and Egypt; permit Palestinian goods and business people using Jordanian and Egyptian ports and airports speedy passage.

24) Change system of cargo transportation from back-to-back (requiring that goods be unloaded at the crossing points from trucks of exporters to trucks of importers) to point-to-point (allowing exporters' trucks to be escorted to their final destination).

H) Trade Between WBGS and Other Countries

25) Speed the movement of goods imported to and exported from the WBGS via Israeli ports and airports.

26) Provide dedicated facilities in Ashdod and Ben Gurion airports that offer accelerated access for goods from and destined for the WBGS.

27) Allow inexpensive and reliable shipment by competing private firms of bonded goods destined for the WBGS and provide for custom clearance to occur in the WBGS.

28) Provide custom clearance facilities for Palestinian exporters in the WBGS so that they do not need to enter Israel in order to perform this task.

I) Measures Requiring Much Longer Time for Full Implementation, Increased Trust and More Intense Security Cooperation:

29) Construct a rail link to dedicated facilities in Ashdod to permit containerized shipments.

30) Begin construction of a Palestinian port and eventually establish a fully functioning airport in the PA.

31) Negotiate an agreement to allow Palestinians the right to administer customs for goods destined for the West Bank and Gaza Strip; begin the training of Palestinian officials by the Israeli customs service to ensure uniformity of treatment.

32) Cooperate with the PA in examining the feasibility of a high-speed rail link between the West Bank and Gaza Strip.

Conclusion

The above measures obviously do not offer a panacea to end the deep distrust that now exists between Israelis and Arabs. Seriously weakening the instinctive hostility among these peoples will take years and ending it decades at best. But history does demonstrate that enduring hatreds among neighbors can first be attenuated and then eliminated, that long-time enmity need not be permanent. The concepts and prescriptions in this report offer only a partial means to help build trust among the parties, and especially between the Israelis and the Palestinians. But if successfully implemented along with parallel enhancements in security cooperation, tangible steps like these can make a positive difference. In our judgment, it is time to try.

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