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PALESTINE INTERNATIONAL BUSINESS FORUM

**FUTURE ECONOMIC RELATIONS BETWEEN
THE PALESTINIAN AND ISRAELI ECONOMIES**

***A PRIVATE SECTOR PERSPECTIVE:
IMPACT OF THE POSSIBLE TRADE SCENARIOS***

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WORKING PAPER ON TRADE POLICY – Detailed Analysis of the different Trade arrangement Scenarios

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I. Introduction

Note: As a pre-product to the Main Research Paper the project team developed a draft Working Paper on Trade Policy as a tool and basis for consultations among the private sector working groups, PIBF and the experts. The main body of this paper has meanwhile been absorbed into the Main Research Paper. Three Exhibits to the draft Working Paper, however, are also included below as they contain additional useful information.

The future relationship between Israel and Palestine will only be stable, prosperous and peaceful if economic relations are put on a solid footing. Businesses, the essential drivers of economic development, hold the key to making the future work for both sides.

Palestinian and Israeli negotiators are currently discussing options for future economic arrangements between the two parties, from the possibility of reaching no agreement at all to the possibility of continuing the present customs union, from basing relations on normal “most-favoured nation” principles (WTO) to a Free Trade Agreement.

Palestinian and Israeli businesses need to understand the options in store. They need to understand what a future *without any agreement* between Israel and Palestine would mean for them, as much as they need to understand what the different *scenarios for a possible future economic agreement* may mean. Only if they know this can they formulate their interests in a way that will enable their negotiators to negotiate the best possible arrangement.

At the same time, however, businesses also hold the key to (most of) that knowledge. No abstract economic projection will give them what only they themselves can and have to provide, namely the *business perspective* on the possible scenarios. Only businesspeople themselves can tell with any degree of certainty what they will, or may, do under any given scenario. This presupposes that they understand clearly what the different scenarios mean.

This draft working paper aims to assist in both processes. It is at the same time a working tool for consultations within sectoral working groups (first) and a growing collection of vital business inputs. It is, at this stage, a living document, a “work in progress.”

As a working tool for businesses the paper aims to explain the scenarios, their background and their contexts (historical, international etc.) to provide a basis for informed discussions with and among businesspeople. As a “matrix” for business inputs it provides designated spaces where such inputs will be slotted in, for the benefit of future users.

While not all blanks will be filled in, it is hoped that at the end of the present project at least a significant number of them will have been replaced by relevant information. This information together with the basic legal, economic and political information on the scenarios aims to provide a key reference for businesses and negotiators on both sides.

II. The Existing Trade Regime and the Paris Protocol – An Overview

This section aims to provide the readers with some background on the present arrangements under the Paris Protocol, their history and their shortcomings. Readers who feel that they are sufficiently familiar with these may want to skip this section and proceed directly to Section 3.

2.1 Background

The Paris Protocol (PP) was adopted in 1995 by the Government of Israel and the Palestine Liberation Organization as Protocol 5 of the Oslo Agreement. It was meant and designed to operate as the provisional and transitional regime which would govern the Palestinian – Israeli economic relationship during the Interim Period, a period at that time imagine to last for only up to five years until a final status agreement was reached.

The PP was thus intended to be a transitional instrument with a very specific objective and purpose. It was meant to ensure that the two economies and their businesspeople, intertwined through (at that time already) 28 years of occupation, would have a solid framework for the continuation and development of business for the benefit of their economies while the political, and hence also social-economic and regulatory, emancipation of Palestine would move ahead. The PP is thus defined by its starting point – occupation with political and economic domination – and its perceived goal, namely Palestine’s emancipation (which could, from the perspective of 1995, also well mean a developed version of the existing customs union with Israel).

The PP thus aimed to ensure that any changes in the economic and regulatory relationship would not be harmful to the existing economic relationship between the two sides. Hence, the PP was aimed at avoiding shocks to both the Palestinian and Israeli markets through the continuation and potential expansion of the cooperative relationship between the two sides, while ensuring that businesses are eased through the separation into two markets.

It is in this context that the twists and obvious shortcomings of the PP must be understood. Given that the goal – Palestine’s emancipation, not least in terms of economic sovereignty – is still the same, it is worthwhile looking at the PP not only as a failed regime but also as a source of ideas and concepts for designing workable transitional arrangements (see Section 8).

2.2 Conceptual Parameters and Limitations of the Paris Protocol Regime – Some Key Points in Summary

The PP took an important step forward from the previous *de facto* arrangements under occupation. It recognized Palestine (WBG) as an in principle separate customs territory that would, however, operate in a customs union with Israel. While the effective power and control of the partners remained highly unequal, their equality in principle in terms of economic sovereignty was thus established.

While the PP created a close web of obligations which, in combination with the continuing occupation, resulted in far-reaching Israeli control over the customs union and over Palestinian economic affairs, the PP also gave the Palestinian side some

policy space in managing its internal market, and the potential for diversification of trading partners, recognizing the historical ties between the Palestinian market and Arab and Islamic markets that were severed earlier due to occupation. Most importantly, however, the PP was intended to ensure the free movement of goods between the two sides under the premise of a union between the two markets with no economic borders. The Protocol also dealt with the free movement of labor, recognizing the dependence of the Palestinian economy on the Israeli labor market that had developed under occupation.

The Paris Protocol also included measures which would serve the fiscal needs of the Palestinian side in terms of revenue collection (tax and customs duties) to ensure operations of the Palestinian National Authority until Palestinian customs could handle customs clearance independently through the process of clearance by the Israeli customs and revenue transfer. This part of the PP is a very important and integral part of the customs union which the Protocol envisaged for the transitional period until Palestinian institutions are built which can handle this responsibility as stipulated in the Protocol.

The concept of a customs union, which is at the base of the agreement, was seen at the time as the best economic arrangement for the transitional period but it also served the purpose of avoiding final status negotiations on borders. The decision of implementing a custom union controlled primarily by one partner, namely Israel, however, also led to the adoption of trade arrangements – bilaterally and with third parties – which were consistent with Israeli interests but not necessarily with those of the Palestinian economy.

The PP, crucially, has no effective enforcement mechanism. Implementation was (and is) based on the goodwill of both parties. With the exception of the Joint Economic Committee (JEC), a body operating by consensus, thus based on the goodwill of both sides, there was and is no dispute settlement mechanism to which either party can resort if amicable resolution is not found in the JEC.

The Paris Protocol was and is also in a sense an incomplete contract, since it was a transitional agreement; the end product at the termination of the transition period was not identified. It is also important to note that while in the Oslo (Interim) agreement final status negotiations issues were identified, economic relations were not included in the package, hence upon the termination of the interim period, economic relations were not (properly) thought of as an issue to be negotiated.

2.3 Implementation

The PP today still applies as a matter of law, but crucial elements are not or only partly implemented, largely at (Israeli) will. Many thus see the PP as dead letter law. However, it is important to keep in mind that the PP is still the basis for important bilateral processes, including the cooperation in duty and tax administration. It is also the basis for the ongoing duty-free treatment for goods in bilateral trade (without the PP in force Israel would arguably violate its WTO MFN commitments by giving Palestinian goods duty-free access).

Why was and is the implementation of the PP problematic? Although the PP was negotiated with good will and good intentions, it was not implemented the same way. Ingrained resistance to change persisted within the Israeli economic structure. The

Israeli economy had for the last 30+ years enjoyed the Palestinian captive market and had now difficulties with the idea of losing some market share or having to compete with products from other markets.

As a result, the PP was designed primarily from the Israeli perspective. For example, because joint Palestinian-Israeli import tariffs for third country goods were “pegged” to the Israeli tariffs. Only with respect to certain listed goods the PNA could apply lower tariffs. As a result, the very same highly protective policies which were forced on the Israeli economy in the areas of tariffs, standards, health requirements were effectively forced on the Palestinian economy due to the quasi customs union established by the PP.

But the PP contained a number of very useful and constructive elements (see above). The main problem was and is the lack of implementation. The reasons for this are manifold. Most fall in either of the following categories (i) political choice, (ii) pressure of interest groups, or (iii) (the guise of) security requirements.

As a result of the lack of implementation of key elements of the PP, the severe infringement on both the spirit and letter of the agreement, as well as the changes which have taken place within the last six years of conflict (closure, the unilateral construction of physical barriers to movement of goods and people, the establishment of commercial crossings, the withholding of Palestinian revenues collected by Israeli customs... etc.) and the transitory (and hence in substance “gradual”) nature of the agreement, which no longer meets the needs of either side, the PP’s applicability has been minimized to the level of being almost defunct.

It is true that closures were already in effect in 1993-94. According to Israeli interpretation, the PP accommodated some forms of closures. But arguably this is not the issue. The problem is not the existence of any particular closure measure, and is not even so much a matter of degree, but rather a qualitative shift in the manner in which business is conducted within the Palestinian Territory and between the Palestinian Territory and others. In summary it is not unfair to state that an Israeli policy of disregard has caused the issue of PP non-implementation to shift from the occasional violation or non-application of provisions and sections to nearly total obsolescence.

This qualitative shift is a result of the ongoing political turmoil and the Israeli policy of separation and disengagement, including the building of the separation wall/barrier, continued settlement expansion and associated restrictions and closure regime, and the establishment of border crossings between the Gaza Strip and Israel from one side and the West Bank and Israel from the other side. There have been a number of policies implemented on a local basis that collectively have rendered the PP inoperable in both the letter and spirit:

- The Israeli settlements in the West Bank had essentially resulted in the dissection of the West Bank into various cantons and thus limited movement within the West Bank as well as created greater barriers between the West Bank and the Israeli market.
- The restriction of the Jordan Valley from most Palestinian access has limited Palestinian investment and economic benefits from this critical agricultural region.
- The continued low level of operation and intermittent closures of Karni and closure of Rafah have choked off economic activity in Gaza.

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- The continued separation of East Jerusalem from the West Bank.
 - The complex system of areas and sub-areas created by the separation wall/barrier, Israeli defined municipal boundaries, and checkpoints have deprived the West Bank from an important source of trade and commerce.

2.4 Current State of Applicability – From Integration to Separation

These transformations eliminated any potential for the free movement of goods between the sides, as envisaged in the PP, as well as created *de facto* border crossings, which can no longer support the ongoing PP's basic concepts of free movement of goods and people.

Though continued hostilities played a major role in the measures taken and served as a possible basis for their justification, their categorical implementation and intensiveness have had a detrimental effect on the entire economy and population.

The nature and severity of closures has increased and created a new economic regime which has taken the sides down a path far from economic integration. Rather, the unilateral creation of de-facto and non-agreed economic borders (the separation wall/barrier) brought things closer to what one could call 'imposed separation'. Imposed separation is no doubt the worst of options. It brings enormous economic losses, in particular to the weaker economy – the Palestinian economy, which has suffered from continuing crises, especially in 1994 to 1996 when the closures were severe, and again since 2000 when in addition a system of internal closures emerged.

By contrast, the tremendous importance of continued trade relations between the sides, while also the importance of the PA diversifying its external trade, can be seen in the share of trade between the sides out of their total trade. In 2004 73.7% of total Palestinian import of goods was from Israel. In the same year 89.8% of total Palestinian exports of goods were to Israel. The share of Israeli import of goods from the PA in 2005 was relatively low (close to 1%) while the share of Israeli exports of goods (excluding diamonds) to the PA out of Israel's overall exports was 6.3%¹.

These statistics point to the obvious: Further separation and limitation on trade between Israel and the PA will have severe negative effects on the Palestinian economy and its recovery potential. The Israeli side will face fewer difficulties on the macro level, but nonetheless, some sectors will be harmed.

Before moving into a discussion of the type of economic regime needed for the future, it is essential to stop, albeit briefly, and consider the reasons behind the non-implementation of the PP. As discussed, the root of the issue was the emergence of a new Israeli unilateral policy of separation and disengagement and the continued commitment to the settlement enterprise in the West Bank that are incompatible with the spirit of the PP (and indeed even of the Oslo agreement) as well as with the continued hostilities. Part of the answer also lies in the fact that the PP was an incomplete contract and the fact that it was time-inconsistent, but for our purposes now, it will suffice to say that the Protocol was not implemented because the conflict and unbalanced bargaining between the two sides continued. The economy became another form of pressure and a victim of the transitory and partial nature of the process.

Unfortunately, the process of negotiating on the ground under a highly changeable political environment continues until today, giving scant reason to believe that the Paris

Protocol can be revived from its dead *de jure* status to real de facto implementation on the ground. However, it may still be worth considering, and fighting for, the implementation of certain elements of the Paris Protocol as a transitional measure.

The current state of non-implementation of the PP does not meet the needs and interests of either the Palestinian or the Israeli economies. In order to confirm this understanding we must delve into the identification of these interests.

III. Palestinian and Israeli Interests in the Context of the Current Regime – A Brief Review

This Section aims to provide a brief reminder of certain key Palestinian and Israeli economic interests as they appear in, and are affected by, the most recent historical context, culminating in the 2005 “Disengagement” and the near-completion of the West Bank Wall/Separation Barrier. Again, the purpose is to provide context to the discussion of future scenarios. Readers pressed for time are encouraged to proceed directly to Section 4.

In view of the specific situation emerging from occupation, where there was not yet independence and certainly not a viable Palestinian state, the architects of the Paris Protocol (and the Oslo process) avoided in 1993-4 the difficult issue of sovereignty (a state, borders, withdrawal, removing settlements etc.) by relying on a vague concept of Palestinian (economic) sovereignty.

They constructed a framework of an interim agreement where the two societies will first (continue to) coexist under Israeli controlled external borders, no internal borders and a link between the WB and Gaza, slowly moving towards the creation of a Palestinian state, through Palestinian control of external borders, the creation of the safe passages, and then entry into permanent status negotiations whereby the borders will be demarcated, and the permanent territorial link will be discussed. This transitional framework promised the Palestinians high living standards as well as time to build their internal capacity, in order to operate the institutions and semblance of a state.

3.1 Pre 2000

The Paris Protocol framework was originally supposed to terminate in 1998/1999/2000,¹ with the two sides reaching a permanent status agreement by then. This never happened.

The dominant joint expectation in pre-2000 discussions and negotiations was that of a continuation of the very close economic ties between Israel and Palestine, and hence close cooperation in the form of either a continued customs union or a new Free Trade Area (FTA). During the 2000 Camp David negotiations and beyond, until the outbreak of the “Second Intifada,” the basis of most discussions on future economic relations between the two sides was the vision of the creation of an FTA. This vision, it was thought, would facilitate the growth of both economies, through meeting the requirements of both sides, while leaving room for high levels of cooperation and integration based on the mutual interests of both sides. This assumption shaped interests and perspectives of businesses and workers on both sides.

Many Palestinians envisaged their future business activity as continuing to operate via Israeli channels (subcontracting, brokerage, transport services – ports, roads, air -, facilitation services, etc.), under at least some Israeli administrative measures (because

¹ The determination of the date, now an academic exercise, depends on the interpretation of the terms of the various documents agreed upon.

business would touch Israeli territory on its way in or out) and with Israeli capital playing an important role in investment in Palestine.

Many Israeli businesses, in turn, saw their interests in the continuation of the status quo, with a captive consumer (and industrial user) market for their goods and services in Palestine, cheap and convenient (and relatively skilled) Palestinian labour commuting cross-border, and a high degree of effective control over exports and imports, executed both through business control (transport services etc.) and political/regulatory control (and hence lobbying).

In other words: Both business communities assumed a continuation of the status quo, with the potential of gradual evolution, with Israeli businesses and regulators operating as big brothers, Palestinian businesses and regulators as little brothers.

To what extent this perspective reflected their true long-term economic interests, however, is questionable. The risk of flawed allocation of resources (investments) in view of (future) international competition would have appeared appear high. This risk may have been even higher when it comes to the development of business perspectives. For Palestinian businesses to define themselves primarily as subcontractors (to Israelis or others) carries a significant risk of being too distant from important market signals, and hence to suffer damages from delayed reaction. This still applies today.

3.2 Post 2000

Shifts in Perspectives

The Post-2000 period was (is) characterized by the progressive disruption of effective cooperation, including in economic affairs. Meaningful political engagement came to a standstill, and measures taken no longer respected the (remaining) tenets of applicable agreements, least of all the Paris Protocol.

Trading (import and export) became increasingly difficult for Palestinians. Mere survival became the dominant short-term goal of many Palestinian businesses. Israeli businesses retracted/discontinued investments in Palestinian economy. As reliance on Palestinian labour became difficult (and politically undesirable) for them, third country labour gradually replaced Palestinian labour in Israel.

All this had some effect on longer-term business perspectives. As reliance on each other became more difficult, business started looking outwards for perspectives, and found some. Israelis found Jordanian and Thai suppliers as textile subcontractors, and Filipinos as workers. Palestinians (businesses and workers), in turn, found little compensation for the lost business with Israel. Some (service providers in particular), however, “discovered” the Arab markets.

As a result, the prospect of a very close future political-economic cooperation thus became – gradually – less obviously desirable.

Context: From Camp David to the Road Map

With start of the 2000 Camp David negotiations on final status, both sides undertook heavy positioning in negotiations, and the formula which President Clinton suggested was rejected on the grounds that neither party was able to make the necessary

concessions, which would have inflicted heavy political costs. After the failure of the Camp David summit, further entrenchment took place both in the Palestinian and the Israeli positions. This entrenchment led to the collapse of negotiations, having reached agreement on some areas, but bitter disagreement on others.

The failure of the negotiations which followed Camp David and the Israeli government's allowing a visit by Ariel Sharon to Al-Aqsa mosque further fueled the conflict and Palestinian ire, thereby sparking the start of the 2nd Intifada, which was met by a heavy-handed response from the Israeli side – again, fuel for further violence.

The Quartet (United Nations, United States, European Union and Russia) was formed in order to provide for a plan out of the violent cycle which Palestinians and Israelis found themselves in. At that time, President Bush announced his vision for two states, Israel and Palestine living side by side in peace and prosperity. This vision, was then translated into what is now known as the “Road Map,” which stated very clearly “Two states, Israel and sovereign, independent, democratic and viable Palestine, living side-by-side in peace and security”.

To Palestinians, the concept of a two state solution meant the end of occupation, the institution of justice on the Palestinian People, and the creation of a viable state of Palestine. The idea of an economically viable State of Palestine with a meaningful potential for socio-economic development grew, gradually, to include an implicit (not clearly defined) notion of economic sovereignty. This, in turn, implicitly suggested a turn away from the previous goal of very close economic cooperation between Israel and Palestine. The option of a continuation of the PP customs union or a close FTA became less politically desirable.

Unfortunately, the road map was never properly implemented and the violence continued, thereby leading to further frustration on both sides and a growing assumption that the two peoples could not live together. From this assumption, the Israeli government, headed by Ariel Sharon, decided to prepare a plan for the separation between the peoples, a concept which was highly perpetuated by the Israeli military, as well as the Likud.

3.3 “Disengagement”, the Wall and the Concept of Separation

This trend in perspectives grew with developments on the ground. The idea of separation, which found its most manifest expressions in the “Gaza Disengagement” and the West Bank Wall / Separation Barrier. People, and hence businesses, on both sides started adjusting more and more to the idea of separation, including economic separation.

“...the potential for a positive context for disengagement and the mutually declared policy to consider ways of improving the economic situation in the Palestinian Territory”² may inspire some into thinking that disengagement's potentially more positive results for both the Palestinian and the Israeli economies. Disengagement, however has a downside that must be addressed, and there are several pre-conditions which must be met in order to ensure that the concept of separation is not interpreted to mean full economic separation, which would have a negative impact on both business

² Israel and Palestine; Between Disengagement and the Economic Road Map, Aix Group, May 2005

communities, considering that the Palestinian markets is a very significant market for the Israeli economy, and that over 90% of Palestinian exports are currently destined to the Israeli market.

Decision makers must be fully aware of the significant risks associated with disengagement; since implementing the concept of Disengagement as it is being implemented since the beginning (non-implementation of the Agreement on Movement and Access), will result in the Gaza Strip and Northern West Bank will have very restricted economic links to the Israeli market, the West Bank, Egypt and other foreign markets. Such an extreme version of the plan, including closed external borders of the Gaza Strip, it will turn it into an isolated and economically weak region.

According to the Aix Group, “The Separation Barrier [wall] currently under construction, should it prove to be a permanent structure, will have severe negative effects on Palestinian economic viability”³ With impending completion of the wall in the West Bank, the highly isolated environment created in the Gaza Strip as a result of disengagement will be transferred to the West Bank. Hence, the inefficient and ineffective commercial crossings being enforced, which would mimic a number of Karni crossings between Israel and the West Bank, would result in choking any potential for the continuation of Palestinian – Israeli trade on the existing scale.

For the positive potential of the Disengagement concept to work, the following conditions should be met:

- The removal of internal closures within the West Bank and Gaza Strip.
- The creation of a secure, efficient and reliable economic link between the West Bank and the Gaza Strip, including a long term territorial link between the two geographical units
- The establishment of a secure, cost-effective, efficient and systemized border regime.
- Allowing the export of Palestinian Labor into the Israeli labor market and reducing it gradually over time, and once the Palestinian economy is capable of absorbing the labor glut.
- Ensuring security on the Palestinian side, including implementing the rule of law, instituting a separation of powers, and developing mechanisms for legal recourse.

The 2004 World Bank Report to the AHLC, the Roadmap and all international parties and observers without exception have been calling on Israel to ease and eliminate the countless restrictions on internal Palestinian movement, which not only make the banalities of everyday life a challenging experience but also make economic recovery an impossible task, adding prohibitive transaction costs to all but the most localized economic activities. Israel, in turn has consistently not reduced but increased these obstacles.

³ Israel and Palestine; Between Disengagement and the Economic Road Map, Aix Group, May 2005

The effect on business perspectives is dramatic. Many Palestinian businesses focus strictly on survival. Like hostages, many focus on reaching (gradually) alleviating arrangements. Even discussing long-term perspectives seems a pointless luxury. Hopes for cooperation and arrangements with Israel and Israelis run very low.

Interestingly, however, disengagement, as a concept being furthered by the Israeli government, also exposes the simple fact that the logic of separation, twisted as it is, is the logic of the two-state solution. This, in turn, offers some hope that there is, in fact – perhaps even somewhat inevitably – light at the end of the tunnel.

IV. The Present and Emerging International Context: WTO, EuroMed and GAFTA

This Section provides an overview of the immediate international context within which Palestinians and Israelis (will) operate. In order to discuss any options for the future it is crucial to understand that Palestine and Israel are not operating in a vacuum. The world markets, to put it drastically, couldn't care less about a few million people's ability or inability to get their business act together.

Palestinian and Israeli businesses compete with others on those markets. Access to and from these markets is shaped by relevant international agreements, to which Israel and/or Palestine are (or are not) parties. Any future arrangement (no agreement or agreement) will have to fit into that context. It is therefore crucial to understand how this context shapes, and limits, the options for such future bilateral arrangements. Only then can these options be assessed.

4.1 Introduction: Israeli and Palestinian Trade in the International Context

Several *regional* integration initiatives and activities have taken place, or are under way, which will affect the future relations of, and between, both Israel and Palestine. Perhaps the most important one is the Barcelona, or Euro-Med, Process, which aims to establish a Free Trade Area including goods, services and investment in the Euro-Mediterranean space. Both Palestine and Israel are parties to this process, which aims to impact not only on their respective relationships with the EU but also on their bilateral relations in matters as diverse as rules of origin (Palermo Protocol), trade in services and investment. A further aspect of this process is the prospect of Palestine joining the Agadir Group (Jordan, Egypt, Morocco and Tunisia).

Another important development is the emergence of the (Greater) Arab Free Trade Area (GAFTA), a process that is likely to have a significant impact on the Palestinian Economy's integration with Arab economies. Depending on political factors in particular, this process could indirectly affect Israeli regional economic perspectives, too. Another regional integration initiative is the US-initiative to develop a "Middle East Free Trade Area (MEFTA), meaning a Middle East – USA free trade area.

These factors – and many more – need to be accounted for when considering and designing scenarios for the future shape of the regional economy, and hence the blueprint for Palestinian – Israeli trade and economic relations.

The same is true for the larger, and more fundamental, umbrella of the World Trading System established by the World Trade Organization (WTO) and its agreements. These provide a less finely structured, but in turn imposing framework not only for the respective external trade relations of both Palestine and Israel, but also for any preferential trade agreement on goods and/or services between them. While only Israel is a WTO Member at this point, Palestine's accession should be firmly anticipated when looking at its future trade relations, including those with Israel. WTO rules, in other words, must be assumed to apply when considering any future arrangements.

Palestine and Israel are not alone – the world is full of both (potential) competitors and (potential) business partners, with potential for cooperation in areas such as cumulation

of origin, raw materials, as well as marketing and distribution, and trade in services. These areas are covered by bilateral trade agreements, as well the agreements of the World Trade Organization such as GATT, GATS, TRIPS and TRIMS. The WTO as the overall framework, tend to move its participants towards greater market access, thereby increasing opportunities for trade, export and investment abroad, leading to more competition and the erosion of preferences.

The WTO regime has also created more sophisticated disciplines on erstwhile internal issues, or “domestic regulation,” such as technical barriers to trade such as standards and regulations (TBT) and sanitary and phytosanitary (SPS) measures, as well as the regulation of trade in services.

Regional agreements, in particular the EuroMed and GAFTA, are of major and sharply rising importance – not only regarding preferences and the resulting trade diversion coupled with trade creation in both goods and services, but also regarding accompanying further integration moves that include disciplines in matters such as investment/establishment, institutional cooperation in areas such as competition policy and market regulation.

With regional integration agreements, one of the most serious problems which must be addressed is the management of Rules of Origin. Bilateral agreements and preferences, in particular the respective Palestinian and Israeli bilateral preferential relations with the EU and the U.S., will continue to play a role. Both, however, may be gradually “consumed” by the EuroMed (the Palermo Protocol on cumulation of origin is an important step) and MEFTA processes.

4.2 The World Trade Organization (WTO)

The World Trade Organization is the embodiment of international multi-lateral trade rules, whose aim is to facilitate international trade and to enforce rules of globalization. The WTO is based on the principles of market access, non-discrimination, transparency and predictability and accountability through the rule of law.

Key WTO operating concepts are concrete Market Access commitments (binding of maximum tariff ceilings, per product; binding of access commitments for services) and non-discrimination through the Most-Favoured-Nation (MFN) and National Treatment principles (see Annex). Specific disciplines, all focused on avoiding protectionist abuse, cover TBT, SPS, subsidies, anti-dumping and other issues. Perhaps most importantly, the WTO offers its Members a *binding* dispute settlement process.⁴

Israel as a current and founding member of the WTO is already bound vis-à-vis other Members. Palestine is not yet a member of the WTO but on its way to membership, which – for practical purposes – should be considered only a matter of time. The first step was taken through Palestine’s participation as an observer in the 2005 WTO Hong Kong Ministerial Meeting.

Palestinian WTO membership will result in positive benefits both through ensuring that the up and coming trade regime is according to international standards as well as in

⁴ For a more detailed overview of the WTO system and principles please see Annex 3 and/or the WTO’s website (www.wto.org).

ensuring to Israeli businesses that their access to the Palestinian market can be maintained in a transparent and acceptable matter. For Palestine, WTO membership (irrespective of any bilateral arrangements) will mean that its trade with Israel can no longer fall (too easy) prey to discrimination. The WTO framework will offer a higher authority that Palestinian businesses (through their government) may resort to when their trade is in trouble through Israeli policies or actions.

4.3 *Palestine, Israel and the EuroMed (“Barcelona”) Process*

The Euro-Med Process has been termed politically “a child of the Oslo process” since it is based on the concept of peaceful relations in the region, and the requirement that all members including a number of Arab countries and Israel aim to build a free trade area both between them and with the EU. Both Israel and Palestine are founding members of the Euro-Med process.

The starting structure of the Barcelona – EuroMed process is a “Hub & Spokes” concept, with the EU in the middle and the EuroMed partners around, all linked to the EU by bilateral Association Agreements, on its way to a Euro Mediterranean Free Trade Area for goods, envisaged to be established by 2010. A key element of the Barcelona Process is the concept of cumulation of origin, which for Palestine and Israel is currently bilateral with the EU. In the future diagonal cumulation, whereby, under Palermo Protocol rules (Pan-Euro-Mediterranean cumulation), complementarity of production can be utilized and exploited to increase market penetration and market share for both parties. Currently, however, RoO and cumulation constitute major practical challenges for Palestinian and Israeli businesses; but the potential benefits are significant and growing as the FTA grows from bilateral zones via groupings to a EuroMed zone (“variable geometry”).

Along with the free trade area for goods, the EuroMed process is also on its way to generating an “FTA” for trade in services and investment. The negotiations are well under way, involving again both Israel and Palestine.

Importantly, further negotiations in the EuroMed process now aim to establish a much stronger dispute settlement mechanism is being negotiated that will complement and eventually replace the (de facto) weak political mechanisms in bilateral Association Agreements.

These developments are very important for Palestinian and Israeli businesspeople and negotiators alike. If the EuroMed process proceeds as foreseen, Palestinian-Israeli bilateral trade will be covered by regional FTA(s) for goods, services and investment, reinforced by a strong dispute settlement mechanism, by around 2015 at the latest. While this presupposes some bilateral negotiations, much may be predetermined by existing rules and progress in bilateral deals with EU. This strongly suggests that Israel and Palestine will eventually need to establish at least an FTA for goods with EuroMed Rules of Origin, and will likely be pushed towards a services agreement incorporating each other’s concessions to the EU.

4.4 *The “Greater Arab Free Trade Area” (GAFTA)*

GAFTA is a free trade area conceived by and under the League of Arab States. Initially suffering from a lack of implementation and enthusiasm, it is now being realized. Some

very positive experiences in Arab countries have created incentives for expansion and completion. It is expected that with proper implementation, all Arab states will have zero tariffs towards each other's products by the end of 2007.

Beyond trade in goods, negotiations are now under way towards services trade liberalization. These negotiations proceed with a view to achieving harmonization with with the EuroMed process on trade in services (see above).

Palestine currently enjoys a peculiar status within GAFTA. Palestinian goods have – in principle – duty free access to all Arab markets under this agreement. Palestine is exempt from the requirement of offering its GAFTA partners reciprocal market access, given that Israel still *de facto* controls all Palestinian external borders and, more importantly, its tariff policy through the Paris Protocol arrangements.

Palestine's full GAFTA Membership, however, must be expected as a matter of course under virtually any future scenario involving Palestinian (economic) statehood. GAFTA Membership will lead to significant, legally secured market access to Arab markets. This market access, importantly, could be exploited *inter alia* through forms of cooperation between Palestinians and Israelis.

In turn, however, it is important to note that at least under current political perspectives Palestine's GAFTA membership will not sit easily with (and possibly be effectively incompatible with) entering into (maintaining) a customs union with Israel, and vice versa. While it is imaginable that some arrangement could be found to exclude (purely) Israeli goods from effective market access (a clear political dogma for some Arab states at this stage), or alternatively that the Arab states continue to grant Palestine unilateral, non-reciprocal benefits, this seems not very likely. This assessment may change radically, however, if an overall political solution is found that finds the acceptance of all Arab states and which results in serious political relaxation on both sides and an end to the conflict. In such a scenario Israeli market access to Arab markets, *de facto* or *de jure*, may become a non-issue.

4.5 Other Preferential Trade Arrangements

One of the most important trade agreements for Israel is the Israel-U.S. Free Trade Agreement, which provides for full access of Israeli goods to the U.S. market, and which has placed the U.S. market as the most important market for the Israeli economy. Currently, the Palestine–US Free Trade arrangements are based on the Israel–U.S. agreement, and would need to be further developed if the customs union were to be terminated and replaced by another type of agreement.

It must be noted here that the agreement has not benefited the fledgling Palestinian economy due to several internal and external reasons. Potential for benefiting from a U.S. – Palestine free trade arrangement in cooperation with Israel can be realized through the further development of the MEFTA, which was presented by the U.S. government as a concept for developing cooperation regionally, including Palestine.

It is also important to note that both Israel and Palestine have free trade agreements with EFTA states, Canada and Turkey, which are quite similar in nature, and which would facilitate joint cooperation in targeting these markets, even if the customs union would be replaced by a free trade agreement.

V. A Review of Palestinian and Israeli Interests in a Future Trade Regime

This section aims to capture and reflect the main Israeli, Palestinian and joint interests in any future trade arrangement. The interests must be analyzed on two levels: (1) the level of the respective national economy and (2) the business /sectoral level. These interests do not necessarily run in parallel, and are therefore reflected here in respective separate sub-sections.

This section, like others, is a “work in progress.” Within the concept of identifying the trade regime most conducive to Palestinian – Israeli trade and economic relations in the future, an exercise of identifying Palestinian and Israeli private sector interests has been / is being undertaken by the working groups. The results will be reflected successively in future drafts of this paper.

5.1 Joint Interests

Both the Israeli and Palestinian business communities have identified some norms or joint interests under which they believe the relationship can grow and prosper.

- **Normality and the Absence of Conflict.** The first of these is the general but highly important notion of “Normality” for Israeli and Palestinian businesses, whereby both parties deal with each other as they would with any other trading partner, with or without a special relationship, but in any case without the burdens (and hence costs) of a volatile, cumbersome and unpredictable environment.
- **Palestinian Statehood.** It appears obvious that at least in the long run such normality will only arise if and when Palestine reaches full and effective statehood.
- **Predictability and Stability.** As an element of (developed) normality, both economies will benefit from high standards of stability and predictability in the relationship whereby delivery can be predictable, transfers and payment can be done on time, and the political situation has stabilized to a point of having minimal impact on trade and economic relations.
- **Use of Synergies.** The two business communities expect to be able to explore and create synergies which would lead to reaping the fruits of existing and potential cooperation through trade, investment and joint ventures and projects. The two sides also perceive a relationship beyond economics, whereby trade and economic cooperation are seen as elements of a normalized relationship, and hence of future peace for both sides.
- **Cooperation (existing/further) wherever there is no Conflict with Overriding National Interests.** It follows that both sides have a clear interest in continuing and/or developing further cooperation wherever national interests do not prohibit such cooperation. Both economies are currently intertwined on many levels, and disruption would therefore cause (1) significant transaction costs. Further, synergies not used because of an (unwarranted) lack of

governmental cooperation would cause (2) significant opportunity costs for both economies.

- **Specifically: Cooperation in the Regulation of Trade and Businesses.** Economic activity within and between the two economies will benefit greatly from any regulatory/administrative cooperation between the States of Palestine and Israel. Businesses on both sides thus have a strong interest, for example, in :
 - the harmonization of product and service standards, technical regulations, sanitary and phytosanitary measures;
 - the mutual recognition of such standards etc., and of control, inspection and conformity assessment procedures and their results (certificates);
 - the pooling of regulatory/administrative resources (leading to lower fees and time savings), e.g. laboratories, testing, certification ;
 - the harmonization of supervisory measures (e.g. in banking);
 - the cooperation of supervisory authorities (e.g. joint insurance supervision);
 - the cooperation of competition authorities (general and specific, e.g. telecoms)
 - the harmonization of foreign trade policies & measures to the extent possible (e.g. tariffs, NTBs) to level regional playing field.

On both sides it is generally agreed that the most feasible political compromise is a "two-state" solution. We have assumed that a viable two-state solution will embody the following factors:

- The Palestinian state will have the power to define its economic objectives and strategies and to implement them freely, within the parameters of a bilateral permanent agreement;
- Economic cooperation will be conducted in good faith and mutuality, free of any intention to dominate;
- There will be a clear, unambiguous agreement on borders, including the final resolution of the issues of Jerusalem and the settlements.
- The Palestinian state will have full economic jurisdiction over its external borders with Jordan, Egypt and Israel, meaning that the Palestinian state and Israel will implement trade, labor and other regulatory policies in a manner congruent with normal relations between sovereign states;
- The Palestinian state will feature contiguity within the West Bank and efficient connections with Gaza;

A "two state" solution, therefore, means agreed political borders. Economic analysts over the last few years came to the conclusion that economic borders, if constructed in agreement and efficiently, would contribute rather than harm the prosperity of both economies. Thus, assuming the final status agreement is a two state solution, and that the most viable economic agreement between the sides is an implementation of a regime which would allow for continued cooperation and integration, while at the same time giving each side the freedom to create relations with other parties independently of the other side, the short term goal is to create a transitional regime that is more time

and situation consistent, and that would better serve the interests of both economies, while easing them into the vision of the future trade regime which would meet the long term interests of both parties.

5.2 Palestinian Interests

Beyond key joint interests explored above, such as stability, normality and cooperation, Palestine's key general, economy-wide interests can be summarized under the following (overlapping) concepts:

- **Viability of the Economy.** The population in the West Bank and Gaza is expected to reach 6.6 million by 2020 not including the refugees and the displaced. This great growth in the population will require potential for economic growth, whereby the market will be able to absorb the unemployed as well as the natural growth within the job market. Due to the small size of the Palestinian market, the only way to increase the Private Sector's capacity to absorb such employment is to increase the market penetration in the internal market as well as to open up to the outside world through trade agreements and regional trade arrangements, as well as membership in the multilateral trading system. Increasing local market penetration starts with the creation of territorial continuity and contiguity within the West Bank and a safe passage until the establishment of a sovereign territorial link, and opening external markets according to Palestinian interests can only be done through developing Palestinian control over external borders with Israel, Jordan and Egypt, and the implementation of the Palestinian trade regime on these crossings. It should be clearly understood, therefore, that economic viability for Palestine in the medium to long term requires a serious look at economic sovereignty for Palestine.
- **Economic Sovereignty.** The concept of economic sovereignty has become prominent within the context of Palestinian economic viability through the understanding that control over exports and imports requires sovereignty over economic borders in order to facilitate the movement of goods and people in order to reach external markets which is pivotal for economic recovery and future growth.
- **Physical Access to and from Palestine.** Sovereignty should also include mature trading & transit arrangements with Israel (which go beyond the PP), Jordan, Egypt.
- **Key Physical, Institutional and Legal Infrastructure for Trade & Business.** Palestinian businesses need (reliable access to) trade infrastructure such as airport(s), seaport roads network, electricity grid, water desalination. The same applies to institutions and legal elements such as land registration. In the specific Palestinian context access to reliable physical, institutional and legislative infrastructure requires some degree of political, or stakeholder control.
- **Palestine's Integration into the Regional and World Economy.** To build long-term competitiveness, Palestinian businesses need full exposure to, and opportunities on, world markets. The near-exclusivity of the classical business route via Israel filters and distorts market signals, leaving Palestinian

businesses vulnerable and dependent. Palestine's businesses therefore have a vital interest in a full and stable integration of Palestine into key international systems, including in particular the EuroMed process and future FTA, GAFTA, the WTO as well as preferential arrangements with other key partners (in particular the United States).

- **Social Viability.** Economic recovery and development will depend in good part on social stability, which in turn requires stable and powerful social security systems.

5.3 Israeli Interests

5.3.1 General (Economy-Wide) Interests

While Palestine's situation is characterized by extreme encumbrances and a very specific, peculiar and atypical overall set of circumstances, Israel's situation is that of a normal state and economy with *some* (even if major) specific problems and issues. In contrast to Palestine's interests at this point, thus, Israel's general, economy-wide interests can be summarized in a more straightforward manner.

Background

Israeli internal market, its situation in the global economy, and key trading partners

Compared to the Palestinian economy Israel's is large. It enjoys a sizeable internal market as well as fast-expanding export markets. Israeli GDP is almost 40 times larger than the Palestinian GDP, and its export volume (goods and services) is approximately 100 times larger than the Palestinian export volume.

Over the last two decades, Israel has undergone a profound process of economic and external trade liberalization; which was reflected, inter alia, in the build-up of significant trade volume with all major international markets (except, of course, for the Arab markets). Moreover, many of Israel's leading businesses have become multinational players, with global production and marketing systems. The global sales-volume of certain Israeli-based multinationals is many-fold larger than their sales in the internal Israeli market and their Israeli-origin exports combined.⁵ In certain industries Israel has become an important global player (certain sectors of high-tech industries, advanced electronics, agriculture, etc.).

The US is the most important single market for Israeli exports, accounting for around one quarter of exports, while the EU is the most important trading bloc, accounting for around one third of Israeli exports. In recent years, however, Israel has succeeded in significantly diversifying its exports, experiencing substantial increases in its export to the fast-growing markets of China and India, as well as markets like Turkey, etc.

⁵ This global activity is not reflected in Israeli national accounts, neither in Israeli export figures; though it constitutes a very important element of Israeli economic strength, and Israeli position in the global business community.

Relations with Palestine

In sharp contrast to these general trends, Israeli policy towards its trade with Palestine retained its basic "traditional" characteristics; namely: looking at the Palestinian market as a captive market for Israeli exports; and limiting the access of Palestinian exporters into the Israeli internal market, through various non-custom-barriers.

Israel's economic relations with the Arab world

Israeli trade with the Arab world is predominantly influenced by the political situation. Thus, trade is practically non-existent with most of the Arab countries that do not have peace agreements with Israel (except for marginal non-direct trade); and is encountering grave political obstacles even in the case of Jordan and Egypt.

However, in certain specific fields, which have been given special treatment, which "freed" them from the political obstacles and certain trade incentives (mainly QIZ related industries), trade has been booming.

Key Israeli interests in future economic relations with Palestine, and reflections on the future trade regime

Israeli exports to the Palestinian market

Palestine is still a very important export market for Israel, second only to the US and the EU. As a result, and as suggested by past experience, a recovery of the Palestinian economy would likely translate into a strong increase in Israeli exports to Palestine.

However, it should be noted that the forces that power Israeli exports to Palestine have been profoundly transformed. The basic changes in the Israeli industry over the last two decades, namely, its upgraded technological advantage, and enhanced competitiveness in international markets, have created a new situation regarding the Palestinian market as well.

A large part of the Israeli industry today feels enough confidence in its ability to compete in the Palestinian market under free and fair competition with local Palestinian producers, as well as other foreign competitors. This is especially true in relation to supply of inputs, intermediate products and equipment (for Palestinian agriculture, industry and construction sectors), which constitute a significant part of Israeli-produced exports to Palestine, as well as most of the future export-growth potential.

Most Israeli businesses are therefore gradually coming to the understanding that a continuation of the "old regime" practices that try to preserve a de-facto trade regime that discriminate against Palestinian exports to Israel, and tries to create advantageous conditions for Israeli exporters to Palestine, is not only no longer feasible but also runs increasingly counter to Israeli business interests. This part of the Israeli business community is ripe for shifting to a new regime that will equally and appropriately reflect the interests of both sides.

One should note, however, that there is still a part of the Israeli business community that has a vital interest in the preservation of the "old regime" in Israeli – Palestinian economic relations. Some of these businesses consider the protection against Palestinian imports to Israel as a vital means of survival, while others have a strong vested interest in preserving their current advantages in the Palestinian market.

Israeli exports to the Arab world

Notwithstanding the importance of the Palestinian market for the Israeli business community, the most important Israeli economic interest in the Palestinian context lies in the potential impact of Israeli–Palestinian relations on Israel’s future access, and hence export potential in trade, to the major Arab markets, in particular the Gulf countries.

According to various analyses, the potential magnitude of the Arab market for Israeli exports is in the magnitude of Israeli exports to the US, around one quarter of total Israeli exports.

The Israeli ability to tap this vast potential is conditioned on its political and economic relations with Palestine. Moreover, cooperation with the Palestinian business sector may prove to be the best way to access and compete in the major Arab markets.

Other issues affecting future trade regime

Other important elements that should be taken into consideration, include: the coordination of the bilateral Palestinian – Israeli future trade regime with existing and emerging regional trade arrangements (various Euro-Med arrangements; US- initiatives regarding regional free trade arrangements, etc.); the coordination of Israeli – Palestinian future trade arrangements with Israeli existing and future free trade arrangements, in order to maximize mutual benefits vis-à-vis third parties (for instance, accumulation arrangements, QIZ-style incentives for joint Israeli – Palestinian production, etc.); and appropriate consideration of the disparities in the development level of the two economies.

VI. Scenarios of Potential Trade Regimes

This section addresses potential scenarios for future trade regimes between Israel and Palestine, in two distinct ways.

(1) Explaining the key features of each potential regime. *While many people believe they know the parameters of the main concepts and the differences between them, few actually do, and even fewer understand them. For Palestinian and Israeli businesses it is very important to be fully aware of these parameters and differences in order to identify opportunities and risks, and hence formulate their interests and positions, with respect to each scenario.*

(2) Exploring sectoral examples, analyses and business perspectives with respect to each regime. *As a next step, and as the core of this exercise, this section aims to capture key sectoral perspectives regarding the regimes on the table through sectoral examples (fictional or real), economic analysis (to the extent useful data are available) and, importantly, reactions and perspectives formulated by the businesses themselves.*

This second set of aspects is currently being developed through the sectoral working group process, and is thus more than anything else “work in progress.” The respective sub-sections at this stage are thus left to be completed.

The two aspects are discussed in sequence with respect to each scenario. A summary synopsis will later assist in distilling key lessons.

6.1 Overview: Trade Agreements and their Basic Elements and Mechanics

Trade agreements are agreements that aim to gradually lower or completely eliminate trade barriers between national economies. They are thus steps towards the integration of markets, designed to realize certain benefits of such integration to both sides party to such agreement.

The starting point for all trade agreements on goods is the aim to provide preferential market access given by each party to the entry of nationally produced goods of the other party to their respective markets. They thus reduce or eliminate the two classical, or main, trade barriers, namely tariffs and quantitative restrictions.

The effective market access of goods to other markets, however, is also – and often significantly – affected by non-tariff barriers (NTBs). These include, for example, sanitary and phytosanitary measures (e.g. health measures), national standards and technical regulations (TBTs), environmental measures, cultural measures and licensing procedures. These measures are therefore often also addressed in trade agreements in the form of disciplines that apply to the national legislative, regulatory and administrative measures taken to advance such non-trade concerns, which also include national security. Trade agreements vary significantly in this respect. Some eliminate virtually all of these barriers, some very few.

Tools to eliminate or reduce such barriers include the harmonization of standards, sanitary and other measures; the recognition of all or some of the other party's measures; and/or regulatory and/or administrative cooperation, which may even reach –

partly or completely – forms of integration, for example a joint standards organization or environmental protection agency with constitutionally recognized functions in all parties (direct or indirect effect of joint measures).

Most trade agreements include as their main features the principles of non-discrimination (in particular Most-Favoured Nation and National Treatment), market access, transparency (publication, notification, information points) and the rule of law (local and international dispute settlement).

To the extent that trade agreements also cover trade in services, the concepts are broadly similar to those used for trade in goods, with some important variations. Because services are regulated almost exclusively on the domestic level, with no or very few actual “border” measures being applied, agreements in this area have a strong focus on domestic regulation – roughly comparable to issues raised by non-tariff barriers with respect to goods. Actual market access is often provided on the basis of positive lists of commitments which define in detail which services and which “modes of supply” are admitted to the respective market. While negative lists (all liberalized except those listed) are used in some agreements, their actual reach is often not very different from the positive lists used elsewhere.

6.2 Scenario I: “No Agreement”

This scenario imagines a situation where Israel and Palestine separate without any agreement on economic relations remaining applicable between them, not even the WTO agreements.⁶

6.2.1 Key Features

In the absence of *any* agreement on preferential trade, trade between the countries in question (here: Israel and Palestine) is regulated exclusively by national measures which can be applied freely. No international disciplines apply. No remedy is provided for any treatment perceived as “unfair.” The national legislators, regulators or administrators can take any measure affecting foreign trade with perfect sovereignty and impunity. While national traders may or may not have recourse under *national* legal systems against any such measures, foreign goods and services, and their producers and traders, enjoy no legal protection under international law, except for broad and basic rights such as diplomatic protection. This scenario thus offers by far the lowest level of predictability for businesses.

One potentially important effect of this scenario is that cumulation of origin between Israeli and Palestinian producers under the EuroMed system is not possible, as this requires at least a Free Trade Agreement between the two cumulation partners.

6.2.2 What does this mean? Examples, Analyses and Business Perspectives

“No Agreement” means unlimited policy space for the governments of both sides, for example for Palestinian and Israeli tariff policies, both external and *vis-à-vis* each other’s goods. This may appear attractive to governments, but would make bilateral

⁶ This is imaginable as long as Palestine has not yet acceded to the WTO, or if Israel upon Palestine’s WTO accession reserves the right to not apply the agreements between them. This would be unusual and would likely occur only if a total breakdown in bilateral relations were to prevail. This scenario is thus improbable.

trade highly unpredictable for businesses. On the other side, businesses with protective interests may have a better chance to obtain such protection from their governments.

Trade barriers could thus at any point become prohibitive for imports, either for specific sectors or for all products, with no remedy. For example, Israeli tariffs on Palestinian tomatoes could be raised to 350% overnight. More realistic, and possibly more damaging, are consequences regarding non-tariff barriers (NTBs), such as technical regulations, standards, health measures and plant and animal protection measures (TBT & SPS). “No agreement” means also no agreement on recognition of technical standards or sanitary and phytosanitary measures. Israeli milk and yoghurt, for example, may find itself subject to Palestinian SPS testing and onerous standards – again with no remedy whatsoever.

“No Agreement” would thus likely increase the transaction costs tremendously and slow down the process of entry of goods from one market to the other. It would, in its last consequence, imply the risk of losing the largest and most potential market for Palestinian producers. For the Israeli side, it would mean the potential loss of the second largest market.

Apart from the loss of existing, current markets for both business communities, “No Agreement” would also likely cut off any chance to make use of the future business potentials that would arise from cooperation.⁷

6.3 Scenario II: Non-Discriminatory Trade Policy (WTO)

This scenario envisages a situation where both Israel and Palestine apply a non-discriminatory trade policy to each other, either as an autonomous choice or as a result of their (future) WTO membership. No other preferences would apply. Israel and Palestine would treat each other exactly as they treat other (non-preferential) trading partners. Preferential trading partners, such as for example (for both Israel and Palestine) the EU and EFTA, will be treated better.

This scenario appears as a realistic possibility, namely as a default scenario in a situation where Palestine and Israel cannot agree on a specific, preferential agreement but accept that normal – i.e. WTO – principles apply between them.

6.3.1 Key Features

Under the system established through the World Trade Organization (WTO) and its system of treaties (GATT, GATS, TRIPS and others), Members grant each other guaranteed market access which, however, must be applied to all WTO Members on a non-discriminatory basis (MFN principle). For all trade in goods, and those services sectors where commitments have been made, the Members must also apply the “National Treatment” principle, i.e. treat goods and services from other Members at least as well as they treat their own.

WTO Members agree to certain market access guarantees, i.e. maximum tariffs and protection measures on services in their negotiated national “schedules.” Importantly,

⁷ See *The Untapped Potential...*

however, trade between WTO Members is not “free”, as tariffs and other limitations – within the limits agreed – may still be applied, provided this happens on an MFN basis.

The WTO system also imposes certain disciplines on exceptional trade measures (from trade remedies such as anti-dumping to environmental measures and security measures affecting trade) and classical domestic regulation measures, such as sanitary and phytosanitary measures (protection of human, animal and plant health and safety) and technical regulations and standards (TBTs). These disciplines, while important, remain relatively broad and leave significant room for national policies. They encourage, but do not require, cooperation. As a result, non-tariff barriers between WTO Members, while broadly regulated, remain significant.

Importantly, the WTO system is reinforced by a binding – and very effective – dispute settlement mechanism.

“Non-Discriminatory Trade Policy (NTDP)” is a carry through of the WTO’s Most Favoured Nation Clause (MFN), and can be applied, of course, without WTO Membership as a sovereign national policy. NDTP/MFN simply means that there is a certain level of preferences which are given by each member of the WTO to all other members without discrimination.

Under NTDP the preferences given by Palestine to Israel would be the same as those given by Palestine to China or South Africa. Once Palestine is a WTO Member, the preferences would necessarily have to be the same (MFN principle).

However, the WTO does allow for higher levels of integration among groups of its Members, provided these integration zones created by preferential trade agreements reach a high level of effective integration in goods and/or services trade. The models for these agreements are the Free Trade Area (FTA) and the Customs Union (CU).

As for the “No Agreement” scenario, one potentially important effect of this scenario is that cumulation of origin between Israeli and Palestinian producers under the emerging EuroMed system of cumulation will not be possible, as this requires at least a Free Trade Agreement between the two cumulation partners.

6.3.2 What does this mean? Examples, Analyses and Business Perspectives

It is important to note that under the NDTP, trade between Palestine and Israel would be subject to the tariff levels which are adopted by both sides towards trade partners with no preferential trade arrangements. Hence, Israeli trade with the Palestinian market, which amounted to around 2.1 billion USD in 2005, would now be subject to Palestinian tariff rates and duties. How high or low these will be remains to be seen.

Conversely, Israeli existent tariff rates would apply to Palestinian goods. These rates are effectively committed to the WTO average of around 6% for all industrial goods, while agricultural products including processed foods operate in a much higher tariff range.

Under this scenario, Palestinian exports to Israel, which amount to around 400 to 500 million USD per year, would thus be subject to these tariff rates. They would no longer benefit from the preference margin that results from their current “duty free” treatment. For certain Palestinian goods this would mean the loss of a significant competitive advantage they currently have in the Israeli market *vis-à-vis* third country products.

Although the establishment of a non-discriminatory trade regime may be beneficial to both the Palestinian and Israeli economies in the sense of creation of predictable and rule based trade, it is much less than the current situation and will deny both economies access to their respective markets, which are significant for the local economy, and which they had access to on a preferential basis.

Under this scenario (WTO, not autonomous NDTP), product standards for Palestinian window frames in Israel or for Israeli construction machinery in Palestine, for example, are subject only to the WTO's TBT Agreement. Unless specifically agreed in addition, there would be no mutual recognition of standards and specifications; products from the other side would thus likely be subject to delays and multi-level inspections when entering into the respective markets. These effects would likely be more pronounced with regard to health & safety inspections of food products.

The WTO, however, does accept and even encourage institutional cooperation, mutual recognition of standards and health requirements, as well as other forms of cooperation, provided other WTO Members are given the chance to benefit from similar cooperation if they are in a similar situation. It would thus be possible for Palestinians and Israelis, even if they do not manage to conclude a comprehensive trade agreement, to arrive at specific cooperation arrangements under this scenario, for example a mutual recognition agreement (MRA) on food safety standards for milk products, or the coordinated regulation and supervision of car insurance providers.

Box: Why Not Sectoral Trade Agreements?

Countries may, in principle, chose to agree on some liberalization (elimination of trade barriers) and/or on-discrimination on trade in specific goods or services, while leaving other parts of their trade unprotected. Any variation can be imagined.

However, such agreements are usually illegal under WTO law (to the extent that the countries concerned are WTO Members), as WTO law requires that Members treat each other without discrimination, except if such discrimination is the necessary effect of an integration agreement that reaches a certain (high) level of intensity and coverage ("substantially all the trade"). This would require a Free Trade Agreement or a Customs Union (see below).

As Israel already is a WTO Member and Palestine aspires to be one, only applying some sectoral preferential arrangements, for example for certain construction services or specific food items, is not a realistic long-term option.

6.4 Scenario III: Free Trade Area / Economic Integration Agreement

This scenario envisages a situation where Israel and Palestine agree on the duty free treatment of mutually originating (i.e., Palestinian or Israeli) goods, but not for imported third party goods.

6.4.1 Key Features

The WTO system does, however, allow for the establishment of a free trade agreement or area (FTA) between two or more Members. A free trade area is an economic integration agreement, but achieves a lower level of integration than a Customs Union

(see below). In a free trade area, the majority if not all of the goods nationally produced (based on agreed rules of origin) enter into the other market exempt of any customs duties or charges of equivalent impact.

However, other market entry requirements such as technical standards and health and safety regulations of the importing market remain usually in place and are enforced, as before (under “no agreement” or NDTP/WTO) at the point of entry of goods into the market.

Because free trade areas liberalize trade in the nationally produced products of the parties, but do not aim to affect their respective trade with third parties, rules of origin play a major role. They serve to distinguish national products from third party products, and hence are a cornerstone that keeps the exclusivity of the system. In the absence of effective rules of origin, many third party products could benefit from the preferences through simple transactions (e.g. mixing) or even just transshipment arrangements, thereby nullifying the function of the free trade area. The flipside, however, is the administrative burden for producers, traders and administrations associated with rules of origin. FTAs thus impose a certain cost on their functioning.

The main difference between a Free Trade Area *vis-à-vis* a Customs Union is the lack of a common external tariff towards third party imports (even though some harmonization of tariffs may be desirable to reduce the pressure of smuggling and to ease bilateral border administration). Under an FTA, bilateral economic borders remain fully intact, and even become important to avoid non-originating goods from entering into the territory under the guise of originating goods. The FTA therefore, requires completely separate customs administrations for the parties to the FTA, even though harmonization, cooperation, and even some integration is possible and desirable. Most importantly, the FTA allows each party to have completely separate trade policies *vis-à-vis* third parties, without any (legal) need to harmonize. Being only in an FTA with Israel, but not a Customs Union, would thus, for example, enable Palestine to become a full Member of GAFTA.

6.4.2 What does this mean? Examples, Analyses and Business Perspectives

An FTA between Palestine and Israel would maintain the positive potential for duty free trade of goods such as agricultural produce between Palestine and Israel, so Palestinian tomatoes, for example, would continue to enter Israel duty free – if accompanied by the right certification of origin.

By contrast, goods imported to Palestine from third countries, for example China, via Israel would no longer enter duty free. Such third party products would not be freely traded in an FTA, contrary to a Customs Union. It is estimated that at present around one third of all Palestinian imports (that would mean goods worth around 500 to 600 million USD per year) “from Israel” are actually undeclared third party products (indirect imports). Provided the FTA arrangement were to lead to more effective origin examination by Palestinian customs, these imports would thus generate customs revenue for the Palestinian treasury, as opposed to the Israeli one (as it currently happens). *It should be noted, however, that this is only an indirect effect of the presumably increased border presence of customs under an FTA, not of the FTA as such. Also under a Customs Union (including under the Paris Protocol) imports should be monitored and customs revenue distributed according to the destination principle.*

It is also important to note that under an FTA specific rules of origin will likely be applicable. This not only means administrative burdens for businesses, which will have to prove the origin of their goods and production inputs and/or value added. It also means that some Palestinian and Israeli products that are currently crossing the border duty free would not qualify as originating in either economy under normal rules of origin, and would thus no longer qualify for preferential treatment (and would hence attract MFN duties).

Within the concept of sub-contracting of services from one side to the other, a system of temporary entry of products would have to be devised which would accommodate such work as the sub-contracting of textile and sewing servicing of Israeli ready wear in Palestinian factories and workshops.

An FTA, however, does open up the potential for diagonal cumulation between Palestinian, Israeli and European products aimed at entry into the European market (as well as under certain conditions with American products under the concept of Qualified Industrial Zones), which would allow for the utilization of input materials within certain percentages from Palestinian and Israeli products to be exported to European (or American) markets duty free.

For the Palestinian side, the benefit of entering into an FTA would be the freedom to enter into preferential trade agreements which Israel is not party to, such as the Greater Arab Free Trade Area (GAFTA), and benefiting from Arab –European trade arrangements such as the Aghadir Group (Egypt, Jordan, Tunis and Morocco), which has a cumulation agreement with the EU, hence the potential for utilization of production inputs from these sources that would still meet the rules of origin of the EU if production inputs are cumulated.

It is worth noting that, while every agreement is different, a standard FTA would not normally include within it any provisions for the movement of labor from one market to the other – even though such labour arrangements are not in any way prohibited, either. Any access of Palestinian labour to the Israeli market would thus have to be negotiated, to the extent it is not covered by provisions on services trade (which usually cover very little actual “presence of natural persons”, or “mode 4”).

6.5 Scenario IV: Customs Union

This scenario envisages a situation where Israel and Palestine allow the free flow of goods (and services) between them and maintain a common external customs tariff for all or most goods. It is possible, but not necessary, that goods from third countries also benefit from almost free flow between the parties.

This situation resembles in many ways the present practice, as the Paris Protocol did in fact establish a quasi-customs union between Israel and Palestine, albeit under far-reaching de facto Israeli control, (which may be reduced – but most likely not eliminated – in a future customs union build on (more) equality).

6.5.1 Key Features

The customs union is a high level economic integration model which includes all features of an FTA (liberalization of trade in local products and/or services between the parties), but adds to this elements of a common external trade policy, most importantly

a common customs tariff. Import taxation and regulation are thus (largely) harmonized between the two sides.

As a reflex of the harmonized external policy, it is much easier to allow for the largely free circulation of goods, whether national or imported, between the parties to the customs union. This, in turn, makes the use of rules of origin, and hence their administration, much less important and costly. They can be completely eliminated if, as is often the case, the common external trade policy harmonizes all rules of origin.

While customs unions may, and usually do, allow their members to retain at least some non-tariff barriers between themselves, a customs union in principle, for the same reasons as indicated regarding rules of origin, is highly conducive to the progressive elimination of those measures, to the extent that the parties want this to happen. One of the most advanced examples of such an enhanced customs union is the European Community (EC), which has created a largely functional internal market between its member countries. However, even within the EC certain SPS and TBT measures are still being applied.

6.6 Scenario V: “FTA Plus” (FTA with Enhanced Features) or Other Hybrid Agreements

This scenario envisages a situation where Israel and Palestine establish an FTA, but with significantly enhanced “deep integration” elements. These could include, for example, cooperation of health, tax, standardization, competition and bank supervision authorities; the recognition of product standards and professional qualifications of service providers; and institutional arrangements such as joint committees and dispute settlement.

6.6.1 Key Features

With the WTO requirements of “substantially all trade” satisfied, parties to an FTA / a CU are free to take further measures towards integration and cooperation (sometimes referred to as “deep” or “deeper integration”).

Hybrids between the basic models FTA and CU can be imagined and designed (e.g. an FTA with a partly harmonized external tariff, e.g. on all industrial but not agricultural goods). Similarly, additional elements of cooperation and integration can be freely added, e.g. cooperation between standards organizations, general recognition of health certificates, joint supervision of banks and insurances, joint telecoms regulation, harmonized immigration policy for certain services specialists from third countries, etc. The possibilities for these additional features are in principle not limited, with minor requirements imposed by the WTO.

As a basic structure, one can imagine these hybrid agreements as FTAs with added features – hence the expression “FTA Plus.” Which elements of “deep integration” are added to an FTA is a matter for negotiations.

6.6.2 What does this mean? Examples, Analyses and Business Perspectives

“FTA Plus” features are generally desirable in particular in the area of Non-Tariff Trade Barriers, such as standards or sanitary and phytosanitary measures, where for example mutual recognition of conformity testing certificates by the standards institutes of either

side confirming conformity of the product of one side to the standards and specifications of the other side through tests conducted by the standards institute of the first (exporting) party. In the Palestinian-Israeli context any such arrangement would have a significant effect on mutual trade in the respective goods.

In addition to mutual recognition agreements, the substantive harmonization of SPS/TBT measures where appropriate and possible, such as adherence to the European standard by both Palestine and Israel would have significant facilitating effects.

A further possible feature would be a package of mutual services which would facilitate movement of goods across borders, such as customs administration for each other where logistically useful, or mutual assistance in the collection / clearance of Value Added Tax. Further steps could be the integration/cooperation of other authorities or the harmonization / synchronization of customs procedures.

The possibilities are equally broad in the area of trade in services. Measures could include, for example, the recognition of qualifications (e.g. doctors, engineers), licensing (e.g. courier services) or supervisory measures (e.g. banking supervision); or administrative cooperations such as a joint or harmonized tour guide register and joint insurance regulation facilitating coverage of both markets, which is a necessary component for car insurance if cars are to move across borders.

The concept of an “FTA Plus” opens up the door for more intensified institutional cooperation in general, examples of which are Intellectual Property administration, anti-dumping regulations, and health and pest control procedures (the list can go on and on), with the flexibility to adopt and utilize all that is beneficial for both parties, within a customs union, while avoiding all that is restraining or debilitating. This scenario can provide for a significant component of dispute settlement mechanism, possibly with direct domestic enforcement mechanisms similar to the NAFTA agreement, whereby national courts have built in mechanisms to deal with disputes between the trading partners. Issues which would be out of the realm of trade, while being extremely relevant to trade, such as investment, competition regulation sectoral regulation agreements such as telecoms, government procurement (whether full coordination or some features such as transparency).

An “FTA Plus” approach thus opens the door for further integration while maintaining some key features of autonomy *vis-à-vis* a customs union, most importantly the freedom of each side to manage relations with third parties. An “FTA Plus” would thus allow for far-reaching, fine-tuned integration bordering on a Customs Union, but would nonetheless allow Palestine to design its own foreign trade policy, including for example Membership in GAFTA.

VII. Selection of a Reference Scenario: The Likely Future Trade Regime

This section aims to provide a sketch, and brief evaluation, of what appears to be the most likely, and possibly most desirable, scenario, namely a “FTA Plus” with certain features.

This sketch is thus necessarily risky guesswork, as it is, of course, impossible to predict the outcome of negotiations, in particular negotiations that this project aims to influence. However, it still appears to be a useful exercise as it may help businesses to position themselves more concretely with respect to certain aspects – i.e., for or against certain features – of the future regime. It is hoped that this will help them to inform negotiators about the interests of their stakeholder communities.

7.1 Sketch of a Reference Scenario: Likely Elements of a Future Trade Regime

The likely elements foreseen for a future trade regime between Palestine and Israel is foreseen as a free trade area with some sectoral agreements. The free trade area will include tariff free trade between the two sides on the most substantial percentage of goods locally produced in both sides, including agricultural goods and processed foods, as well as a gradual liberalization of trade in services. The “free trade” will require the implementation of rules of origin that would guarantee a certain level of processing and value added which will be locally produced. These rules of origin would have to accommodate the existing capacities of both Palestinian and Israeli producers, and can potentially carry time-limited asymmetric rules which would give Palestinian industry a chance to increase their levels of processing or value added.

Along with the free trade area agreement, and in order to increase the cooperation and coordination between the two sides aiming towards trade facilitation and the continuation of cooperative economic relations, a set of sectoral agreements which would allow for more cooperation and integration of the economies, thereby minimizing the shock which would result from the change in trade regimes. Most of these sectoral agreements fall within the basis of the WTO agreements, but the use of sectoral agreements will re-enforce the cooperative relationship and widen the potential for integration into levels which the WTO agreement does not venture towards. These sectoral agreements may include, but are not limited to:

- Mutual recognition of standards, testing and certification, which would include recognition of the testing process of each side’s standards institute against the standards of the other side.
- A labor agreement, which would regulate and regularize the movement of laborers from both sides into the labor market of the other side.
- The signing of a transit agreement, which would facilitate the use of international border crossings of either side by the other side, as well as the movement of goods through the territory of one side to reach the other side.
- Border control and customs co-operation agreements come hand in hand with the transit agreement, and are a necessary part of a more extended agreement

on trade facilitation, which would provide rules for ensure the smooth movement of goods through border crossings.

- A protection of investment agreement may be signed by both sides, which would spell out the rules for investments by one side in the economy of the other side, and the protection of such investments and investors.
- Dispute settlement is a key issue which may either be an integral part of the FTA agreement, or as an extended complimentary agreement which would spell out the dispute settlement process in more detail, including the necessary Institutional cooperation which needs to exist in order to ensure that commercial disputes are resolved in the swiftest and most effective way.

The aforementioned likely scenario is the one most likely to meet the requirements of both parties on the economic level because it maintains the duty free status of originating goods from both sides, while giving each party the freedom to trade with other trading partners freely without interference or conditions restricting such trade. A customs union on the other hand is not a very likely candidate for the future relationship due to the restrictive nature of customs unions, having common tariff levels and a high level of harmonization, which cannot meet the developmental needs of both a highly sophisticated economy such as Israel and a developing economy such as Palestine.

The experience of the Paris Protocol, which is a customs union of sorts is not a very encouraging example of how either party would be interested in such a high level of integration. Having a customs union would also affect the Palestinian economy's ability to integrate more intensively into the economic structures of the region, especially Arab countries. NDTP on the other hand is not a likely scenario either because is would go against the interests of both parties, by introducing a level of tarrification, which would go against the market access needed by both private sectors to the other's market. Hence, NDTP would mean that Palestinian – Israeli trade would be subject to customs duties, thereby restricting or even significantly reducing the market share of either party in the economy of the other party.

Realizing that both parties' interest is to maintain preferential access to the other's markets, while maintaining the differences required for development at varying levels of development, the choice of an FTA seems clear. As a result of the high levels of integration which exist under the current situation, agreements such as transit, or labor market access prove to be an outstanding way of ensuring that this integration is maintained, while at the same time guaranteeing that other needs are met.

An additional layer of preferences which can only be addressed by the proposed FTA scenario is that of the Euromed and AFTA, both of which require duty free relations, while the AFTA requires preferential treatment between Palestine and other Arab States, which would be different from Palestine's relations with Israel. Therefore, the additional sectoral agreements which may be reached between the parties give some negotiating room for the structure of the future relationship, while ensuring the required ingredients for regional integration are present, without the restrictions of a customs union or a new layer of tariffs.

7.2 Check against Key Criteria

In order to ensure that the recommended scenario of future relations is the most likely, or most appropriate, a check against some predetermined criteria must be done. The following is a synopsis of the criteria which need to be met, and the potential for meeting them through the proposed scenario.

7.2.1 Political realities and context

Under the existing political context addressing the Palestinian need for sovereignty and independence, and the Israeli interest of disengagement and separation from the Palestinian side, and coupled with the interest on both sides to maintain and potentially improve economic relations, the FTA plus scenario seems to be the most appropriate one for addressing both needs.

7.2.2 Managing transition, maintaining cooperation

Within the process of convergence from the existing levels of integration to the future projected scenario will require a detailed and well thought out process of transition, which would allow for continuation of trade without interruption as well as aimed at reaching the final goal of establishing a free trade area which would ensure both smooth transition and continued trade relations.

VIII. The Transition to the Future Normality: Immediate Issues and Transitional Measures

This section aims to address the issue of transitional arrangements on the way to any future long-term regime. While the focus of this project is on developing (elements of and inputs for) a viable long-term option, sustainable and forward-looking transitional arrangements are of key importance for businesses and may well “make or break” an overall deal.

The development of specific suggestions for such transitional measures is part of the consultations with the sector working groups. The following draft section therefore is provisional and necessarily incomplete “work in progress,” to be modified and complemented on the basis of the said consultations.

The following concepts define medium-term options and deal with trade relations, in particular with the State of Israel. These policies cover a time-span beginning with the adoption of a potential transitional Agreement, mandating that the Parties agree to develop and adopt stable economic relations, including the establishment of a Palestinian state. The time required to build an economic and trade agreement will depend mainly on progress towards formulating and implementing the autonomous trade laws and regulations depicted above. It will also depend on the negotiating process, which in turn will depend on the approach and complexity of the agreement envisaged.

The measures to be adopted for a transitional period obviously depend on the specific type of economic/trade agreement envisaged. For example, work towards an FTA will require different transitional arrangements from work towards an agreement (or a solution without a specific agreement, except the WTO framework) based on the NDTP/MFN principles. Similarly, the manner in which the Paris Protocol is phased out will vary according to the approach chosen.

At the same time, however, a number of elements are likely to be common to all. They relate in particular to the core issues of movement & access, security measures, rapid dispute settlement and transit arrangements. Under all options discussed above, these issues require particular attention, since the achievement of legal, security, third-party dispute settlement (under third-country monitoring) and secure transit arrangements will be of paramount importance. As a first priority, these issues should be fully prepared for immediate negotiations.

However, it is crucial to emphasize that this needs to be done in parallel with the development of the long-term vision, viz the target trade scenario. Only then can it be assured that temporary measures do not turn out to be wasteful dead ends.

8.1 Immediate Issues Independent of the Future Regime

The World Bank and others have listed key measures to be taken by Israelis, Palestinians and others. Against this background, the following measures appear to be both necessary and feasible (politically and technically) and should be addressed as a matter of immediate priority:

- **Straightforward movement and access issues.** Day-to-day, plainly unnecessary impediments to the movement of goods, services, people and money into and out of the Palestinian Territory can and should be removed immediately. The minimal results of the Agreement on Access and Movement of November 2005 should and could be implemented in full (see Box).
- **Stop to all discrimination at airports, seaports and in all administrative processes.** Palestinian businesses, goods, and businesspeople are routinely treated differently in Israel than their Israeli, Western and even some Eastern and Southern counterparts. This is sometimes due to conscious (including legislative) choices, but in most cases simply the result of engrained and tolerated practice and attitude. This can and should be changed. (The same may apply on the Palestinian side, even if evidence and opportunity is scant.)

Box: Key Aspects of the Agreement on Movement and Access (AMA) of November 2005

- **Access for all Palestinians to all parts of the West Bank.** The AMA provides for a reduction “to the maximum extent possible” of obstacles to movement within the West Bank. Despite some (rather feeble) token efforts by Israel lately, the numbers are sobering. Hundreds of checkpoints and countless other restrictions (permits or no permits) mean a – often prohibitive – cost on doing business in and with Palestine. Few foreign markets, few foreign investors and less and less Palestinian workers, service providers, businesspeople, investors and consumers themselves are able to sustain such premium costs of doing business in Palestine. The result is brain drain, capital flight and economic devastation.
- The Agreement stipulated that a minimal **link between Gaza and the West Bank** in the form of truck and bus convoys would be instituted. Israel refuses to discuss the issue.⁸
- Opening and operationalizing the **Rafah crossing point**. It is not in doubt that the Palestinians and the EU observers did everything they were asked to do. Israel did not.
- The issue of Rafah is worsened by the non-implementation of Israel’s commitments regarding the operation of the **Kerem Shalom terminal**. Palestinian customs officials have at no time been admitted to process imports to Gaza, as stipulated in the Agreement, leading to severe disruptions of trade flows. Worse, the officers are thereby prevented from completing their preparation for the full operation of Rafah for both imports and exports.
- Regarding **passages between Gaza and Israel such as Karni** the AMA stipulates in no uncertain terms that “*The passages will operate continuously*”, specifying minimum numbers of truckloads per day. These numbers were never met by Israel, neither before nor after the Palestinian elections of January 2006, and neither before nor after the Hamas takeover of power in Gaza.
- Finally, the Agreement envisages the reopening of **Gaza’s airport** and the building of a **seaport**. But Israel at no point in time made any effort to engage in the envisaged talks on the airport, nor to give donors the needed assurances for the seaport – including the assurance not to destroy it.

⁸ It should not be forgotten that this “link” was a minimal, drop-on-a-hot-stone measure, a far cry from the “safe passage” provided for in several agreements in place and *in force* between the parties, all equally sponsored by the International Community and all equally unimplemented by Israel.

8.2 Transitional Measures on the Way to the Future Regime

The concrete transitional steps to be taken on the way to a future trade regime obviously depend on the regime chosen as the target.

That said, certain elements of cooperation may be common to the most likely scenarios, from “WTO/NDTP” to “FTA plus.” Transitional steps towards such elements of cooperation could include the following:

- Enhancing **institutional cooperation** wherever possible, establishing / moving towards equality of goods/services/businesspeople of both sides on both sides. This could include:
 - Full reciprocal information sharing between customs and tax authorities on relevant matters. Harmonization of new and existing measures wherever possible.
 - Full reciprocal information sharing of standardizing bodies. Harmonization of new and existing measures wherever possible.
 - Full reciprocal information sharing of ministries/agencies dealing with technical regulations, health & safety regulation incl. food safety etc. Harmonization of new and existing measures wherever possible.
 - *[concrete sector-specific and general issues/measures/suggestions to be developed as part of the working group process].*
- Notwithstanding the need for cooperation, there is also – and simultaneously – a need for systematic **institutional and substantive separation**, or disentanglement, in certain areas, precisely to prepare for a functioning working relationship between functioning separate entities in the future. This concerns, for example, the administration of customs and taxes. *[concrete sector-specific and general issues/measures/suggestions to be developed as part of the working group process].*
- (Re) establishment / enhancement of **systems of mutual recognition** and harmonization of standards, SPS measures etc. At present many standards, technical regulations, certificates etc. are recognized, *de jure* and/or *de facto*. This facilitates mutual business relationships and avoids needless waste. Israel and Palestine should make a conscious and concerted effort to secure this practice as much as possible; where necessary, legalize and canonize it; and where possible, expand and consolidate it. It is of key importance to avoid needless disruption because of separation in these areas. No-one would benefit, everyone would suffer, and the wheel will have to be reinvented when moving again towards cooperation. *[concrete sector-specific and general issues/measures/suggestions to be developed as part of the working group process].*

On the broader political front, the following appear to be important steps towards a functioning agreement-based “normal” trade relation in the future:

- **Creation of autonomous Palestinian exit/entry points for goods, services and people.** Under *any* separation scenario Israel obviously cannot continue to manage trade borders between Palestine and the rest of the world. This is true irrespective of the security situation, legitimate security concerns and security

measures. It would be useful to implement Palestinian control and autonomy as early as possible. Models for Israeli security oversight exist (*inter alia* in the Paris Protocol, even if crude) and could be implemented on a transitional basis to build confidence.

- **Removal of obstacles to trade within the West Bank (and Gaza) and full use of existing infrastructure.** It is obvious that a normalized Palestinian economy as Israel's counterpart and cooperation partner will, first and foremost, have to rely on normalized internal economic conditions. Checkpoints, roadblocks, barriers and earth mounds are not part of a normal internal trade infrastructure, nor are walls within a continuous economic territory.
- **Territorial Link between West Bank and Gaza.** A physical, reliable long-term territorial link between West Bank and Gaza should be established without delay to create full and unhindered territorial continuity for the Palestinian economy.

8.3 Making Use of Existing Structures and Concepts – The Paris Protocol as a Toolbox

Notwithstanding the weaknesses and poor state of implementation of the Paris Protocol, Palestinians and Israelis should not overlook its current function and potential.

Firstly, the Paris Protocol, despite all its shortcomings, is the only agreement currently in place, and hence the only legal framework to rely on for businesses and administrators from each side. Even a badly implemented Paris Protocol is still better than no agreement at all – see the discussion of the “No Agreement” scenario above.⁹ It is, for example, the basis for the currently still duty-free bilateral trade, as well as for the customs and tax coordination and cooperation, now more or less restored. Palestinian and Israeli business therefore have an interest to keep the Paris Protocol operational unless and until it is replaced by a future – hopefully better – agreement.

This is even more true if seen through from the specific perspective of this chapter, namely when considering transitional steps towards a future trade regime. The Paris Protocol, despite its poor overall design, does contain a number of mechanisms that can serve to implement the goals and steps contemplated under 8.1 and 8.2 above. In this sense the Paris Protocol represents a highly useful “toolbox” which Palestinians and Israelis should use, not discard, while working on a future regime. The implementation of (at least) key parts of the Paris Protocol can thus serve as a useful transitional measure.

As a pragmatic approach, businesses should thus work towards, and demand, such implementation, not because the Paris Protocol is currently applicable treaty law (which it is), but because of specific desirable functionalities it offers.

Such highly usable functionalities (beyond duty-free access for goods, liberalization of certain services, non-discrimination and other straightforward elements of liberal trade) include, for example, the following:

⁹ Section 6.

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- The **review of goods lists A1, A2 and B** to address Palestinian trade issues in relations to third parties (Arabs in particular) while the quasi-Customs Union is still in place. This would also assist in preparing for effective Palestinian economic autonomy.
 - **Making use of the Joint Economic Committee** as tool for a constructive working relationship on issues such as SPS/TBT cooperation and others (see list under 8.2 above).
 - *[other potential elements to be highlighted will be discussed within the working groups].*

8.4 Measures in Relation to Third Parties

Palestinians and Israelis should further make optimal use of existing processes and developments beyond their bilateral relationship, not least as a measure to support the transition towards an economic final status.

These measures include the continued and where possible enhanced negotiation by both Israel and Palestine towards their respective further integration into regional and global systems. A particular focus should be on both the WTO and the EuroMed fora.

Both Parties: WTO and EuroMed

Global trade integration under the WTO offers reliable, stable and tested mechanisms that may not only assist in relations with third party trading partners, but also in the design and implementation of a future agreement-based trade relation. The WTO thus provides *inter alia* a good forum for a significant part of the bilateral issues and concerns. This means that both parties have an interest in pushing forward Palestine's application for Membership in the WTO.

This applies even more to the EuroMed ("Barcelona") process. Israel and Palestine, both active members of the process, would be well advised to continue and intensify their efforts in this forum. Existing and evolving EuroMed rules on trade in goods, including for example rules of origin under the Palermo Protocol, provide ready-to-use elements that can assist in building the bilateral regime of the future. This will allow the parties to take such elements out of the purely bilateral equation and will thus simplify and focus negotiations.

The same is true for current negotiations on trade in services and investment. While both Israel and Palestine at present are negotiating bilaterally, respectively, with the EU, it is clear that any result (specific commitments to allow market access for foreign services – examples: foreign tourist guides, banks, telecoms companies; commitments regarding foreign investments) carries with it the potential to be used in other EuroMed relationships as well, including the bilateral Israeli-Palestinian one. Again, the EuroMed process thereby can provide a testing ground and crystallization point that may directly and indirectly assist in building the bilateral regime.

(As indicated earlier, the EuroMed process proceeds under the stated ambition to establish – in the medium-term – a regional free trade area for both goods and services throughout the Euro-Mediterranean space. Provided both Israel and Palestine continue their engagement in the process, this effectively sets the minimum standards for their

future bilateral relationship, which thus would entail free trade for (most) goods and services.)

Specifically: Palestinian Relations with Third Parties

Palestine should further work as a matter of priority on the development and consolidation of frameworks for trade with and through other countries. Making such links progressively more reliable will deliver tangible value to Palestinian businesses (and their Israeli business partners). It will thereby strengthen Palestine on its way towards economic viability, and hence – not least – its ability to act as a fully operational counterpart fro Israel.

Key demands here include the following:

- Technical agreements with third parties, in particular high-standard transit arrangements (incl. matters of practice) with neighbours Jordan and Egypt.
- Active, forward-looking Palestinian participation in all GAFTA negotiations, including in particular those on trade in services.

Exhibits

Exhibit 1.1: Current Obstacles to Palestinian and Palestinian-Israeli Trade

Exhibit 1.2: The WTO/World Trading System in a Nutshell

Exhibit 1.3: Two Important International Trade “Theaters” for Palestine and Israel.

*The EuroMed (“Barcelona”) Process and the Planned EuroMed Free Trade Area-
An Overview*

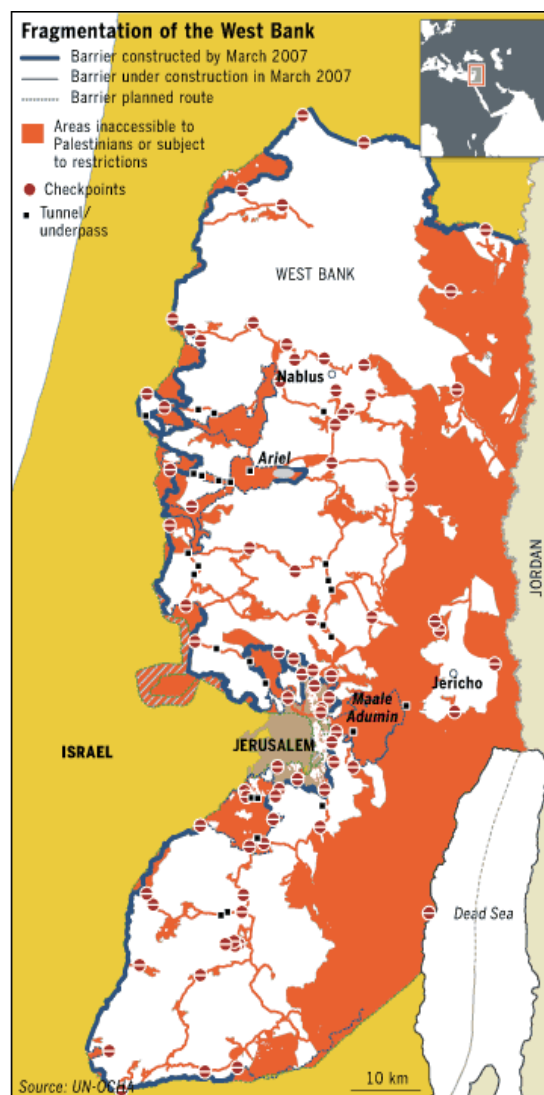
The Greater Arab Free Trade Area – An Overview

Exhibit 1.1: Current Obstacles to Palestinian and Palestinian - Israeli Trade

The current Israeli security system implanted by the Israel Defense Forces (IDF) in the West Bank and in Gaza border is composed by hundred of types of obstacles or barriers restricting Palestinian citizens movements and goods transportation into the West Bank, between and in/out the Palestinian territories. These barriers include permanent and partially manned checkpoints, roadblocks (consisting of rows of 1-meter concrete blocks), metal gates, earth mounds, earth walls (a long series of earth mounds), trenches, road barriers and permit restrictions.¹⁰

For the time being, there are 149 Israeli settlements in the West Bank and East Jerusalem¹¹. The road connection among these settlements and with Israel as well as the barriers and check points have fragmented the West Bank in more than 40 different Palestinian homelands physically separated among them. The interdiction to circulate by the Jordan valley has made more difficult the movement in the West Bank.

There is ample consensus that this closure system is the primary cause of poverty, social distress and humanitarian crisis in the West Bank and the Gaza Strip¹² because it restricts Palestinian access to health and education services, employment, markets and social and religious networks as well as it penalizes



strongly the economic activity in the Palestinian territories.

The actual social impact of the closure system is the fragmentation of the Palestinian society in terms of family, work, land etc, which has an overall effect on the Palestinian well-being. Furthermore due to these restrictions, many Palestinian enterprises have not been able to normally buy/import inputs and sale/export products, which have lead to a growing number of company closures, as well as the unemployment in the Palestinian territory.

10 The Agreement on Movement and Access reached between the Government of Israel and the Palestinian Authority on 15 November 2005 states that: "Consistent with Israel's security needs, to facilitate the movement of people and goods within the West Bank and to minimize disruption to Palestinian lives, the ongoing work between Israel and the U.S. to establish an agreed list of obstacles to movement and develop a plan to reduce them to the maximum extent possible will be accelerated so that the work can be completed by December 31".

11 PCBS Settlements Annual Report, " Israeli Settlements in the Palestinian Territory" July 2007

12 West Bank Closure Count and Analysis, OCHA, October 2007.

Apart from all these constraints, Palestinian trade should transit through Israeli territory or control. Palestinians are highly dependent on Israel due to the lack of other effective alternatives routes. In most of the cases Palestinian imports and exports are usually vulnerable to the change of borders policies. In this sense the trade alternatives for Palestinians are either from Gaza to Egypt through Rafah or from the West Bank to Jordan through Allenby. Both borders are also under (almost) control of Israel.

1. *The West Bank closure situation*

The closure system in the West Bank has included between 528 to 563 physical obstacles placed on roads in the last 12 months, to control and restrict Palestinians movement as well as Palestinian vehicle traffic, compared to 272 in June 2005.

The number of manned checkpoints remained approximately the same – with about 60 to 90 permanently-manned and eight partially-manned checkpoints around the West Bank. The number of flying checkpoints has fallen from 204 on average in a week in March 2007 to 69 in October.

Road barriers and citizen movement restrictions are a common feature within the West Bank. The IDF states that road barriers have two functions: to protect Israeli settlers travelling in roads bordered by Palestinian communities and road safety. Nevertheless, these obstacles block access for Palestinian communities onto and across main West Bank roads.

The construction of the Wall/Fence has completely isolated Jerusalem from West Bank as well as it has increased obstacles in Bethlehem and other Western areas. Agricultural land between the Wall and the Green Line becomes as “closed areas”.

Access from West Bank to East Jerusalem is through only 4 main checkpoints. Their management is being transferred from the IDF to civil control. The checkpoints continue to have limited capacity resulting in long delays for entering Jerusalem. The number of Palestinians able to access the city has dropped dramatically.

Periodic restrictions are imposed to West Bank residents aged between 16 and 35 years old exiting from Nablus, Jenin, Tubas and Tulkanrm governorates. Three check points are periodically operational for trucks. From them, Qusin back-to-back check point have been more efficient.

The Jordan Valley potential of agribusiness and tourism was off-limits to most Palestinians for several months. Since 28 April 2007 permits are not longer required to West Bank residents to enter the Jordan Valley. However vehicle restrictions are the main limitation to circulate in the Jordan Valley. Agricultural goods from the Jordan Valley can cross two checkpoints to access markets in the West Bank. Bisan back-to-back checkpoint is available for exports to Israel. Palestinians are prevented to travel south to the Dead Sea.

Since December 2006, movement in the southern West Bank and particularly in Hebron and Bethlehem has deteriorated: waiting times at the checkpoint have increased.

Access to markets

After the Israel's withdrawal of Gaza in September 2005, it was believed that the obstacles were removed. However, access between WB and Gaza and movement within WB have remained restricted and uncertain. These administrative obstacles have raised transactions costs and have reduced the domestic market. For example, the World Bank estimates that the percentage of West Bank firms operating in Jerusalem decreased from 21% to 18% between 2000 and 2005.

Due to the fact that Palestinians are dependent on Israel for access to markets, they have to negotiate with Israeli businessmen and service providers in order to import and export goods. In 2006 imports from WBG decreased by 10% and exports fell by almost 16%. The closure policies have discouraged investment in WBG, making very difficult companies to be competitive and the development of the Palestinian labor force.

In the West Bank, all these closures and restrictions on movement and access have also impact on education as long as students and teachers can not normally reach their schools. On the other hand, health care has suffered from these barriers and malnutrition has increased by 3% between 2004 and 2006, and the availability of safe drinking water has also dropped by 6% between 2000 and 2007.

The IDF states the reason for the rise in the number of physical obstacles is an increase in Palestinian violence. Actually they acknowledge that some of the physical obstacles and restrictions are unrelated to security needs.

Following the commitments from the Israel side, the GOI has promised to remove some impediments and at the same time provide permits to Palestinian business people.

2. *The Gaza closure situation*¹³

Gaza has a single access point at the Karni/ Al-Montar border crossing to sustain 1, 5 million people. Along 2006 its openings were irregular and involved varying hours and inefficient screening. Since June 12th, Karni crossing has been closed excepting for a conveyor belt for wheat and animal feed, which was open on 5 days and only for a total of 30 hours.

Nowadays, Sufa and Kerem Shalom are used in few days per month for the import of humanitarian goods into Gaza. However the crossings are not well equipped and not prepared to handle any large trade capacity and are not opened regularly.

Since November 2005, Rafah was operated by the PA with third party monitoring by the EUBAM (EU Border Assistance Mission) but with additional cameras accessible to Israel security. Rafah and Erez crossings for people have been closed since 9th and 12th June respectively.

¹³ Report 51 on Implementation of the Agreement on Movement and Access. (AMA) October 2007.

Current Situation¹⁴

From the outset, Gaza has been hit harder by closures and economic crises. Gaza's economic backbone and private sector vitality risks collapse if the current closure policy after Hamas' June 14th takeover of the Strip continues. Recent calls by various parties for the entry of humanitarian goods are a necessary but insufficient condition for the survival of the Gazan economy. However, a sustainable solution must include imports and exports, considering that over 54% of employment in Gaza is private sector-driven (representing more than 100,000 jobs). Of these, 35,000 workers - 18,000 skilled - operate the industrial sector.

According to the Palestinian Private Sector Coordination Council (PSCC), the current restrictions have led to the suspension of 90% of Gaza's industrial operations.

The likely lay-off of over 30,000 industrial workers, resulting from the current restrictions, would translate into an unprecedented private sector-driven unemployment level of about 44% in Gaza. The impacts of these closures will become more difficult to reverse. Most Gaza industries are export-oriented and have purchase and supply contracts with Israeli and other firms. Gaza manufacturers import 95% of their inputs. About 76% of their furniture products, 90% of their garments and 20% of their food products are exported to Israel, and some to the West Bank. Employment in construction and building has also been impacted by the suspension and cancellation of most construction projects due to lack of construction materials. Also, 5,000 Gazan farmers depend on the export of cash crops. Israeli and other suppliers and purchasers needing to maintain their operations will soon cancel contracts and seek alternative supply chains elsewhere.

At the same time, the Hamas control of Gaza is incurring a direct negative impact on the economy. Without delving into the political context of the current stalemate, it is evident that Hamas also bears responsibility for creating a political and logistical environment in which all sides can reengage in Gaza. Furthermore, it must be noted that attacks on the crossings continue to take place, greatly undermining any efforts to shield Gaza's population and private sector from the impacts of the current situation.

Conclusion: In order to recover Palestinian economy and to guarantee stability to the whole society, it is necessary to alleviate these restrictions. Furthermore it will help to enhance cooperation and a continuous dialogue among both sides.

¹⁴ Two Years after London: Restarting Palestinian Economic Recovery. The World Bank 24th September 07

Exhibit 1.2: The WTO/World Trading System in a Nutshell

1. Overview

Since its inception in 1994, the WTO system of multilateral trade rules has fundamentally transformed the international trading system. Based upon the earlier General Agreement on Tariffs and Trade (“GATT”), signed in 1947, which focused on the liberalization of trade in goods, the conclusion of the Uruguay Round of Trade Negotiations and signing of the Marrakesh Agreement establishing the World Trade Organization (the “WTO Agreement”) has vastly expanded the scope of multilateral trade rules and at the same time transformed the original GATT 1947, which was essentially a diplomatic forum, into a strong rules-based institutional framework.

The new WTO system of multilateral trade rules is based on binding commitments of the Members, which are underpinned by a strong dispute settlement mechanism, enabling effective enforcement of the WTO rules. Under the WTO system of rules and exceptions, WTO Members may only depart from the agreed rules and commitments if an exception clause under WTO law permits such departure. And unlike under GATT 1947, which was often criticized for lack of an effective dispute settlement mechanism, these rules can now be enforced much more effectively under the WTO’s strengthened Dispute Settlement Mechanism. This mechanism allows a Member to challenge the violation of another Member’s substantive or procedural obligations under the WTO. While the WTO Dispute Settlement Mechanism does not provide direct access to private parties, some important WTO members like the U.S. and the European Union have enacted laws¹⁵ enabling private parties to initiate WTO dispute settlement proceedings through the respective national authorities, thus giving concerned private business enterprises the opportunity to indirectly take part in the enforcement of WTO rules.

The WTO system as it has emerged from the Uruguay round now consists of the following three main substantive agreements:

- the General Agreement on Tariffs and Trade (GATT 1994) and its associate agreements, regulating trade in goods,
- the General Agreement on Trade in Services (GATS), and
- the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).

These agreements, forming the three “pillars” of the WTO system, are accompanied by a number of multilateral agreements, *i.e.* agreements acceded to by all WTO members, which further clarify and define the members’ commitments with regard to specific issues and sectors. Under GATT operate:

- Agreement on Agriculture;
- Agreement on Textiles;
- Agreement on Sanitary and Phytosanitary Measures (SPS),
- Agreement on Technical Barriers to Trade (TBT),

¹⁵ United States: Section 301 of the Trade Act; European Community: Trade Barriers Regulation.

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- Agreement on Trade-related Investment Measures (TRIMs);
 - Anti-dumping Agreement;
 - Agreement on Subsidies and Countervailing Measures;
 - Safeguards Agreement;
 - Agreement on Customs valuation;
 - Agreement on Pre-shipment Inspection;
 - Agreement on Rules of Origin;
 - Agreement on Import Licensing Procedures.

Further plurilateral agreements under the WTO system, which are only binding upon those members that are party to the specific agreement, include the Agreement on Public Procurement and the Agreement on Civil Aircraft.

Each of the WTO agreements reflects certain basic principles underpinning the entire WTO system and dating back to the original GATT 1947. These basic principles can be described as the following:

- **Market Access and Progressive Liberalization**

The central objective of the WTO system, like that of its predecessor GATT 1947, is the progressive liberalization of international trade by reducing and, where possible, eliminating tariffs and other “non-tariff” barriers to trade. This is achieved by a system of progressive trade negotiation rounds in which the members take on specific commitments regarding market access, e.g. specific tariff levels for foreign goods. Members are only bound to the extent that they have taken on such specific commitments.

Thus, apart from signing up to a set of multilateral agreements containing generally applicable rules, each Member agrees to its individual schedule of specific market access commitments, the so-called tariff schedule. In the schedule, a Member commits to maximum tariffs for specified goods. While a Member remains, of course, free to apply tariffs below the “bound rates”, it is not allowed to apply tariffs above these rates. Most developed Members have bound virtually all of their tariffs, while many developing countries have chosen to make commitments only with respect to a selection of goods.

Apart from these specific market access commitments, the WTO rules aim to generally limit and contain the so-called non-tariff barriers to trade. These include quantitative restrictions, but also national laws, regulations and procedures relating to other issues, e.g. inspection or labeling requirements, which may be abused as instruments for the protection of national industries.

- **Non-discrimination**

The principle of non-discrimination as used under the WTO system can be broken down into two subsidiary principles:

Most Favored Nation (MFN) Principle

Article 1 of the GATT 1994 and Article 2 of GATS contain the general principle that a WTO Member’s treatment of the imports of goods or the provision of services into its territory from another Member must not be less favorable than the treatment accorded to any other member. This principle ensures that Members do

not discriminate between goods and services based on the country of foreign origin. Seen in connection with the specific market access commitments undertaken by each member, the Most Favored Nation Principle also ensures that concessions made in bilateral negotiations between two WTO members apply to all other members as well, adding an important dynamic element to trade negotiations.

National Treatment (NT) Principle

Article 3 of the GATT 1994 and Article 17 of GATS contain the general principle that domestic producers should not receive better treatment than foreign producers. This principle aims to ensure that national legal systems do not, in law or in fact, discriminate against foreign goods or services.

- **Transparency, Predictability, Reliability and the Rule of Law**

In order to understand how a national trade system works, it is critical to have information about that system. Multiple WTO rules require that Members publish details about their trading system. Even more fundamentally, the WTO's objective to eliminate non-tariff barriers to international trade, allowing only tariffs as a means of protection of national industries, can be understood as an issue of transparency. Unlike published tariff schedules, which offer clear guidelines, hidden non-tariff barriers make cross-border trade unpredictable for concerned business enterprises.

Taken together, the purpose of the WTO system is to create predictability and reliability for trade. The system of specific market access commitments and general rules such as non-discrimination, as well as many specific disciplines, e.g., on technical barriers to trade, aims to create stable and predictable conditions for businesses. The worst barrier to trade is a lack of predictability and reliability. While tariffs and other barriers, if known, can be factored into prices, insecurity about the applicable rules leads to risks that are much harder to manage. Reliability and predictability are created not only to rules and commitments, but crucially, through their effective enforcement, e.g. the Rule of Law. In this context, of course, the WTO Dispute Settlement Mechanism plays a crucial role.

The WTO as an organization administers the application of all agreements under the WTO and offers a forum for negotiations between Members within the framework of the WTO. While there are no centralized enforcement mechanisms enabling an enforcement of WTO law by the organs of the WTO, the WTO is given some form of supervisory functions in the shape of the Trade Policy Review Mechanism. Under this mechanism, the WTO, in cooperation with each Member, performs a substantial review of that Member's national trade laws and policies in relation to the WTO rules, however without any binding conclusions or recommendations for that Member. Enforcement of the WTO rules, as interacted, is limited to the Members-based Dispute Settlement Mechanism.

2. A More In-Depth Look at Selected WTO Agreements

2.1 GATT 1994

The General Agreement on Tariffs and Trade (GATT) 1994, replacing the earlier GATT 1947, lays down multilateral rules for trade in goods. Its basic objective, reflecting the principles described above, is to create a liberal and open trading system for trade in goods. This is realized, on the one hand, in the shape of tariff schedules, which set out each member's binding commitments for the reduction of tariffs on specific products. On the other hand, the tariff commitments are accompanied by a number of general rules setting out the basic WTO principles described above, *i.e.* the principle of non-discrimination, the elimination of non-tariff trade barriers, and transparency requirements. The GATT includes, in particular, rules on national treatment (Article III GATT), the most-favored nation principle (Article I GATT), quantitative restrictions to trade (Article XI GATT), the use of subsidies, antidumping and countervailing measures (Article VI GATT), customs valuation, and the notification and publication of trade laws and regulations (Article X GATT). Many of these rules are further detailed in the additional specialized multilateral agreements, such as *e.g.* the Anti-Dumping Agreement or Subsidies Agreement (see below).

Under the balanced system of rules and exceptions provided by the GATT, members may only depart from rules under the conditions expressly set out in the provisions on exceptions. These exceptions aim to secure members sufficient flexibility in national policy decisions in non-trade-related issues, such as *e.g.* health protection, environmental or cultural protection measures, or issues of national security, while ensuring that these measures do not lead to an unjustified discrimination or disguised restriction to international trade. Most important of these exceptions is the general exception clause in Article XX GATT.

It is important to note that the GATT system aims to be a *complete* system of rules. Deviation from agreed specific commitments and general rules is only allowed if an explicit exception applies. These are in particular, on the one hand the said general exceptions (Article XX GATT), the security exceptions (Article XXI GATT) and the balance of payments exception (Article XII GATT) and on the other hand the so-called trade defense instruments, namely entire-dumping, entire-subsidies and save guards. The violation of rules, which cannot be justified under explicit exceptions is illegal under GATT.

2.2 Agreement on Technical Barriers to Trade (TBT)

While technical regulations and industrial standards are an important part of national regulation, diverging national regulations and standards create barriers for international trade and in some cases may be abused as a form of protectionism for national industries. Against this background, the Agreement on Technical Barriers to Trade (TBT Agreement) aims to ensure that national regulations, standards, conformity assessment and certification procedures do not create unnecessary barriers to trade while at the same time respecting the Members' right to select the level for protective standards that they consider appropriate.

The TBT Agreement covers (binding) “technical regulations” and (voluntary) “standards” including packaging, marking and labeling requirements, and procedures for the assessment of conformity with technical regulations and standards. The issue of flexibility for Members’ national policy decisions is particularly important in this area as such standards are commonly set out for non-trade-related reasons, such as the protection of human, animal or plant life or health, the environment, or consumer protection against deceptive practices. While no country should be prevented from taking measures necessary to ensure protection at levels it considers appropriate, the TBT Agreements sets out that technical regulations shall not be more trade-restrictive than necessary to fulfill a legitimate objective, taking account of the risks that non-fulfillment would create. The TBT Agreements further encourages members to take part in the preparation of international standards, such as the International Standards Organization (ISO). *Where relevant international standards exist, members shall, in principle, use these standards as a basis for their technical regulations.*

Notifications

A key function of the TBT Agreement is to create transparency and predictability through early notification. This applies in particular where a relevant international standard for a proposed technical regulation with potentially significant effect on the trade of other Members does not exist, or where the proposed regulation is not in accordance with the relevant international standard. In these cases, Article 2.9 of the TBT Agreement requires Members to make extensive notifications in advance before the enactment of the proposed regulation, namely to

- publish a notice in a publication at an early appropriate stage announcing the proposed introduction of the particular technical regulation so as to enable interested parties to become acquainted with it,
- notify the other WTO Members through the WTO Secretariat of the products to be covered by the proposed technical regulation, together with a brief description of its objective and rationale, and
- allow reasonable time for other WTO Members to make comments in writing, discuss these comments upon request, and take these written comments and the results of the discussions into account.

Additionally, Members shall allow a reasonable interval between the publication of the adopted technical regulation and its entry into force in order to give producers in exporting countries sufficient time to adapt their products or production procedures to the new requirements (Article 2.12 of the TBT Agreement).

In exceptional cases, Members may omit some of the notification requirements described above, however only to the extent necessary in the event of urgent problems of safety, health, environmental protection or national security (Article 2 (10) of the TBT Agreement). In this case they must promptly subsequently fulfill the notification and consideration requirements described above. It should be noted that these notification and consideration requirements apply not only to technical regulations adopted by central government bodies, but also in principle to those adopted by local government bodies and even non-governmental bodies (Article 3.1 of the TBT Agreement).

Generally, Members must ensure that all technical regulations adopted, i.e. even those in accordance with international standards, are published promptly or otherwise made available in such a manner as to enable interested parties to become acquainted with them (Article 2.11 of the TBT Agreement). Additionally, they must establish enquiry points which are able to answer all reasonable questions of other Members and other interested (private) parties and provide all relevant documents regarding existing as well as proposed national technical regulations, standards, and conformity assessment procedures (set out in detail in Article 10 of the TBT Agreement).

2.3 Agreement on Trade-Related Aspects of Investment Measures (TRIMs)

The TRIMs Agreement focuses on the trade distorting effects of investment measures in relation to trade in goods. Its objective is to clarify the requirements of Article III GATT (national treatment principle) and Article XI GATT (prohibition of quantitative restrictions) with respect to such investment measures. For this purpose, an illustrative list of investment measures inconsistent with GATT is appended to the Agreement. This list includes measures which require particular levels of local procurement by an enterprise (“local content requirements”) – qualified as violations of the principle of national treatment – as well as measures which restrict the volume or value of imports such an enterprise can purchase or use to an amount relating to the level of products that it exports (“trade balancing requirements”) – qualified as prohibited quantitative restrictions.

Additionally, the TRIMs Agreement sets out specific notification requirements, including the notification of publications in which TRIMs may be found, and covering in particular TRIMs that are applied by regional and local governments and authorities.

2.4 Agreement on Import Licensing Procedures

The Agreement on Import Licensing Procedures (the Agreement) lays down general rules and principles with regard to national procedures for import licensing in order to limit the trade-distorting effects of import licensing to a minimum and ensure that import licensing procedures are administered fairly and equitably.

The Agreement distinguishes between two types of import licensing, *i.e.* automatic import licensing and non-automatic import licensing. Automatic import licensing procedures are systems under which an import license must be applied for – commonly for trade surveillance purposes –, but is granted in all cases and with no administrative discretion. Where automatic import licensing systems are used, the Import Licensing Agreement requires WTO Members to grant such licenses immediately on receipt of an application, and within a maximum of 10 working days.

Non-automatic import licensing procedures, on the other hand, are commonly used to enforce import quotas and similar quantitative restrictions, meaning that the license may be refused. For non-automatic import licensing systems, the agreement obliges Members to issue licenses within 30 days if applications are considered on a first-come first-served basis, within 60 days if all applications are considered simultaneously. Where non-automatic import licensing systems are

used to administer quotas, the Member government must publish information on the overall amount of quotas, and opening and closing dates of quotas. In the case of quotas allocated among supplying countries, the Member government must additionally provide information on the specific allocation of shares to the various supplying countries. In allocating licenses, the Agreement obliges Members to take an applicant's past import performance, *i.e.* the extent to which past licenses have been used, into consideration (Article 3:5(j) of Agreement). At the same time, Members should ensure the distribution of licenses to new importers, giving special consideration to importers importing products from developing and least developed countries.

For both automatic and non-automatic import licensing, the Agreement sets out a number of common rules ensuring transparency and protecting importers' rights. These include Members' obligations to:

- publish information concerning products subject to licensing and procedures for the submission of applications;
- ensure that application forms and application procedures are as simple as possible;
- ensure that applications are not refused for minor documentation errors;
- ensure that no penalties greater than necessary as a warning are imposed in respect to omissions or mistakes in documentation or procedures that are obviously made without fraudulent intent or gross negligence.

2.5 Agreement on Rules of Origin

Governments use rules of origin in everyday administrative practice in order to determine where a product comes from. The question of product origin remains important even under WTO law as the basis for the application of many national trade regulations, such as e.g. for imports under preferential trade arrangements, for the collection of anti-dumping and countervailing duties, and for the administration of tariff quotas. At the same time, the determination of product origin has become increasingly difficult due to the globalization of manufacturing processes. Currently, the national systems used by WTO Members to determine the origin of products still vary considerably, with two basic system choices: While some Members determine product origin on the basis of a certain percentage of value added in processing, others determine origin on the basis of a change in tariff classification due to further processing. Some apply conditions of both. Sometimes the rule of origin used even varies between different national trade regulations. Besides lacking transparency, this current flexibility has the disadvantage of potentially enabling rules of origin to be adopted for protective purposes.

With these problems in mind, the WTO Agreement on Rules of Origin central aim is to clarify and harmonize the rules of origin by creating a common set of rules of origin for all WTO Members. The Agreement on Rules of Origin does not yet provide such rules, but calls for the development of harmonized rules of origin. These rules are currently being developed by a Technical Committee under the guidance of the WTO Committee on Rules of Origin. The new rules of origin, based in principle on the rule that country of origin is the country "where the last substantial transformation has been carried out" (Article 3 (b) of the Agreement on

Rules of Origin), shall be incorporated into the Agreement on Rules of Origin and will then be binding upon all WTO Members. During the transition period until such common rules are adopted, Members may still use their national rules of origin, but must follow certain general principles laid down in the Agreement on Rules of Origin (Article 2 of the Agreement on Rules of Origin). These include the obligation to clearly define rules of origin and administer these rules in a consistent, uniform, impartial and reasonable manner, to publish rules of origin, to base rules of origin on a positive standard, and to provide for prompt judicial review of any administrative action taken in relation to the determination of origin.

It should be noted that even after the incorporation of binding harmonized rules of origin into the Agreement on Rules of Origin, these rules will not be applicable to the determination of imports under preferential arrangements. However, the Agreement does provide that countries with preferential arrangements shall take into account the general principles regarding transparency, impartiality, and judicial review described above.

2.6 Agreement on Customs Valuation

Where customs duties are levied on an *ad valorem* basis, which is the case in most countries, the determination of the value of a product becomes a central factor in the determination of the final customs levy. The Agreement on Customs Valuation (in full title “Agreement on Implementation of Article VII of GATT 1994”) sets out common rules for the valuation of goods for customs purposes in order to ensure fair, uniform, and neutral valuation principles.

In principle, the Agreement on Customs Valuation follows the basic rule that the value of a product for customs purposes is determined by the price actually paid or payable when sold to the country of importation (transaction value)¹⁶. This price may only be adjusted in specific cases in order to exclude commissions, packing, transport, and handling charges and similar charges (permitted adjustments)¹⁷.

Under the Agreement on Customs Valuation, Member governments may reject the transaction value declared by the importer only under narrow conditions, e.g. when part of the proceeds of a subsequent resale by the buyer accrues to the seller, or where the buyer and seller are related¹⁸. However, in response to the concern voiced by many governments that the practice of undervaluing imported goods in order to evade customs duties could not be effectively dealt with under these rules, an additional “Decision regarding cases where customs administrations have reasons to doubt the truth or accuracy of the declared value” was adopted as part of the Uruguay Round Agreements forming the WTO Agreement. This decision allows national governments, in the case of reasonable doubts as to the declared value, to ask the importer to provide further information. If even under consideration of the additional information provided these doubts remain, the national authorities may declare that the value of the imported goods

¹⁶ Article 1 of the Agreement on Customs Valuation.

¹⁷ Article 8 of the Agreement on Customs Valuation.

¹⁸ Article 1 of the Agreement on Customs Valuation.

cannot be determined under the provisions of Article 1 of the Agreement on Customs Valuation. In this case, as in other cases where the value cannot be determined under the transaction price principle, the national authorities must determine the customs value using other independent valuation standards. For this purpose, the Agreement on Customs Valuation lays down a number of additional valuation standards to be used alternatively and which aim to secure uniform, and neutral valuation standards.

2.7 Anti-Dumping Agreement

While the GATT respects the Members' right to take action against dumping practices by foreign business enterprises which are harmful to national industries, it is fair to say that anti-dumping measures are frequently also abused to protect national industries against foreign competition. Therefore, Article VI GATT allows anti-dumping measures only under specific conditions and procedural requirements. The Anti-Dumping Agreement further clarifies Article VI GATT by setting out precise and narrow rules for national anti-dumping procedures, defining the central substantive requirements for anti-dumping measures, and ensuring the concerned foreign businesses basic procedural rights in anti-dumping procedures.

These procedural rules, designed to prevent abuse (*i.e.*, to ensure that anti-dumping measures are only taken if 1. there is actually dumping and 2. this injures the local industry, and not for protectionist reasons), put a significant burden on a Member's competent authorities. In particular for small and developing states' administrations it is often very difficult to administer anti-dumping investigations in accordance with those rules. As a result, anti-dumping was long perceived as a tool primarily for developed countries. However, in recent years many developing countries have taken up the challenge, and despite many shortcomings have succeeded in making this instrument work for themselves. Whether this is cause for celebration is another matter. Many analysts believe that anti-dumping itself is an oddity and should be abolished, ongoing that it penalizes perfectly rational market behavior and provides an excuse for protectionist measures. However, in particular for small economies with narrow production bases where external shocks, including predatory pricing by foreign competitors, could relatively easily deal fatal blows to local manufacturing businesses, the general availability of this instrument, even if rarely used, may be a blessing.

2.8 Agreement on Subsidies and Countervailing Measures (SCM)

Subsidies are still one of the most controversial issues under GATT. Though not generally prohibited under GATT, subsidies are viewed with special scrutiny due to their trade-distorting effects (Article VI GATT). The SCM Agreement clarifies the term of subsidy, sets out strict limitations to the use of such subsidies, and defines the conditions under which countervailing measures to counteract the effects of subsidies may be taken.

The Subsidies Agreement distinguishes three categories of subsidies:

- prohibited subsidies;
- actionable subsidies, and
- non-actionable subsidies.

While export subsidies and subsidies discriminating between foreign and local goods are generally prohibited (Art. 3 SCM Agreement), most other subsidies are qualified as actionable (Art. 5 SCM Agreement). This means that another Member may take recourse to the WTO dispute settlement mechanism to challenge the actionable subsidy provided it has “adverse effects”¹⁹ on the affected Member, i.e., These effects can happen in the market of the subsidizing Member, in a third market or in the market of the affected Member as an importing state. The latter case – subsidized imports harming local industries – is the most important in practice. In this case, the affected Member has the choice between two remedies: It can either challenge the subsidy through the WTO Dispute Settlement Mechanism or take unilateral balancing measures by levying “countervailing duties” on the subsidized imports.

Countervailing measures under the SCM Agreement are very similar in character to anti-dumping measures under the Anti-Dumping Agreement. Both are unilateral measures against “unfair” trade practices. Like dumped imports, subsidized imports are often called “unfair” because their prices are artificially low with the effect that competing local industries are put at a disadvantage. In parallel to the Anti-Dumping Agreement authorizing unilateral anti-dumping duties against dumped imports, the SCM Agreement authorizes unilateral countervailing measures against subsidized imports. Like in the case of anti-dumping, however, this presupposes that the domestic industry suffers “material injury” because of the “unfair” imports. Further, like the Anti-Dumping Agreement the SCM Agreement imposes very strict disciplines on countervailing investigations and measures (initiation of an investigation; evidence; determination of a subsidy, of injury and of causation; timelines). As discussed earlier with regard to anti-dumping, these sophisticated disciplines pose a difficult challenge for small administrations in developing countries.

However, despite all these parallels between anti-dumping and anti-subsidies law, it is important to note one difference. While dumping practices are perceived as “unfair” and Members are authorized to act against them, they are not illegal under WTO law. This is different for subsidies: as indicated, some subsidies, namely export subsidies and subsidies requiring local input, are directly prohibited by Article 3 of the SCM Agreement. Others are prohibited if they have the required “adverse effects” on other Members’ trade, as defined by the SCM Agreement. In the case of subsidies, therefore, the affected Member often has two options instead of one: either take unilateral countervailing measures (which do not remove the subsidy, but its adverse effect on the importing Member’s domestic industry) or attack the subsidies themselves and aim for their removal. Of course, a Member is free to pursue both alleys at the same time.

Very importantly, however, the prohibition of certain subsidies is qualified for developing countries. Article 27 of the SCM Agreement entitled “Special and Differential Treatment of Developing Country Members,” explicitly recognizes “that subsidies may play an important role in economic development programmes of

¹⁹ See Article 5 of the SCM Agreement, which defines relevant adverse effects as (i) injury to the domestic industry, (ii) (generally) nullification or impairment of the importing Member or (iii) serious prejudice to another Member’s interests.

developing country Members.” For developing countries, which are not Least Developed Countries, the Article allows for the continuation of export subsidies for 8 years after the entry into force of the WTO agreements. This period ended on 31 December 2002. However, the provision also allows for an extension, provided the Member applies for such an extension in time and the WTO Subsidies Committee agrees to the extension. Another type of prohibited subsidies, namely, subsidies requiring a certain local input, are no prohibited also for developing countries after a face in period ended in 1999.

Under the same Article 27 of the SCM Agreement, developing countries further benefit from protection from countervailing duties imposed by another Member if the overall level of subsidies does not exceed 2 % of the value of these subsidized product or, more importantly, if the volume of the subsidized imports from the developing country into the other Member represents less than 4 % of the total imports of the liked products into that Member. This special *de minimis* rule provides an effective protection for small economies, which rarely reach above the threshold. However, a caveat applies: if the total subsidized imports of the respective products from developing country Members (which individually account for less than 4 %) amounts to more than 9 % of the total imports of the like product, they may be subjected to countervailing duties.

As indicated, the SCM Agreement originally provided for a third category of so-called “non-actionable subsidies.” This was designed to explicitly allow for certain subsidies generally not deemed harmful to trade, such as research subsidies and regional development subsidies, and to shield them from trade action. However, as Members could not agree on extending the relevant provision²⁰ of the SCM Agreement, these subsidies are now subject to normal rules. This means that they are “actionable”, as described above, if they have the required “adverse effect” on other Members.

2.9 Safeguards Agreement

Under the exception clause of Article XIX GATT, a WTO Member may take measures against imported goods for the protection of national industries under specific, exceptional conditions (“safeguard measures”). Safeguard measures are limited to cases in which, due to unforeseen developments and as a consequence of that Member’s commitments under GATT, goods are imported in such large quantities and under such conditions that national producers of competing goods are or are in danger of suffering “serious injury.” In this case, that Member may temporarily depart from (*i.e.*, violate) commitments under GATT to the extent and as long as necessary to eliminate such injury.

The Safeguards Agreement supplements this GATT provision on safeguards by setting out the precise conditions for safeguard measures, the procedural requirements for determining if such a condition exists, and further notification and consultation requirements. Again, the procedural requirements are relatively onerous, and therefore pose a difficult challenge for small administrations.

²⁰ Article 8 of the SCM Agreement; Article 31 provides for the expiration of Article 8 five years after the entry into force of the agreement, unless extended by the Members. This did not happen.

Safeguards are the third type of unilateral “trade remedies” authorized by WTO law, the other two being anti-dumping and countervailing measures. However, while anti-dumping and countervailing measures are directed against “unfair” trade, safeguards target perfectly “fair” trade which, however, due to particular circumstances is causing severe disruption for the local industry. Safeguards, in other words, are a tool for “pure” protectionism and thus a somewhat peculiar element in the WTO system, from the point of view of free trade. However, their function is crucial: they provide an important outlet for emergency measures against unintended consequences of free trade. In that sense they are a necessary element of free trade agreements, and therefore can be found in most of them. However, because of the exceptional and counter-systemic nature of safeguards, it is logical that WTO law attempts to impose tough disciplines on their use, resulting in the said procedural requirements.

2.10 Preshipment Inspection Agreement

Preshipment inspection refers to the common practice of using the services of independent private inspection companies to check shipment details, in particular price, quality and quantity, of goods to be imported. Such inspections are regularly performed prior to shipment in the country of exportation and are, in principle, aimed to reduce later disputes regarding contractual specifications. Today, many developing countries have made preshipment inspection mandatory for imports, with the objective of ensuring correct tariff classification of imported goods as well as avoiding incorrect price indications by the importer.

While the Preshipment Inspection Agreement (PSI Agreement) recognizes the need for such contractual or mandatory preshipment inspections, the agreement lays down general rules for PSI procedures aiming to ensure non-discriminatory practices, transparency, and the protection of confidential information, and to avoid unreasonable delays. Additionally, the PSI Agreement provides binding rules with regard to price verification by preshipment inspection entities (Article 2 (20) of the PSI Agreement). Nonetheless, the ultimate responsibility for determining the value of goods for customs purposes remains with the competent national customs authorities in accordance with the rules laid down in the Customs Valuation Agreement. The price verification by PSI entities is not determinative for customs purposes. Exporters may challenge decisions of preshipment inspection entities under special appeals procedures established under the PSI Agreement.

3. *Specifically: The General Agreement on Trade in Services (GATS)*

GATS is one of the key agreements administered by the World Trade Organization. It is designed to “secure progressively higher levels of liberalization of trade in services through successive rounds of negotiations, which should aim at promoting the interests of all Members of the WTO and at achieving an overall balance of rights and obligations “(Article XIX of the GATS).

The articles of the GATS, and a set of Annexes, establish some general rules for government measures that affect trade in services. In addition, national schedules of commitments set out specific commitments by each member country. The schedules are an integral part of the Agreement, as tariff schedules are an integral part of the GATT. While the text of the Agreement applies uniformly to all Members of the WTO the scheduling of commitments is negotiated by each member countries or customs territories with every other Contracting Party.

The GATS does not define “services “but does define “trade in services.“ The definition covers not only the cross-border supply of services but also transactions involving the cross-border movement of capital and labour.

International trade in services can occur through four **modes of supply**:

- **“Mode 1” - cross-border supply:** The supply of a service from the territory of one Member into the territory of any other Member. This is the type of transaction analogous to trade in goods (e.g. international transport, supply of a service through telecommunication or mail, online services).
- **“Mode 2” – consumption abroad:** This happens when the consumer moves to the territory of another country and buys services there (e.g. tourism).
- **“Mode 3” – (supply through) commercial presence:** This involves direct investment in the export market through the establishment of a business there for the purpose of supplying a service (e.g. foreign bank branches, supermarkets, hotels)
- **“Mode 4” – (supply through the) presence of natural persons:** This means the temporary entry of an individual for the purpose of supplying a service; this person could be the service supplier himself or an employee of the services supplier (e.g. engineering overseeing a construction project).

The relevance of the different modes varies significantly between services. However, since commercial presence tends to be the dominant mode overall, services trade is often associated with foreign direct investment and the employment of domestic workers by foreign services suppliers. Consumption abroad is mainly relevant for certain sectors such as tourism, education and medical services, while technological progress is making cross-border supply a feasible mode for an increasing number of services across the board. The presence of natural persons for the purpose of service delivery should not be confused with migration, as it is of a temporary nature and by and large involves higher-skilled people such as managers or specialists.

Obligations under the GATS may be categorized into two groups:

- General obligations, including
 - **MFN Treatment** (Article II) – however, Members are allowed a one-time exemption for specific services at the time they enter the GATS; such exemptions are subject to review and should in principle not last longer than 10 years.
 - **Transparency.**

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- Specific Commitments, in particular on
 - **Market Access**, in accordance with each Member's individually negotiated schedule of commitments (see below).
 - **National Treatment**. In any sector included in its Schedule of Specific Commitments, a Member is obliged to grant foreign services and service suppliers national treatment unless it lists the nonconforming measure in its national schedule; national treatment is defined as treatment not less favourable than that extended to its own like services and service suppliers; in this context countries commitments themselves not to adopt any law or other measure that would give its services or services suppliers a competitive advantage through more favourable treatment).

Each WTO Member is thus required to have a **Schedule of Specific Commitments in Services**. It is a document which identifies the services sectors and modes of supply subject to Market Access and National Treatment obligations. For each listed sector, and mode of supply within the sector, the schedule either indicates that the country has placed no limitation on its market access or national treatment commitments or that the country is conditioning the commitment by listing conditions or by enumerating nonconforming measures. The schedule also includes horizontal commitments and reservations that apply across all sectors.

The GATS does not impose the obligation to grant market access or national treatment commitments in a particular sector. In scheduling commitments, Members are in principle free to tailor the extent of the commitments they take so as to avoid or modify obligations that they consider too demanding at present. However, as commitments are negotiated between WTO Members as part of an overall give-and-take, countries may face strong demands which they have to accommodate in one way or another, so schedules may not always contain only "painless" commitments. This is particularly true for acceding countries which often face relatively highly pitched demands.

Article XVI sets out six types of government measures that are covered by a market access commitment, unless the government lists an exception, they are:

- Limitations on the number of services suppliers;
- Limitations on the total value of services transactions or assets;
- Limitations on the total number of services operations or the total quantity of service output;
- Limitations on the number of persons that may be employed in a particular sector or by a particular supplier;
- Measures that restrict or require supply of the service through specific types of legal entity or joint venture;
- And percentage limitations on the participation of foreign capital, or limitations on the total value of foreign investment.

Article XVII deals with national treatment. It states that in the sectors covered by its schedule, and subject to any conditions and qualifications set out in the

schedule, each member shall give foreign services and service suppliers treatment, in measures affecting supply of services, no less favourable than it gives to its own services and suppliers.

Any markets access or national treatment obligations inscribed in schedules must be granted **unconditionally** to all Members, **without discrimination**. Countries are allowed at the time of accession to list specific exceptions to this requirement. Parties to an “Economic Integration Agreement” (*i.e.*, a Free Trade Agreement for services) are not bound to give Parties that are not signatories of the agreement the same treatment, according to Article V, provided the agreement has sufficient coverage to justify such an exemption. Also, countries are allowed to negotiate agreements for the mutual recognition of standards, though they have to give the same opportunity to other member countries.

GATS commitments combine “**positive lists**” and “**negative lists**.” Schedules consist of a matrix of commitments for various sectors and sub-sectors, as well as the four modes of supply. Each Member specifies the sectors to which GATS rules should apply (positive list). For each of these “bound” sectors, however, the schedule contains an exhaustive negative list of remaining restrictions (or possible limitations) – only trade barriers that are explicitly listed may be maintained. Even if no actual additional market opening occurs at the time the commitment is made (because the sector was already unilaterally liberalized), a GATS commitment thus considerably increases the transparency of the regulatory framework for traders and investors.

GATS schedules are classically divided into **horizontal commitments** and **sector-specific commitments**. The “Horizontal Section” contains limitations that apply across all sectors included in the schedules. They often refer to a particular mode of supply, notably commercial presence and the presence of natural persons. The “Sector Specific Section” contains limitations that apply only to the particular sector, sub-sector or activity, as well as mode of supply, to which they refer. For each sector, commitment in all four modes of supply can be made regarding market access and national treatment (a commitment matrix). Countries have the option to make “full” or “partial” commitments (subject to restrictions).

Whereas the main trade barriers for goods are tariffs and quotas enforced at national borders, restrictions to trade in services come as “**behind-the-border**” **laws, regulations or administrative barriers**. These tend to be targeted at the service provider, rather than at the service itself. If cross-border trade in services is to be liberalized, a wide range of domestic policies need to be reformed. They include rights of establishment (e.g. for foreign banks to set up branches); rules for market access (e.g. network access in telecommunications or electricity); licensing regimes (e.g. for accountants or medical staff); investment rules (e.g. restrictions to foreign ownership or the repatriation of profits); restrictions to the temporary movement of workers (e.g. stringent visa requirements); and competition policies (e.g. monopolies or cartels). Policy measures to liberalize trade in services can be of a cross-sector nature (e.g. general rights of establishment or competition policy) as well as sector specific.

Exhibit 1.3: Two Important International Trade “Theaters” for Palestine and Israel: EuroMed and GAFTA

1. The EuroMed (“Barcelona”) Process and the Planned EuroMed Free Trade Area – An Overview

1.1 Introduction

In 1997 the EC and the PLO, for the benefit of the Palestinian Authority of the West Bank and the Gaza Strip (hereinafter referred to as **PA**), concluded an Interim Association Agreement on trade and cooperation (hereinafter referred to as **IAA** or **agreement**, respectively). The IAA is part of the so-called *Barcelona Process* whereby the EC and the Mediterranean countries, as stipulated in the Barcelona Declaration of 1995, seek to establish:

- a common area of peace and stability through the reinforcement of political and security dialogue;
- a zone of shared prosperity through an *economic and financial partnership and gradual establishment of a free trade area*;
- a social, cultural and human partnership aimed at encouraging understanding between cultures and exchanges between civil societies.

The goals of the Barcelona process, especially the economic goal, can only be reached if the bilateral (treaty) relationships between the EC and the Mediterranean countries are coupled by bi- and plurilateral (treaty) relationships between and among the Mediterranean countries as well, including Palestine and Israel.

1.2 Assessing the Implementation of the IAA: The Conceptual Framework

The agreement’s objectives, set forth in the very first provision of the IAA, are the following:

- progressive liberalization of trade;
- social and economic development of the West Bank and Gaza Strip;
- balanced economic and social relations between the contracting parties;
- regional cooperation;
- comprehensive dialogue between the contracting parties.

Special attention should therefore be paid to understanding which factors stand in the way of liberalizing progressively trade between the contracting parties and their reaping the intended benefits from this liberalization process, and which measures should be taken to overcome any impediments.

The legal obligations enshrined in the IAA are the primary means to reach the said objectives. These obligations relate to the following subject matters:

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- free movement of goods, including agricultural and fishery products;
 - payments, capital, competition, intellectual property and public procurement;
 - economic, financial and cultural cooperation and social development, including economic policy, industrial, customs, scientific and technological as well as regional cooperation.

1.3 The IAA's Trade-Related Provisions on the Free Movement of Goods: Current Legal Framework and Prospects for Expansion

Basic Principles

Article 3 of the IAA sets out the basic principles according to which free movement of goods is to be ensured.

- The first basic principle is the *establishment of a free trade area* over a transitional period; this transitional period was to be completed by 31 December 2001;
- The second basic principle is that the free trade area has to be in *conformity with the WTO rules on trade in goods*.

One of these requirements is that substantially all the (internal) trade between the parties of a free trade agreement must be free of tariffs and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX of the GATT 1994).

Industrial Products

a) Abolition and Prohibition of Customs Duties and Quantitative Restrictions

The IAA has established some obligations with the aim to ensure that trade in industrial products originating in the Community and in the West Bank and the Gaza Strip is liberalized. Some of these obligations include: a prohibition to repay indirect internal taxes on products exported to the territory of one of the contracting parties, the imposition of antidumping duties, imposition of safeguard measure, abolition of any quantitative restrictions and measures having equivalent effect on trade between the contracting parties, a prohibition to impose custom duties on imports of Palestinian products into Community, phase out fiscal charges levied on imports of the Community products, into the West Bank and Gaza etc.

b) Rules of Origin

The rules of origin which determine the whether products have originating status and which procedures must be observed in this respect. These rules include:

- conditions for obtaining the status as "originating product" ;

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- territorial requirements (principle of territoriality, direct transport, exhibitions);
 - prohibition of drawback of, or exemption from, customs duties;
 - proof of origin (e.g. movement certificate EUR 1, invoice declaration, approved exporter, validity of proof of origin, submission of proof of origin, exemption from proof of origin);
 - administrative cooperation (e.g. mutual assistance, verification of proof of origin).

However, the Barcelona Process envisages implementing the principle of diagonal cumulation in the Euro-Med area, thus creating a Pan-Euro-Med cumulation zone. These model rules of origin are to be incorporated in all association agreements between the EC and the Mediterranean countries and all free trade agreements between the Mediterranean countries. This is because diagonal cumulation among three or more trading partners necessitates that the trading partners in question all have *identical* rules of origin.

Agricultural Products

Only the Palestinian agricultural products enjoy preferential access to the Community market; other agricultural and fishery products are subject to (in most cases) rather high (*ad valorem* and/or specific) customs duties.

1.4 Future Prospects: Services and Investment and Full Coverage in Agriculture and Fisheries?

Beyond Trade in Goods: Services and Investment

The IAA aims to progressively liberalize trade between the contracting parties; in the meantime, the transitional periods established by the IAA have lapsed.

The liberalization of trade in services and investment is thought to be a key priority for the Euro-Med area since it would provide access to new markets, create investment opportunities, and enhance the competitiveness of business, thus generating significant welfare gains and boosting the Mediterranean countries' GDP.

Moreover, trade in services between the Mediterranean countries and the EC currently represents only 3.5% of the EC's total services trade. Hence, there is a huge potential for developing trade in services in the Euro-Med area.

The EuroMed services and establishment negotiations between the EU and six Mediterranean partners, including Palestine were launched at the Trade Ministerial Conference in Marrakech in March 2006. The first round of negotiations started in July 2006. The negotiations aim to gradually liberalise trade in services and reduce restrictions on the right of establishment between Europe and its Mediterranean partners.

Parties to the negotiations in July 2004 adopted the Istanbul Framework Protocol as a non-binding basis or blueprint to the envisaged services agreement (see

Annex III). Since the start of the negotiations multiple rounds of talks were held, focusing initially on the draft proposals (templates) for agreements submitted by the European Commission.

Trade in Goods: Full Liberalization of Trade in Agricultural and Fishery Products in the Future

The progressive liberalization of trade in agricultural and fishery products under the IAA is not designed to lead to fully liberalized trade; rather, the IAA provides only for a “greater” liberalization, meaning something less than full liberalization.

The preferential treatment of Palestinian agricultural products imported into the Community market is tied to both quantitative and temporal conditions which prevent Palestinian producers from fully exploiting their potential in exporting to the Community market.

As among others the EC Trade Commissioner Mandelson argues, it is essential to add liberalization agricultural and fishery products, with only a limited number of products exempted, free trade in goods between the EU and its Mediterranean partners will be all but complete.

1.5 Implementation of the IAA: Concerns and Problems

Israel does not recognize the IAA, a position which inter alia means that goods arriving at Israeli ports with an EUR1 form claiming duty free treatment under the EC-PLO IAA. While Israeli officials have been reported to have pointed to various justifications for the non-recognition when prompted, no official, written Israeli position is available until today.

Already according to its title, the Paris Protocol (hereinafter PP) establishes the conditions for the “economic relations” between Israel and the West Bank and the Gaza Strip. The words “economic relations” suggest that the PP sets forth rights and obligations of two distinct parties regarding their economic relationship.

The Israeli non-recognition of the IAA is political rather than legal in nature. On the other hand, Israel, has signed up to the Barcelona process, which includes the Palestinians as a full partner. Since the progressive development of the web of association agreements of the Mediterranean partners with the EC is a key element of that process and a primary legal tool for achieving its objectives, it seems difficult to understand how Israel can consider itself a partner in that process and at the same time not recognize another association agreement.

1.6 Concluding Observations

Seen from a Palestinian perspective, both economic and political relations with the EU are of paramount importance, currently and possibly even more so in the post-disengagement future. In stark contrast to this importance, the key instrument for the realization of the relationship, the IAA, is largely inoperational, and has been left in a virtually vegetative state for the past eight years, largely due to what appears to be tactical maneuvering by Israel, purportedly one of Europe’s Mediterranean partners.

Palestinians and many observers have difficulties understanding how this contrast, or contradiction, is allowed to remain active. Given the rather obviously political nature of the Israeli non-recognition of the IAA, the main obstacle to its effective implementation, and the fact that the two-state solution, to which Israel and the Palestinians have subscribed when accepting the Roadmap to Peace, will in any case render any legal argument against recognition moot, it would appear that a more categorical approach from the side of the EU could present an adequate response to the situation. The nexus to progress in the Barcelona Process appears obvious.

Meanwhile, the progressive development of the IAA towards more comprehensive coverage in agriculture/fisheries and, in particular, towards coverage of trade in services and investment, appears a very promising way ahead. Services trade in particular may present a complementary if not in many parts alternative way of responding to the mutual Palestinian and European desire for deeper and more extended economic relations. Since much of services trade travels through intangible means, in particular means of electronic communication and/or telephone and fax lines, it does not require overcoming physical obstacles such as roadblocks, checkpoints, back-to-back border terminals and scanners. In other words: Some if not most of the key obstacles to Palestinian trade in goods simply don't matter for trade in services, at least for some of the modes of supply. In addition, no legal constraints, neither actual nor imagined, would appear to emanate from the Paris Protocol or other treaties in force.

It appears thus a matter of high importance for Palestine to further explore and develop the potentials of services trade, in particular in the context of European-Palestinian relations.

2. The Greater Arab Free Trade Area- An overview

2.1 Introduction

In 1997, fourteen Arab countries concluded an agreement, aimed at achieving the Greater Arab Free Trade Area (GAFTA) by 1.1.2007 at the latest. The main provisions concerned the progressive removal of tariff and non tariff barriers (NTBs) on intra-GAFTA trade in manufactures. Agricultural products were provided special treatment: each country could exclude at most 10 agricultural products from the agreement during the harvest season. In addition, rules of origins were set at 40% of the value added. The last provisions provided for the agreement's conformity with WTO rules as well as special delays for least developed Arab countries. On 1.1.2005, the tariff removal was fully completed, although countries only partially removed NTBs.

In Sept 2002 the number of the Arab countries in the Arab free trade area reached 16, including Palestine. Palestine has special treatment, the same as the less developed Arab countries treatment in giving privileges and discounts. After the Intifada started, and after all the aggressive Israeli procedures, the Palestinian products were exempt from all the customs and duties based on the Arab league decision in 22/10/2000.

GAFTA is a free trade area conceived by and under the League of Arab States. Initially suffering from a lack of implementation and enthusiasm, it is now being realized. Some very positive experiences in Arab countries have created incentives for expansion and completion. It is expected that with proper implementation, all Arab states will have zero tariffs towards each other's products by the end of 2007.

2.2 Integration and trade in the Arab area: an overview

Trade integration in the Arab world is an old story. Starting with the creation of the Arab League in 1945, several attempts have been made to promote regional political and economic integration: the 1950 Treaty for Joint Defense and Economic Cooperation, the 1953 Convention for Facilitating and Regulating Transit Trade, the 1957 Arab Economic.

Unity Agreement, the 1964 Arab Common Market, the 1981 Gulf Cooperation Council, the 1989 Arab Cooperation Council as well as the 1989 Arab Maghreb Union (Neaime, 2005). However, these agreements have generally not been implemented. As a result, trade barriers have remained high within the Arab region.

The economic benefits expected from this far-reaching regional integration are numerous and well-known. GAFTA members are first expected to increase intra-regional trade, thanks to the removal of trade barriers. Second, production efficiency should be enhanced through by exploiting comparative advantage and scale economies. Third, competition within domestic markets will be increased with greater product varieties for consumers as well as lower prices. Fourth, an improvement of terms of trade is expected thanks to the decrease in import prices.

Finally, GAFTA should help to increase economic growth through the dynamic effects of regional integration.

However, the Arab Free Trade Area faces many economic obstacles, such as the differences in the economic and financial systems, especially on the legislative, systematic, administrative, and organizations level, the weak banking activities, services activities, and trade helping activities such as insurance, transportation, and communications, plus that some member countries plans for the importing from abroad according to its cash budget, and to the available foreign cut offs.

Moreover, the weak competition ability of the Arab products if compared to the similar kind of products imported from other countries (From both price and quality aspects). And because many of the Arab member countries at the free trade area are also members at international trade agreements, especially the world trade organization, the flow of the foreign products to the Arab markets, beside the Arab products, limits the environmental Arab trade and represents an obstacle for implementing the agreement. In addition to that, not caring about doing integrated Arab projects and the weakness or absence of the investment environment are considered obstacles for implementing this agreement.

Beyond trade in goods, negotiations are now under way towards services trade liberalization. These negotiations proceed with a view to achieving harmonization with with the EuroMed process on trade in services (see above).

Palestine currently enjoys a peculiar status within GAFTA. Palestinian goods have – in principle – duty free access to all Arab markets under this agreement. Palestine is exempt from the requirement of offering its GAFTA partners reciprocal market access, given that Israel still *de facto* controls all Palestinian external borders and, more importantly, its tariff policy through the Paris Protocol arrangements.

Palestine's full GAFTA Membership, however, must be expected as a matter of course under virtually any future scenario involving Palestinian (economic) statehood. GAFTA Membership will lead to significant, legally secured market access to Arab markets. This market access, importantly, could be exploited *inter alia* through forms of cooperation between Palestinians and Israelis.

In turn, however, it is important to note that at least under current political perspectives Palestine's GAFTA membership will not sit easily with (and possibly be effectively incompatible with) entering into (maintaining) a customs union with Israel, and vice versa. While it is imaginable that some arrangement could be found to exclude (purely) Israeli goods from effective market access (a clear political dogma for some Arab states at this stage), or alternatively that the Arab states continue to grant Palestine unilateral, non-reciprocal benefits, this seems not very likely. This assessment may change radically, however, if an overall political solution is found that finds the acceptance of all Arab states and which results in serious political relaxation on both sides and an end to the conflict. In such a scenario Israeli market access to Arab markets, *de facto* or *de jure*, may become a non-issue.