

## Israeli-Palestinian economic relations

June 2016

### Key Points

- The Palestinian economy is stuttering in the West Bank, and is in a dire condition in the Gaza Strip. In both cases, whilst the causes are inseparable from the political conflict with Israel, they also relate to internal Palestinian political challenges and the role of third parties.

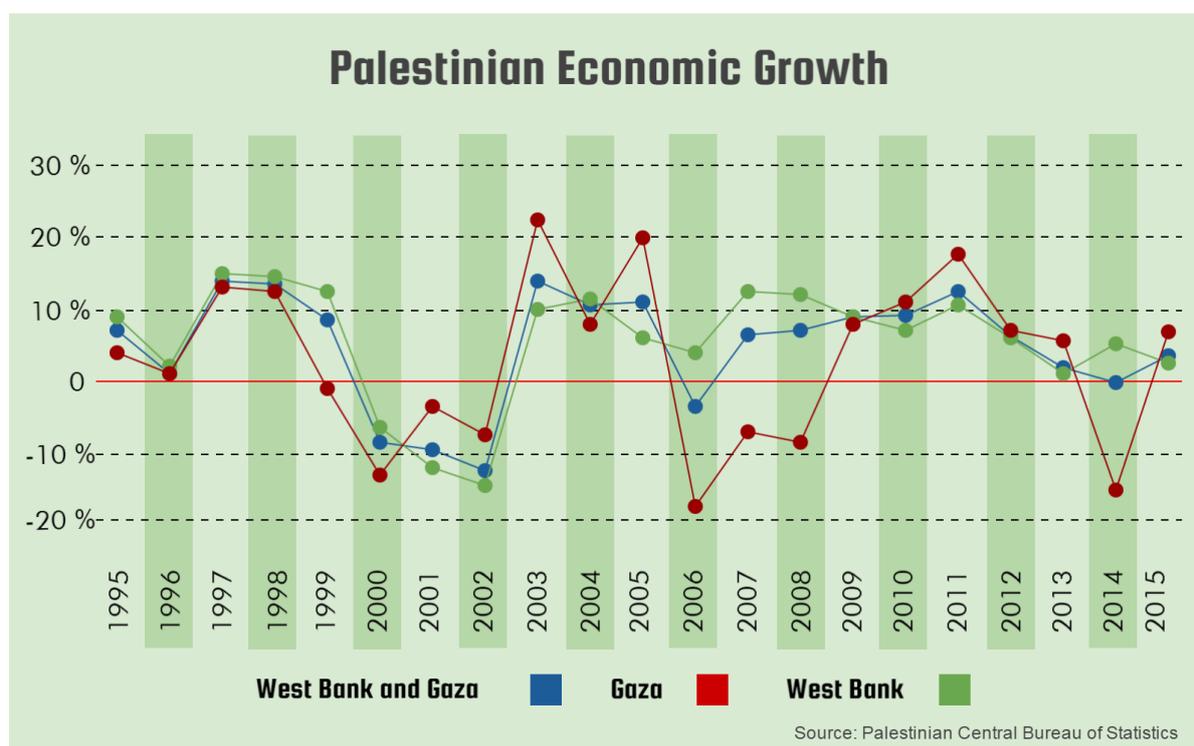
- Many Israeli officials recognise that improving the Gaza Strip and West Bank economies will reduce the chances of violence. Israel has recently taken steps to improve the situation, and there is support from the IDF for major infrastructure projects to transform the Gaza Strip.

- However, cooperation and development are hampered by complex factors including:

- ◊ The security threat posed to Israel by Hamas;
- ◊ The political division and rivalry between

- ◊ the Palestinian Authority (PA) and Hamas;
- ◊ The resistance of Egypt to any steps which might help Hamas;
- ◊ International concerns not to grant legitimacy to Hamas and thereby undermine the PA;
- ◊ Tensions between Israel and the PA exacerbated by recent Palestinian violence and the PA's policy of confronting Israel in international fora;
- ◊ Political resistance on the Israeli right;
- ◊ The deal to re-establish ties between Israel and Turkey, linked to Turkish demands to open up Gaza;
- ◊ Shortfalls in donor aid.

- Improving the Palestinian economy is a shared Israeli-Palestinian interest, and much can be done even in the absence of a broader shared political horizon. However, major changes require international support, which must come with a recognition of the complex factors involved.



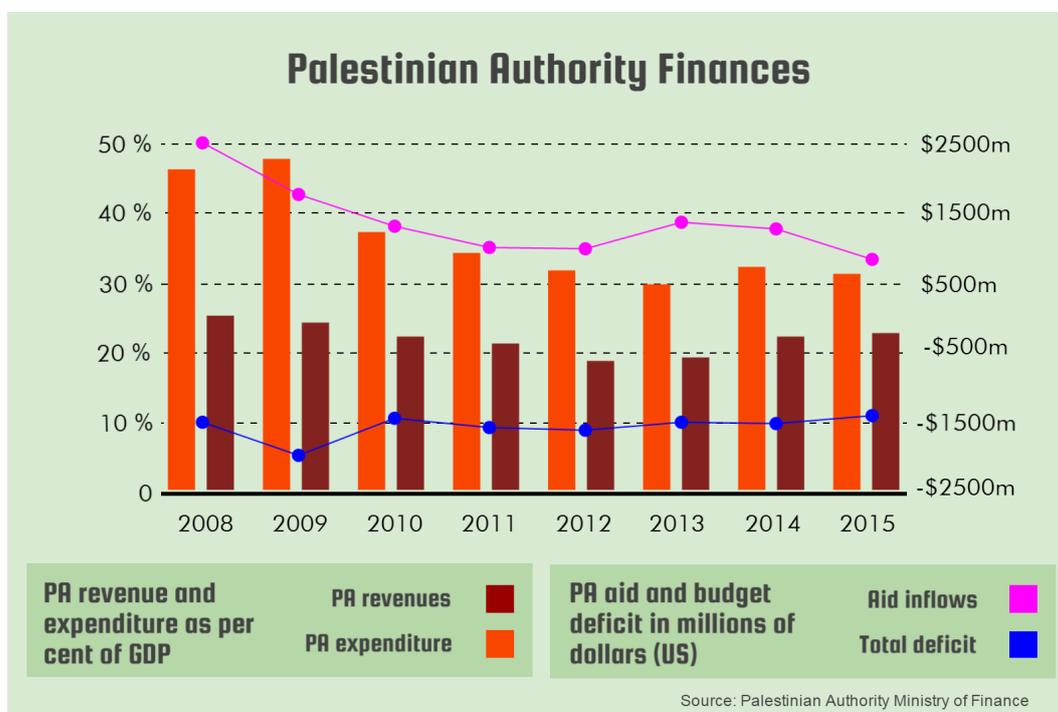
## What is the current state of the Palestinian economy?

Distinct yet interrelated factors are shaping the very different economic situations in the Gaza Strip, under the de facto rule of Hamas, and in the West Bank, under the rule of the PA led by Mahmoud Abbas.

### West Bank

The economy in the West Bank is stuttering after a period of growth. After the Second Intifada ended in 2005, the West Bank economy grew at close to 10 per cent, fuelled by increased donor aid – especially after the 2007 split with the Hamas regime in Gaza – and helped by reduced restrictions on movement and PA reforms under former Prime Minister Salam Fayyad. However,

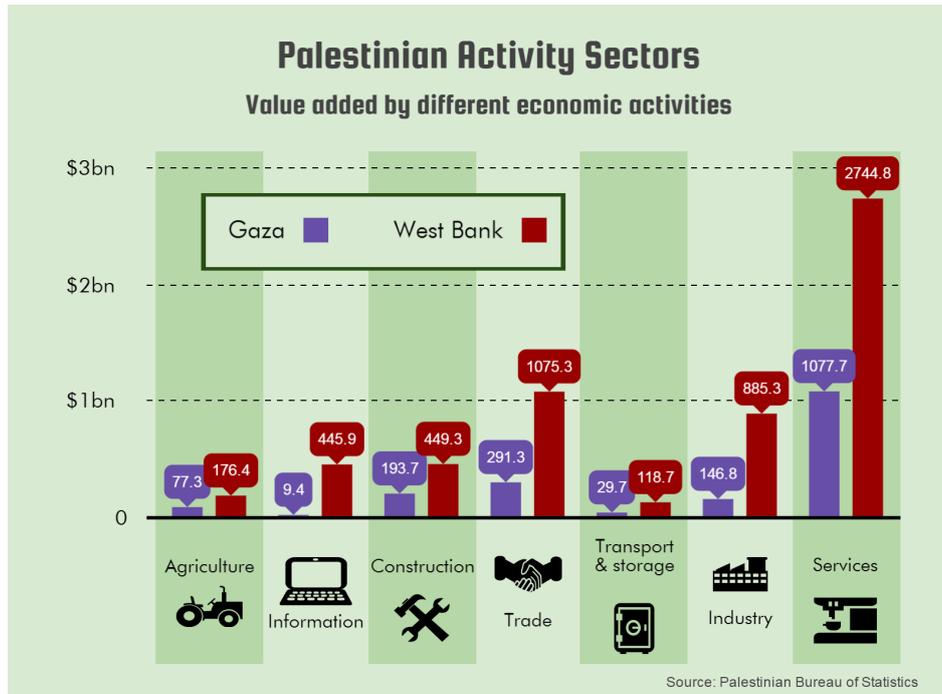
The unresolved territorial dispute limits development. The complex subdivision of the West Bank into PA control (Areas A and B, the 40 per cent of the West Bank where most Palestinians live) and Israeli control (Area C, including the settlements) limits Palestinian development. The situation, meant to be a temporary arrangement under the Oslo Accords, has remained fixed in the absence of a final status agreement. The Palestinians are unable to exploit economic, resource and infrastructure opportunities in Area C, which could add as much as 35 per cent to Palestinian GDP, according to the World Bank. Reports also highlight the failure of the PA to exploit land resources even in Areas A and B, due to problems such as lack of formal land registration. Whilst Israel is routinely criticised for building new homes for settlers in contested Area C, Israel objects to unauthorised Palestinian construction there, including construction



the PA's fiscal position has been hit by a sharp decline in international donor aid from US\$1.2bn in 2012 to US\$750m in 2015, coupled with a decision by Israel to withhold clearance revenues following the PA signing the Rome Statute in 2015. West Bank growth slowed in 2015 to less than 3 per cent, with unemployment estimated at 18 per cent (Q1, 2016). International priorities have shifted with competing demands such as the Syrian refugee crisis. The US, the single largest donor, reduced economic support to the PA from US\$370m to US\$290m in 2015, partly in response to PA decisions to accede to international institutions. Donor confidence is undermined by uncertainty fuelled by periodic threats by Abbas to resign or dismantle the PA. These recent issues compound underlying issues.

conducted with assistance from international donors including the EU.

Mismanagement and corruption in the PA. Some 79 per cent of Palestinians regard the PA as corrupt, according to a March 2016 survey, and international confidence, already low, suffered further with the resignation of Salam Fayyad in 2013. Palestinian civil society organisations such as 'Transparency Palestine' and 'Al Shabaka' highlight endemic corruption issues including the politicisation of public appointments and misuse of public funds and contracts by both Fatah and Hamas. Documents leaked to Associated Press (AP) in August 2015 highlighted how PA officials direct international aid to serve their personal interests and misdirect PA budgets to assist themselves and their families.



The non-functioning of the Palestine Legislative Council (The PA’s legislature, which has not sat since 2007), means there is no accountability for Abbas’ executive authority.

Mismanagement and waste also contributed to the PA’s large fiscal deficit. A particular concern highlighted by an EU report in 2013 is the PA paying tens of thousands of civil servants in the Gaza Strip who have not worked since the Hamas takeover in 2007. Furthermore, according to an April 2016 World Bank [report](#), “The internal divide between the West Bank and Gaza, which has created a dual regulatory framework, has also negatively impacted economic activity and the tax base.” The PA has also clashed with international donors over the money it spends on large monthly salaries for convicted terrorists serving sentences in Israeli prisoners and the family members of suicide bombers, amounting to more than £100m in 2012 according to a report from the [Israeli Foreign Ministry](#).

Israeli security measures impede movement. Israeli checkpoints and barriers intended to prevent attacks on Israelis impede Palestinian movement both within the West Bank and between the West Bank, Israel and Jordan. These barriers, along with political uncertainties, deter both investors, and tourists, and contributes to the Palestinians lacking access to adequate sources of finance.

### *Gaza Strip*

Gaza’s economic and infrastructure situation is dire. A widely quoted 2015 UN [report](#) asserted

that the Gaza Strip could be ‘unliveable’ by 2020. Gaza has a soaring population of 1.85m (43 per cent younger than 15) combined with shattered infrastructure, especially water, electricity and housing. The crisis is a function primarily of the conflict between the Hamas government and Gaza’s neighbours, Israel and Egypt, and its conflict with the PA. Hamas remains committed to the destruction of Israel. Hamas’s infrastructure has been severely damaged by rounds of conflict with Israel. Border access is tightly restricted by Egypt and Israel with no functioning seaport or airport. Unemployment in the Gaza Strip is 41.2 per cent (Q1, 2016).

Gaza’s electricity sources – a small power plant supplemented with power from Israel and a small amount from Egypt – provides less than half of demand, with rolling power cuts of 12 hours a day. The problems are exacerbated by increased fuel costs due to the closing of smuggling tunnels from Egypt; fuel shortages due to Hamas’s non-payment of fuel taxes to the PA; and damage to the power plant caused by Israel during the 2014 conflict. An equally acute crisis is water. Pollution of aquifers, inadequate infrastructure, and energy shortages mean supply is intermittent and largely undrinkable, and large quantities of sewage are pumped into the sea.

Gaza has faced severe restrictions since Hamas took over in 2006-7. When Israel left Gaza in 2005 it signed an Agreement on Movement and Access with the PA. But following Hamas’s violent ejection of PA forces in 2007, Israel declared the Gaza Strip an enemy entity and imposed severe restrictions on movement and access. It aimed to

avoid an acute humanitarian crisis, but prevent Hamas acquiring the means to rule effectively and expand its military threat to Israel. Egypt also regarded Hamas as a threat, and tightened the Gaza-Egypt border. Hamas sustained its rule with international assistance (especially from Iran) and a smuggling economy through hundreds of tunnels under the Gaza-Egypt border. Nonetheless, Gazan exports stopped almost completely and unemployment soared. After the Mavi Marmara incident in 2010, Israel relaxed many import restrictions.

Egypt's clampdown accentuated Gaza's problems. After President Sisi came to power in Egypt in 2013, he accused Hamas of aiding the Muslim Brotherhood and the Islamist insurgency in the Sinai and set about destroying smuggling tunnels. Egypt has kept the Rafah crossing largely closed, and says it will only open it under PA supervision. The clampdown, coupled with declining support from Iran, and the unwillingness of the PA to step in and pay salaries for 40,000 Hamas employees, exacerbated Gaza's crisis. This was one of the factors which motivated Hamas during the conflict in 2014.

Gaza's reconstruction has also been hampered by shortfalls in donor aid. Reconstruction and development have been limited by problems raising pledged money and disbursing it, with only US\$1.4bn of US\$3.5bn pledged at an October 2014 international donor conference delivered.

Since 2014 Israel has tried to relieve the pressure. After the 2014 conflict Israel gradually relaxed some restrictions. In September 2014 Israel agreed the Gaza Reconstruction Mechanism (GRM) with the UN and the PA to import construction materials, including dual use materials, into the Gaza Strip and assure they were not diverted for Hamas' military purposes. An electronic database, run by the PA's Ministry of Civil Affairs, matches the supply and demand for goods, and as of May 2016 more than 1.25m tonnes of material has been dispatched to more than 130,000 beneficiaries. However, the PA is not present in the Gaza Strip to monitor the materials and UN has not prevented Hamas syphoning supplies for military purposes. The PA has no control inside the Gaza Strip and Abbas refuses to take control of the borders, believing he will be simply used as a front for Hamas's continued rule. Israel has agreed to give Turkey a greater role in aid and development in the Gaza Strip as part of the Israel-Turkey reconciliation deal.

## What is the latest in Israel-PA economic and development cooperation?

There is wide recognition in Israel, especially in the security establishment, that improving economic prospects for Palestinians in both the Gaza Strip and West Bank means reduced potential for violence. Senior IDF officers have warned political leaders that a failure to ease conditions inside the Gaza Strip will likely lead to renewed conflict, and there is also a concern that Hamas's collapse could lead to chaos and greater freedom of action for other Jihadist groups. Recent steps announced by Israel with the potential to ease the economic situation, include:

### *In the West Bank:*

- Approval by the Israeli Security Cabinet in February 2016 for an additional 30,000 permits for Palestinians to work in Israel bringing the potential number to 85,000 (in addition to an estimated 40,000 working without permits and 22,000 working in settlements).
- A decision by Finance Minister Moshe Kahlon in February 2016 to release NIS500m (£92m) in withheld Palestinian tax revenues.
- A series of measures spearheaded by Finance Minister Moshe Kahlon in coordination with Palestinian counterpart Shukri Bishara including proposals to [open up](#) areas of the Israeli economy to Palestinian contractors and workers including construction, hi-tech and medicine. Bishara [wrote](#) to Kahlon in February 2016 that, "owing to your leadership and understanding, we have reached a positive turning point and set the stage for new beginnings in the commercial relationship between Israel and ourselves".
- An agreement to install scanners at the King Hussein/Allenby crossing between the West Bank and Jordan in the near future, with US and Dutch funding. This has the potential to decrease Palestinian transaction costs due to Israeli security checks and [increase](#) West Bank-Jordan trade flows by 30 per cent.
- An [agreement](#) in November 2015 between the Palestinian Minister of Civil Affairs Hussein Al-Sheikh and Israel's Coordinator of Government Activities in the "Territories" (COGAT) Maj. Gen. Yoav Mordechai to allow Palestinian telecoms companies to deliver 3G in the West Bank.
- The resolution of years of disputes allowing the new Palestinian city of Rawabi to be connected to

the water grid, announced by Israel in February 2015.

- An announcement by Finance Minister Moshe Kahlon and former Defence Minister Moshe Yaalon in May 2016 to spend NIS300m (£53m) in upgrading crossings between Israel and the West Bank, increasing flows of goods and people, reducing waiting times and improving conditions for workers.
- The IDF has backed a PA plan to build a power plant for the West Bank near Jenin, which will run on Israeli supplied natural gas.
- Talks are also being held between the IDF and the PA on reducing Israeli military incursions into Area A (mainly Palestinian cities and population centres).

#### *In the Gaza Strip:*

- Expanding truckloads of goods entering Gaza from Israel from 4,307/month in 2014, to 7,898/month in 2015 and around 10,000/month in 2016.
- Increased [exports](#) from Gaza (agricultural, clothing, furniture, scrap metal), mostly to the West Bank from around 20/month in 2010-2014 to 113/month in 2015 and around 185/month in the first four months of 2016. (Compared to more than 1200/month in 1999.) A second container scanner is being installed to facilitate exports at the Kerem Shalom crossing.
- The expansion in April 2016 of the fishing zone south of Wadi Gaza to nine nautical miles.
- Close cooperation with the PA and international

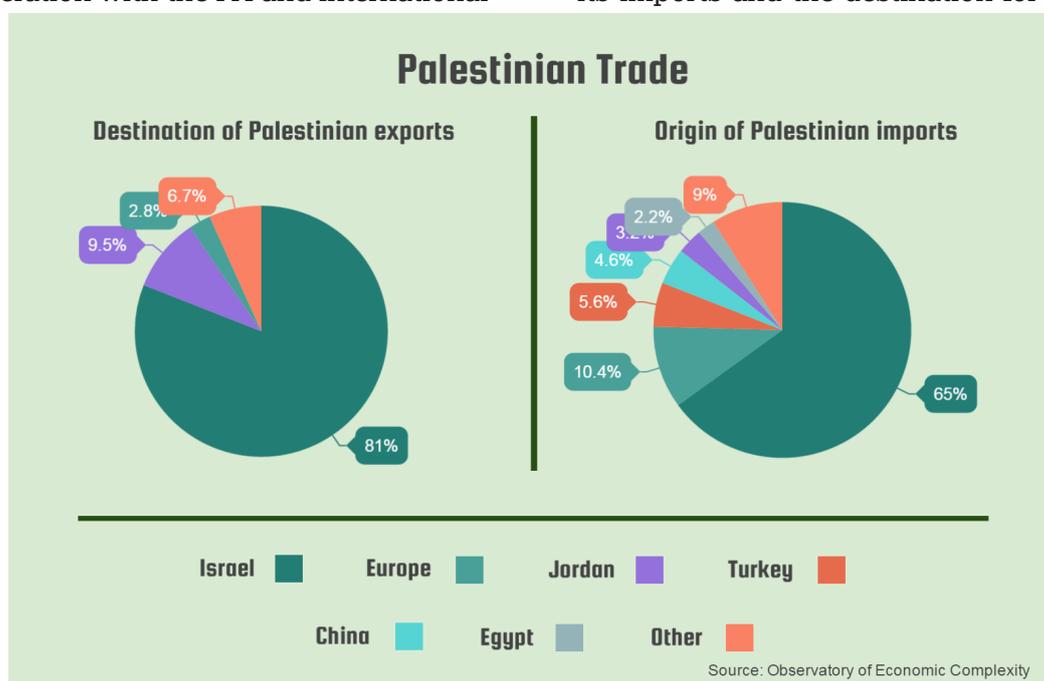
agencies on the ‘Gaza Reconstruction Mechanism’, with around 130,000 residents receiving materials to rebuild homes.

- Announcement from then-Defence Minister Yaalon in May 2016 of intent to reopen the Erez crossing to goods for the first time since 2000.
- Announcement in June 2016 that the EU will fund the second stage of the Deir al-Balah desalination plant with Israeli coordination, with the first phase set to become operational later this year.
- Support from the IDF for other major projects to provide Gaza with new power and water sources.
- Israel has also expanded humanitarian crossings, doubling the numbers of Gazans entering Israel via the Erez crossing from around 7,000/month in 2014 to more than 15,000/month in 2015 and 2016. These are mostly medical patients, traders and aid workers, but Israel has recently also allowed 300/month to visit the Al Aqsa mosque in Jerusalem.

However, these measures remain sensitive to fluctuations in the security situation. Deliveries of cement to private individuals was suspended for a month in April 2016 following the discovery of Hamas tunnels built with cement syphoned from supplies intended for reconstruction of homes.

#### *Palestinian private sector:*

Israeli-Palestinian business cooperation is a daily reality. The Palestinian economy is inextricably tied to Israel, which is the source of 65 per cent of its imports and the destination for 81 per cent of



its exports. In addition, 114,000 Palestinians were employed in the Israeli economy in the 1st quarter of 2016, accounting for 14 per cent of the West Bank's workforce. In Israel they earn on average 113 per cent more than workers in the Palestinian economy. Some 22,000 Palestinians have permits to work in settlements, many of them employed in Israeli businesses in industrial zones located in the West Bank.

## What are the opportunities for more substantial development?

### *West Bank*

There is considerable potential for Palestinian economic development in the West Bank. The West Bank's potential lies in opportunities including relatively high levels of education, and access to the Israeli market. [Reports](#) by the Office of the Quartet, which coordinates international efforts to promote Palestinian development, identified growth potential in sectors including agriculture, manufacturing, tourism, ICT, and infrastructure.

Seizing these opportunities depends on better cooperation with Israel. Such cooperation is vital to improve movement and access, border flows, and addressing restrictions relating to dual use materials. Improved cooperation with Israel on technical issues such as management of the customs regime, would also improve the PA's finances.

NGOs such as the Peres Center for Peace, private individuals, and the Israeli Ministry for Regional Cooperation are working to further promote Israeli-Palestinian business cooperation, in the belief that this will not only help develop the Palestinian economy but build peace. There are many areas of potential complementary work. The hi-tech sector has been widely identified as a shared opportunity for Israel's booming industry to outsource work to Palestinian programmers and to access Arab markets via Palestinian intermediaries. There is considerable growth potential in tourism for visitors that want to access cities and sites in Israel and the West Bank at the same time. In agriculture there is potential for Palestinian farmers to benefit from technological developments in Israel dealing with identical conditions.

Industrial free zones represent another source of opportunity. A new industrial free zone is due to be opened in Jenin in 2016 with Turkish funding, promoting Israeli-Palestinian business

cooperation with improved infrastructure to access export markets. Labour Knesset Member and former venture capitalist Erel Margalit is among those promoting joint economic zones for business and trade at locations straddling the Israel-West Bank border.

Area C represents a further opportunity. There is considerable diplomatic pressure on Israel to allow the PA greater access and more scope to develop civil infrastructure and economic projects in Area C including agriculture and resource extraction. Israel proposed during peace talks in 2013-4 that the Palestinians be able to manage planning for zoning and construction in parts of Area C adjacent to Palestinian cities, a step that would create considerable economic potential, and which remains under consideration by Israel. Israel already allows Palestinian police to operate in Palestinian population areas of Area C.

### *Gaza Strip*

A number of major development projects have been proposed to address the crisis in the Gaza Strip.

Access via sea: Israeli security officials and several ministers advocate establishing a seaport to serve Gaza, which will not be in Gaza itself. They believe that this will alleviate the humanitarian situation, reduce the chance of renewed violence, create employment for Gazans, reduce international pressure on Israel and reduce Israel's responsibility for Gaza. Several proposals have been aired, with the most ambitious, publicly backed by Israeli Transport Minister [Israel Katz](#), being an offshore island port with the potential for an airport, power and water production on the same site. Other proposals include a seaport for Gaza in Egyptian territory in the Sinai, or a special quay for Gaza within Israel's Ashdod port. It was widely reported in 2015 that Hamas was indirectly negotiating with Israel over such an initiative in return for a long term ceasefire. Israel's hesitations relate to both security and political considerations. On security, there is reluctance to reduce Israel's control over what enters Gaza, given the determination of Hamas to rearm. The political concerns relate to the objections of the PA and Egypt to anything which may assist Hamas, and the domestic political concern for Netanyahu of making an accommodation with a terror organisation.

Power: The IDF has [proposed](#) plans to address Gaza's power shortages including adding more

power lines from Israel, help establish solar energy, and convert the Gaza power plant to run on gas from Israel's offshore gas fields. Qatar is willing to finance the gas line. The Dutch government is funding a feasibility study nearing completion, though construction is not expected before the end of 2017 at the very earliest. The Quartet has said it hopes for an agreement to be signed on the solar power development by September 2016. Qatar is also willing to fund new power lines from Israel, though it was [reported](#) in March that Abbas had blocked the plan. Plans for a new power station are now part of an Israel-Turkey reconciliation deal. Long term, gas deposits off Gaza's coast present a potential economic opportunity for the Palestinians as well as a solution to their power needs.

Water: A newly constructed waste water plant on the northern Gaza Strip is due to go online but is delayed due to problems ensuring energy supply. With respect to water supply, expanding desalination would alleviate the situation, and the World Bank, European Commission and Islamic Development Bank supporting technical preparations, with the backing of Turkey among others.

However, long-term development projects are hampered by lack of donor confidence due to the instability of Gaza and the risk of conflict, as well as by complex political challenges affecting Israel, the Palestinians and third parties.

### Political Challenges

The capacity to exploit opportunities to develop the Palestinian economy in both the Gaza Strip and West Bank is hampered by the poor political relations between Israelis and Palestinians, domestic political factors on both sides, and the interests of third parties.

Israeli domestic political challenges: Even those Israelis who are hawkish on the question of a political agreement are generally supportive in principle of measures to improve the Palestinian economy; sometimes referred to as 'economic peace'. The security establishment is broadly of the view that greater economic opportunity will reduce the chance of violence. Objections come when measures to improve the economy are also seen to have security and political implications. In periods of escalating Palestinian violence and incitement, the weight of Israeli public mood in Israel shifts against 'concessions', especially where there appears to be no reciprocity. Key

decision makers, including Prime Minister Netanyahu, are constantly concerned about being outflanked by politicians on the right calling for a hard-line approach in the face of escalating Palestinian violence.

Israel's dilemma over dealing with Hamas: In the wake of the Gaza conflict in 2014 many Israeli analysts and politicians called for a [proposal](#) in which Israel would facilitate reconstruction in the Gaza Strip in exchange for Hamas's gradual demilitarization and transfer of powers to the PA. However, since 2014 Palestinian attempts to reunify have remained moribund and Hamas's military wing has proven fully committed to rearming for future conflict. Abbas has been unwilling for the PA to assume any direct responsibility for Gaza's borders, not wanting to do anything to assist Hamas – which he sees as a direct threat to his own rule – and believing Hamas will not allow him real control. Nor has the PA been willing to transfer salaries to Hamas officials. Israel does not want to legitimise Hamas with a long-term ceasefire agreement, and which could give a green light for third parties to also engage with Hamas.

Palestinian anti-normalisation: Meanwhile, the Palestinian political mood opposes 'normalisation' of relations, and political cooperation with Israel, even where it potentially benefits Palestinians. The notion of 'economic peace' is dismissed by Palestinians as a way of deferring the political issues. The PA leadership both reflects and reinforces the anti-normalisation mood by avoiding open political negotiations with the Netanyahu government, by confronting Israel in international forums, and by Abbas' repeated threats to end security cooperation with Israel. A specific example in the economic field is the Traklin business centre opened by Israel's Ministry of Regional Cooperation at the Efraim Gate crossing near Tulkarem to facilitate Israeli-Palestinian business cooperation. According to the Israeli ministry it [shut](#) in late 2015 due to the PA stopping Palestinians visiting. The facility was intended to enable Israeli and Palestinian business people to meet without the Palestinians requiring any permit to reach it. This climate of mutual mistrust also prevents the outdated 1994 Paris Agreement governing economic relations between the parties from being updated.

Regional interests of Egypt, Turkey and others: Regional politics also complicates efforts to address Palestinian challenges. So long as Egypt sees Hamas as a partner to the Muslim

Brotherhood and Islamic State-inspired violence in Egypt, it opposes opening up Gaza and in particular building a seaport. Egypt is wary of the political and economic support provided by Qatar and Turkey to Hamas, and accuses Turkey of hosting Muslim Brotherhood and Hamas figures involved in terrorism inside Egypt. Egypt also does not want to shift the burden of humanitarian responsibility for Gaza to itself by opening its border. While Turkey has conditioned restoring diplomatic ties with Israel on demands relating to the development of infrastructure in Gaza, Israel needs to take into account the opposition of Egypt to allowing Turkey and other sympathisers of the Muslim Brotherhood a leading role in Gaza. Meanwhile, Hamas's association with the Muslim Brotherhood and its supporters in Qatar and Turkey, as well as its ongoing military relationship with Iran, also limits its ability to acquire support and assistance from the Saudis and other Arab states in the Gulf.

## Conclusion

Improving Palestinian economy and living standards is a shared Israeli-Palestinian interest, and much can be done even in the absence of a broader shared political horizon. The causes for economic and associated humanitarian challenges in the Palestinian areas are complex and multi-faceted, with the positions of Israel, the PA, Hamas, and other parties including Egypt and Turkey playing a role. Whilst many Israeli officials recognise the Israeli interests in improving economic conditions for Palestinians, Israel faces constraints due to internal Palestinian splits, regional political factors, and Israeli domestic politics. Major changes require international support, which must come with a recognition that the barriers to development need to be addressed comprehensively, especially in relieving the acute crisis in the Gaza Strip.

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