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ECONOMIC AND SOCIAL COUNCIL  
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agenda\*\*  
PERMANENT SOVEREIGNTY OVER  
NATIONAL RESOURCES IN THE  
OCCUPIED PALESTINIAN AND  
OTHER ARAB TERRITORIES

Israeli economic practices in the occupied Palestinian  
and other Arab territories

Note by the Secretary-General

1. In its decision 40/432 of 17 December 1985 on Israeli economic practices in the occupied Palestinian and other Arab territories, the General Assembly requested the Secretary-General to prepare a report on the financial and trade practices of the Israeli occupation authorities in the occupied Palestinian and other Arab territories and to submit the report to the Assembly at its forty-first session, through the Economic and Social Council, and invited the Secretary-General to utilize the services of competent United Nations bodies in preparing that report.
2. On the basis of a note by the Secretary-General (A/41/410-E/1986/97), the Council, in its decision 1986/155 of 18 July 1986, subsequently decided that the above-mentioned report should be submitted for consideration to the General Assembly at its forty-second session, through the Council at its second regular session of 1987.
3. As part of its work programme for 1986-1987, the United Nations Conference on Trade and Development (UNCTAD) had embarked on the preparation of an in-depth study of the financial sector in the occupied Palestinian territories of the West Bank

\* A/42/50.

\*\* E/1987/100.

and the Gaza Strip. The study, dealing with various aspects of the financial and fiscal systems of those territories, was being carried out in association with the Economic and Social Commission for Western Asia (ESCWA) and was expected to be completed by the end of 1986 (a similar study of the trade sector in the occupied Palestinian territories is envisaged as part of the forthcoming work programme of UNCTAD).

4. The study, entitled "The Palestinian financial sector under Israeli occupation" (UNCTAD/ST/SEU/3) is scheduled to be made available to the Trade and Development Board at its thirty-fourth session in October 1987. The study comprises five chapters. Chapter I provides a concise overall view of the economy of the occupied Palestinian territories, analysing the recent performance of main aggregates and sectoral developments. Chapter II examines various aspects of money and banking and their role in the financing of economic activities in the territories. Chapter III is devoted to an analysis of the fiscal determinants in the Palestinian economy, with particular emphasis on the role of the tax system. Chapter IV provides a detailed analysis of external financial flows to the occupied territories, concentrating on remittances and private and official transfers. Chapter V presents a summary of the findings and conclusions of the study and examines the possibilities for feasible solutions to the problem of meeting the rapidly growing financial resource needs of the Palestinian economy.

5. In view of the length of the document, the Secretary-General circulates, in the annex to the present note, chapter V of the study. The complete study will be submitted to the Trade and Development Board at the first part of its thirty-fourth session.

ANNEX

Conclusions and recommendations of the study of the financial sector  
in the occupied Palestinian territories of the West Bank and the  
Gaza Strip a/

1. The present chapter draws on the findings and conclusions reached in the study and examines the possibilities for feasible solutions to the problems encountered by the economy of the occupied territories, with emphasis on the specific role of the financial sector. It is hoped that the proposals would contribute to the formulation of guidelines for policy action at various levels in the territories, both by the parties directly concerned and by the international community. As such, attention is focused on some of the main issues that are of vital importance to the future of the Palestinian economy.

A. General economic situation

2. The period immediately following the 1967 occupation of the territories by Israel was characterized by high rates of economic growth in the territories. However, that momentum could not be sustained because of radical structural changes brought about in the economy of the territories through measures embodied in a series of military orders. As a result, the level of domestic output and its contribution to gross national product have been steadily falling in recent years.

3. While the relative share of the traditional sector in domestic output has rapidly declined, the shape of industry has virtually stagnated while labour has become increasingly dependent on employment opportunities in Israel and the rest of the world. The closure of banks and other financial institutions since the occupation of the territories has deprived these and other sectors of the economy from short-term and long-term sources of finance. That lack of financing has acted as a serious bottleneck in efforts to expand output in these sectors. In the area of trade, the territories have been gradually transformed into the largest single importer of Israeli (non-military) products with a growing balance-of-trade deficit that can only be met from workers' remittances and transfers from abroad.

4. The inability of domestic output to meet the rising demand and the growing import of goods from Israel, coupled with the use of a depreciating Israeli currency as legal tender in the territories, have manifested themselves in the high level of prices. This has, in turn, affected the level of savings and investment in the economy of the territories with the existing financial institutions unable to absorb some of the liquidity that is injected from abroad.

5. Domestic contribution to savings has been negative. The rising trend in total private disposable income from all sources has not been adequately reflected in the level of personal savings. Gross capital formation has also followed a declining trend in recent years. Although the private sector accounts for the bulk of total capital formation, much of the investment has been in buildings and construction works, which have been largely aimed, inter alia, at meeting the acute shortage in

housing and as a hedge against high rates of inflation. The continued political and economic instability, lack of investment opportunities in commodity-producing sectors, and land confiscation practices of the occupation authorities have further pushed private savings into speculative activities.

6. In general, the economy of the territories is at present characterized by a high degree of fragmentation reflecting an increasing distortion in the structure of output and income, a widening gap between domestic and national output, and a high degree of openness that renders it vulnerable to outside economic and political forces. The lack of appropriate institutions to safeguard the interest of the local economy through various policy instruments has further compounded the problems of indigenous economic management in the territories and has led to the increasing subservience of the local economy to the economy of the occupying authorities.

7. Bold measures are needed to reverse this state of affairs, including the following: (a) initiating a policy aimed at developing the economy of the territories; (b) accelerating capital accumulation designed to increase productive capacity in agriculture and industry; (c) providing incentives to encourage local and foreign investors in productive sectors of the economy; (d) easing restrictions and licensing procedures on production and marketing in agriculture and industry; (e) promotion of equitable trade relations between Israel and the territories, especially with regard to existing limitations on Palestinian agricultural exports to Israel; (f) allowing the re-emergence of local financial institutions and promoting their financial intermediation; (g) increasing employment opportunities in other sectors; and (h) promoting the entrepreneurial spirit that has served as the basis for economic endeavour and achievements in the territories. Only through such a conscious policy and commitment, coupled with concrete measures at various levels, can the economy of the territories be expected to move out of stagnation and set itself on a course of sustained growth and development. Indeed, the success of such an approach equally necessitates the creation and development of indigenous bodies capable of managing the economy on a day-to-day basis and charting its future course.

8. It should be noted, however, that the policy orientation of measures aimed at reviving the economy of the territories should reflect the aspirations of the Palestinian people in the territories, articulated in terms of overall development objectives and strategies. Given the resource endowments of the economy, its present distorted structure and future prospects, the following basic objectives may be considered, among others, to serve as a frame of reference for designing appropriate policy measures required in each area of economic and social endeavour:

(a) Accelerate the growth of the domestic economy at a rate sufficient to sustain natural increases in population and to bring about improvements in the level of per capita income;

(b) Increase productivity in the neglected areas of agriculture and industry and expand the output of essential goods by promoting import substitution industries based on local raw materials and by diversifying exports, thus reducing the overall foreign exchange gap and the deficit in the balance of trade;

(c) Stabilize the general price level and reduce the prices of essential commodities;

(d) Create productive employment opportunities throughout the territories to absorb both natural increases in the labour force and migrant Palestinian workers employed in Israel and the rest of the world;

(e) Accelerate the rate of development expenditures with a view to creating the basic infrastructural facilities that provide external benefits to the economy and increasing the absorptive capacity of the territories for further productive investment;

(f) Establish and strengthen appropriate financial institutions aimed at mobilizing, allocating and managing domestic resources in line with the needs of the economy;

(g) Establish the requisite institutional capabilities within the public administration of the territories for the effective formulation and implementation of economic and social policy measures.

9. Undoubtedly, the realization of such objectives, which are in line with the expressed needs of the territories, would be dependent upon institutions capable of handling the crucial interplay of various economic and social policy instruments. Obviously, such institutions are lacking in the territories and the issues involved are dealt with by facilities operated by or under the direction of the occupation authorities.

10. This study has examined one of the important auxiliary areas, namely, finance, which contributes towards the realization of certain economic and social needs whether or not expressed in terms of societal goals. The institutional and policy shortcomings in this area are striking not so much because of their lack of development but because of the deterioration that the financial sector has experienced since the occupation of the territories.

#### B. Money and banking

11. Following the occupation of the West Bank and the Gaza Strip in 1967, the Israeli authorities immediately issued military orders closing all banks and credit institutions operating in those territories and declaring the Israeli currency as legal tender. Subsequently, however, the Jordanian dinar was also allowed to circulate in the West Bank, while the Egyptian pound was declared illegal in the Gaza Strip. There is, thus, no specific currency belonging to the territories. The rapid depreciation of the Israeli currency, coupled with significant trade with Israel, has closely tied the territories to Israeli economic realities, which are characterized, inter alia, by high rates of inflation. Branches of Israeli banks were opened in the territories with the majority located in major Israeli settlements serving the Israeli settlers. With these developments, the role played up to 1967 by the Central Banks of Jordan and Egypt was taken over by the Bank of Israel.

12. Consequently, the inhabitants of the territories lost a system that managed monetary activities through regulating the money supply, directing credit and supervising the operations of banking and other financial institutions with a view to promoting production, employment, income and investment in the territories. There has been inadequate disclosure regarding monetary statistics in the territories to allow a thorough evaluation of the operation of the system that has emerged under occupation, especially where analysis of the behaviour of monetary aggregates and their interaction with economic activities would reflect on the policy instruments at work.

13. Branches of Israeli banks that have been opened in the territories have not succeeded in restoring the pre-1967 level of banking operations. In particular, they have not been able to play the conventional and fundamental role of intermediating between Arab depositors and borrowers for the mobilization and allocation of resources into the economy of the territories. A great portion of the resources raised by these banks from the territories is transferred to and used in Israel under balances held with banking headquarters. Moreover, apart from providing some common banking operations, the role of those banks in providing medium-term and long-term finance for the growth and development of the Palestinian economy has been minimal, if any.

14. Consequently, and following 20 years of occupation, the territories do not enjoy the services of banks and other specialized financial institutions designed to promote the growth and development of vital sectors of the economy. Businesses operating in these areas have been obliged to meet their short-term and long-term financial needs by falling back on their meagre savings and/or by resorting to the prohibitive practices of the informal financial market, which is characterized by high rates of interest and difficult guarantee requirements. Even then, the amounts have remained very limited and the conditions rather exacting. External efforts made, for instance, through the Jordanian-Palestinian Joint Committee, to rectify this continued anomaly by providing medium- and long-term finance were confronted with restrictions. As such, development finance needs of the Palestinian economy have not been met during the past 20 years of occupation.

15. The situation has been particularly serious in rural areas where the cost and conditions of finance, even for seasonal credit, are far beyond the ability of an average inhabitant. Such credit has been largely supplied by money-lenders, suppliers of agricultural inputs, marketing middlemen and similar sources. Rural co-operative institutions, which usually provide credit on acceptable terms, are themselves plagued by a shortage of capital and of technical and managerial cadres. This situation is ironic when compared with that of rural areas in the developing economies in general where the credit needs of the inhabitants have not only attracted the attention of local authorities on a priority basis but have also attracted the involvement of an array of organizations from the international community.

16. The role of insurance companies in finance is equally negligible, if not non-existent. The operations of local companies are generally confined to car insurance. The revenues so accumulated are largely kept as bank deposits in view of restrictions on new investment projects. Branches of Israeli insurance

companies transmit premium dues to the accounts of their headquarters in Israel. As such, the potential role of the insurance business is not reflected in the economic scene.

17. Efforts to redress the situation have not met with success. The absence of an indigenous banking system, coupled with the dual, if not triple, currency standard, and the growing credit needs of the economy have prompted local informal facilities to emerge and fill the gap. The role of money-changers has been significant in this respect. The major part of their business has been exchanging Israeli and Jordanian currencies that accrue to the inhabitants of the territories. They have not been able to fill the crucial gap in financial intermediation. The recent relative stability of the Israeli currency, coupled with high real rates of interest, the continuing decline in the international value of the United States dollar and, most importantly, the fall in the volume of remittances and transfers to the territories do not augur well for the business of money-changers. The recent move by the Israeli authorities to regulate and tax the activities of money-changers is likely to add to the problems confronting them. Renewed efforts are needed to replace the very fragile, vulnerable and ad hoc arrangements by appropriate financial institutions reflecting the dire needs of the economy in the areas outlined above.

18. Attempts to reopen local banks in the Gaza Strip resulted only in the reopening of the Bank of Palestine in 1981, which operates under the direct supervision of the Bank of Israel. The reopening coincided with the worsening of the economic situation in the Strip. However, owing to numerous restrictions imposed on its operations, the Bank has had only a marginal impact on the financial and credit conditions in the Strip. Unlike the branches of Israeli banks operating in the Gaza Strip, the Bank of Palestine is not allowed to deal in foreign exchange or to open new branches covering a wider geographic area, or to have a say in the approval of investment projects. These restrictions have inhibited the Bank from financing foreign trade and attracting deposits in foreign currencies, from serving localities that lack banking and credit facilities, and, above all, from carrying the crucial function of financial intermediation. Coupled with the limited capital and the continued devaluation of the Israeli currency, these constraints have forced the Bank to follow a conservative approach in its lending operations. A re-examination of these and other issues that have stifled the operation and role of this Bank is urgently called for. This is particularly needed at this crucial juncture as the Gazan economy is experiencing the most severe recession in 20 years of occupation.

19. In the West Bank, efforts to reopen banks since their closure in 1967 were met with various conditions that were not in line with the laws and regulations prevailing at the time of its occupation. After numerous attempts, the branch of the Cairo-Amman Bank was finally allowed to open late in 1986, in Nablus, under certain conditions. While the reopening of the branch signals the beginning of a move in the right direction, much of the success expected from it will depend on the manner in which the branch is treated in terms of its resource base and on the nature and scope of its operations. This is important in order to prevent the repetition of the experience of the Bank of Palestine.

20. First of all, the resources of the newly opened branch need to be augmented through external contributions until it has succeeded in mobilizing adequate domestic savings. The Central Bank of Jordan may be able to serve not only as a repository of reserves but also as a promoter and the lender of last resort in order to help the branch take calculated risks. The branch could also be allowed to open its other branches elsewhere in the territories with a view to mobilizing the savings of inhabitants over a wider area and thus to carry out financial intermediation and provide credit to the urgent priority areas of the economy, especially agriculture, industry and housing. The interrelationship of its branches should increase the overall capacity of the Bank for credit creation throughout the territories. It is also vital for the newly opened branch to establish links with existing formal and informal entities such as co-operatives, insurance companies, money-lenders and the large number of professional institutions in order to mobilize greater savings. It is important for the bank to avoid developing an urban bias in its operations whether directed to financing trade or industry. The branch might be allowed to deal in foreign currencies so as to enlarge the scope of its operations and enable it to compete with the branches of Israeli banks operating in the territories.

21. The branch might also be allowed to operate with a flexible range of interest rates in order to raise real rates of interests above the level of inflation, thereby influencing the choice between alternative uses of private savings. If need be, this could be accompanied, according to the laws prevailing in the territories, by other incentives, such as tax exemption on income from bank deposits or on income from newly established businesses. The branch can play a pioneering role in this process. In order to further influence the possible insensitivity of the market to a single rate of interest, a system of differential rates of interest for different types of credit could be instituted to help direct resources to desired areas. A complementary tax policy could further strengthen the effectiveness of such measures. In view of the loose nature of the market, it is possible that such measures might not produce high results in the immediate future. However, this should not be construed as a sign of their ineffectiveness. In an effort to develop an entrepreneurial outlook for autonomous investments, it may be necessary to accept a longer gestation period for the effectiveness of these measures.

22. It should be noted, however, that parallel to these efforts attention may also be given to promoting financial discipline among the users of bank services. An adequate scheme could be developed for evaluating credit applications and monitoring loans in order to ensure their effectiveness and provide for the prompt repayment of principal and interest.

23. Given the complexity of the measures outlined above, the success of the newly opened branch would be largely dependent upon its ability to develop an adequately qualified technical and managerial cadre. Such a cadre is needed to evaluate the economic and financial viability of proposals.

24. Finally, an appropriate legal frame of reference is needed to support the efforts of the branch by providing the necessary basis for its mutual contractual obligations and those of its clients in accordance with laws and regulations of the



territories. Similarly, the role of the Central Bank of Jordan with respect to the operations of the branch, including its dealings in Jordanian dinars as well as Israeli shekels and other currencies, needs to be specified.

25. Despite recent developments, institutional arrangements to meet the medium- and long-term financing needs of agriculture, industry, tourism and housing are still lacking. The position of small farmers, industrialists and businessmen remains precarious. Specialized financial institutions are needed to provide support to private initiatives in these areas. The effort to establish an Arab finance house deserves full support as it promises the creation of the nucleus of an arrangement for long-term financing, including the possibilities of attracting external bilateral and multilateral resources on concessional terms.

### C. Public finance

26. General government budgets, both those of Israel and of local Palestinian authorities, serve as the fiscal determinant affecting the level of income and demand, providing basic services, influencing economic activities and promoting growth and development. It should be noted, however, that the limited size of the government budget, coupled with the lack of a growth and development oriented policy, has rendered the role of the budget marginal with respect to these tasks.

27. Despite a breakdown of government outlays into current needs and development purposes, the overall level of government revenues and expenditures reflects a neutral budget approach in the territories. As such, it moves from a certain given level of revenues to determine outlays. Total expenditures in general and those for developmental purposes constituted a negligible portion of national income. The continuing inflationary pressure has further reduced the impact of these limited outlays. As a result, the territories seem to suffer from a low level of basic government services at various levels in such areas as education, health, welfare, public works, postal services and telecommunications. With respect to development outlays, the low level of contribution by the public sector to gross domestic capital formation has left various physical and human infrastructural facilities, which provide external benefits to the economy, virtually unattended. The lack of a policy favouring and encouraging private investment in productive sectors has prompted the contribution by the private sector to gross capital formation to be concentrated in housing and construction works. It is, therefore, the level of autonomous external resources that has had some impact on income and demand as well as on economic activities in the territories during much of the two decades of occupation.

28. The only area where an interventionist government budgetary policy has been pursued is taxation. Numerous military orders and proclamations, issued since 1967, have effected significant changes in the tax system. In addition to changing the structure and rates of existing taxes, the new taxes imposed have been intended not so much to stimulate economic activity as to increase government revenues. In fact, that revenue objective alone has prevailed behind these changes rather than resource allocation, equity and/or stabilization objectives of public policy. Those latter objectives generally provide the overriding considerations for any

changes effected in a tax system. They may have been considered irrelevant in the context of the territories' economy under occupation.

29. In the area of income tax, the threshold for taxable income was lowered through a reduction in the minimum level of taxable income, personal and family allowances and exemptions. In addition, both marginal and overall effective rates were increased throughout the tax schedule. As a result, a higher tax rate is now levied on amounts that generally represent less than half of taxable income under the laws that prevailed in the territories at the time of their occupation. This has put the inhabitants of the territories at a disadvantage when compared to the more liberal attitude reflected in Jordan and Israel itself despite a higher level of per capita income indicating increased ability to pay taxes. Under the present recessionary situation, there is hardly any merit in either retaining or adding to the distortions that affect the incentives to work, save and invest.

30. The most striking change in the income tax law pertains to the collection procedures embodied in chapter 14 of the law that prevailed in the territories at the time of occupation. Those procedures have been altogether replaced by military orders introducing measures that have affected the assessment and collection of taxes. More importantly, the court of appeal for income tax matters and the right of taxpayers to subsequent recourse to higher judicial bodies have been delegated to an "Objection Committee" with the Military Command having the final say in the matter. As such, appeals at various levels have been revoked and confined to an administrative/military committee.

31. It may be stated that the haphazard changes introduced in the income tax law, such as the abolition of administrative procedures that have left assessment and interpretation to tax inspectors, recourse to coercive measures in tax collection and, above all, the arbitrary way of treating tax appeals, seem to have eroded public confidence in the purpose and objectivity of the income tax system. No direct or indirect participation of the taxpayers was solicited before the introduction of changes into the income tax system. The legality of the measures aside, it was of paramount importance that these changes, if introduced within the frame of law, could have been accompanied by detailed manuals of operation for the benefit of both taxpayers and tax officers. The actual involvement of the public, through their legitimate institutions and interest groups, in all these aspects is considered a major factor in the effectiveness of any tax system. The application of this important measure leaves much to be desired in the territories.

32. One area deserving further elaboration relates to tax assessment of artisans and traders who are either unable or unwilling to keep books. An objective and realistic approach could rely on such factors as capital, volume of business, type of trade, the normal level of profit, location and other pertinent issues. These factors can be determined in consultation with local authorities, chambers of commerce, taxpayers' professional associations and tax experts and can serve as an alternative to the direct analytical assessment based on inadequate records. Such an attitude of co-operation is bound to eliminate the climate of mistrust and disagreement that has strained relations between taxpayers and tax authorities.

33. It is equally necessary to consider establishing standardized systems of accounts that have adequate and clear instructions coupled with appropriate training on the methods and techniques involved. The local authorities could play an important role in organizing training programmes on various aspects of the tax system including assessment procedures, accounting techniques and methods and other aspects of tax administration. It is only through such a realistic and systematic approach that acceptable solutions may be found to the problems confronting both taxpayers and the authorities.

34. The success of all such efforts would obviously depend on a number of factors. In the first place, taxpayers need to be convinced that the tax laws applicable are those that prevailed in the territories prior to occupation and that amendments to those laws are only introduced in line with changes effected in the laws. Secondly, procedures for tax assessment and collection should be made more realistic, as noted above. Thirdly, revenues from all taxes should be clearly and adequately reported and spent on the most pressing needs of the territories. In all these matters, the taxpayer needs to be given a feeling of fairness and participation in the efforts made to improve his living conditions, thus instilling in him the pride of contributing to that end in order to ensure the creation of a dynamic atmosphere encompassing all aspects of life in the territories, irrespective of their present political status.

35. An important development that has affected the scope of the income tax law of the territories relates to the manner in which the income of Israeli citizens (settlers) and juridical entities residing in the territories is treated by the Israeli authorities for tax purposes. Under the principle of "territorial application of taxes", the income of Israelis residing in the territories should normally be subjected to the laws of the territories where such income is "derived, received or obtained".

36. According to an amendment introduced in the Israeli income tax ordinance, the income of an Israeli produced in the territories is considered as income produced, obtained or received in Israel and, thus, is subject to Israeli income tax. Meanwhile, the amendment provided the taxpayer with a credit equivalent to the amount of tax that may have already been paid to the territories, which was intended to avoid double taxation - a common feature of many national tax systems. However, in practice, no taxes were paid to the territories. The share of the territories in the taxes and whatever amount was due to the Israeli authorities have both ended up in the Israeli treasury. The objective behind the amendment was to prevent the territories from becoming a tax haven for Israeli citizens and juridical entities. In fact, Israelis residing in the territories were paying virtually no taxes until the amendment was enacted in Israeli law. No statistics are issued to ascertain the magnitude of the revenues due to the territories from this source.

37. Another area where the Israeli Government has followed an interventionist policy concerns the imports of the territories. The customs duties imposed on these imports are those applied to imports of Israel. This is supplemented by the payment of the value added tax on Israeli importers. The overall objective has been to safeguard Israeli products and to raise government revenues. Here also, no

detailed statistics are made available to ascertain the relevance of these duties to the territories' economy and/or to assess the amount of revenues accruing to the Israeli budget.

38. In addition to the changes introduced in the tax system of the territories, a tax introduced in Israel in 1976, referred to as the value added tax (VAT), was subsequently extended to the territories under the category of "fees and excises" covering almost all transactions. Here also, the purpose was to avoid creating a tax haven for Israelis in the territories and to raise government revenues. When the issue was appealed by the inhabitants of the territories, based on international conventions, the decision to extend the tax to the territories was upheld by the Israeli High Court of Justice.

39. The legal aspect of the tax aside, its imposition carries elements of inequity in the territories. The introduction of the tax in Israel was defended on the grounds that the price increases resulting from it would be balanced by income tax reductions so that the total tax burden would remain unchanged. In addition, in order to compensate low-income families that would not benefit from reductions in direct taxes, it was envisaged to increase children's allowances, old-age pensions and social welfare services. None of these compensatory considerations has applied to the inhabitants of the territories. On the contrary, as noted earlier, the burden of a number of taxes has increased against a relatively low and declining level of domestic income. On the whole, the VAT has evolved over the past few years to become one of the most serious fiscal constraints to the development of Palestinian industry and trade. Indeed, maintaining the tax, if legally justified, necessitates a thorough re-examination of the tax system in general and the income tax in particular.

40. Given the prevailing atmosphere surrounding the attitude of the Government towards the Palestinian economy, the tax system has been largely confined to its traditional role of providing revenues for the Government. As such, its role in resource allocation through influencing entrepreneurial decisions has been nil. None of the existing old or new investment-related incentives are at work in the territories, although the relevant laws are theoretically still in force. On the contrary, the amendments to existing taxes and the imposition of new taxes have served to discourage entrepreneurs. This appears in stark contrast to the range of incentives extended to Israeli settlers and their businesses in the occupied territories.

41. The Palestinian economy in its present state is in dire need of assistance and support. As in the area of monetary policy, fiscal incentives could go a long way towards providing such support for the realization of a number of the objectives outlined in the early part of this chapter. In fact, a combination of monetary and fiscal incentives based on the prevailing laws of the territories could encourage productive investments. The tax system by itself could play a significant role in this process. The benefits accruing from tax incentives would not only induce investments even in marginal areas by increasing the rate of return but would also serve to diversify businesses geographically throughout the territories despite difficulties of shortages in basic services. In view of high tax rates and limited allowances, the benefit of any tax incentive offered to both individuals and

juridical Palestinian entities would be high. It may be argued that such incentives could represent a loss of the already low-level government revenues. While this may be true in the short run, in the long run they are believed capable of creating an atmosphere favourable to investment that would provide more "tax handles", thus broadening the tax base in the economy as a whole.

42. Efforts could concentrate on promoting corporate business enterprises. The corporate tax rate could be lowered and applied also on the profits of limited liability companies as well as on other forms of economic enterprises and/or organizations. Undistributed profits of these entities could be taxed at a flat rate lower than the present one. Any distribution of profits could be subjected to the individual income tax at the prevailing rates. In cases where profits are distributed, an additional flat rate, which would be equal to or less than the marginal rate of income tax at its initial bracket, could be withheld and subsequently taken into account when assessing the overall tax liability of the recipients of such profits. In the absence of an adequate banking system and capital market, such a move could, at least, promote self-financing to a certain extent.

43. The shortcomings of the tax system briefly outlined could be individually examined in detail along with possible solutions to prevailing problems. However, an ad hoc treatment of these shortcomings is not likely to contribute to the improvement of the tax system as a whole. In fact, the fragmented structure of the tax system is the product of such ad hoc treatments that have been aimed primarily at raising revenues for the Government, while the tasks of the tax system in regard to equity, stabilization and, above all, allocation have continued to be neglected. As in the case of the instruments of monetary policy, the lack of an overall economic outlook is considered to have been behind the piece-meal approach in amending the tax system.

44. It is, therefore, necessary to envision an overall reform of the tax system as an integrated and co-ordinated set of policy measures guided by short- and long-term economic and social objectives in the territories. Such an approach is more likely to bring the conceptual and structural aspects of taxation into line with the requirements of a dynamic fiscal system aimed at assisting the process of economic and social change and development in the territories.

45. The assistance of the international community in the improvement of all the areas outlined in this chapter could appropriately be solicited. In addition to finding solutions to the anomalies mentioned, such assistance is crucial for establishing and developing indigenous institutions with appropriate technical and managerial capabilities. The accumulated experience of the United Nations in these and other related areas could be called upon.

#### D. External resources

46. The pressing inadequacy of domestic sources of finance, both public and private, has forced the inhabitants of the territories to rely increasingly on external financial support for their subsistence and accumulation of capital. As

with the increasing remittances of workers in Israel, the interaction that has developed between the territories and the Arab countries has enabled the territories to counter the range of restrictions imposed on the local economy and to meet the challenges posed by the increasing links with the Israeli economy. However, any possible positive aspect of such external flows into the territories must be seriously examined in terms of the capacity that those flows create within the local economy to generate, over time, the impetus for sustained growth and development. The absence of a regulatory body has rendered this issue more critical as the volume and orientation of these flows remain beyond the control of the territories.

47. Two distinct but interrelated sources of external finance have emerged for the territories, namely, factor income and unrequited transfers from abroad. Factor income largely comprises the earnings of Palestinian residents of the territories working in Israel and Arab countries because of the lack of local employment opportunities. By the early 1980s, the size of the Palestinian migrant labour force in Israel alone had reached almost two fifths of total Palestinian labour force in the territories. According to Israeli statistics, factor income from labour in Israel has amounted to almost four fifths of total factor income payments to the territories. The contribution of total factor income to GNP has increased steadily since occupation as more Palestinian labour has been displaced and consequently absorbed outside the territories. At one point, this contribution amounted to almost half of gross domestic output - a very high ratio indeed. In absolute terms, it has lately followed a declining trend.

48. The lack of appropriate policies and measures has caused much of the income from this significant source to be absorbed in high-level consumption, which has led to an increasing deficit in the balance of trade of the territories. The contribution of factor income to investment has been in housing and construction works, with agriculture and industry continuing to suffer from a shortage of financial resources for short- and long-term purposes. The increasing reliance on factor income from one source (that is, labour in Israel) has further added to the vulnerability of the territories' fragile economy. Its contribution to the creation of a sound basis for the sustained growth and development of the Palestinian economy has been virtually nil.

49. The lack of indigenous financial institutions has been a further limiting factor in the amount of factor income deployed through formal channels and into productive investments. The various incentive schemes (such as higher interest rates on foreign exchange deposits, premium exchange rates and/or productive investments) that labour-exporting countries have devised in order to attract more remittances from their labourers abroad have been absent in the territories. While for the majority of Palestinian workers abroad factor income may just be sufficient to sustain their subsistence, for many other families it has been a supplementary source of income. However, in view of limitations, a portion of such income never enters the territories. Not only have incentives for productive investments been lacking for this category of income earners, but restrictions have been imposed on the actual amount of funds permitted entry into the territories. These restrictions have only recently been relaxed - at a time when the level of economic

activity, especially in the labour-importing Arab oil-producing countries, is at its lowest.

50. The entire issue of exported labour and its resultant income is in need of serious consideration in view of the deteriorating economic situation in the territories. Some of the incentive schemes designed along the guidelines indicated above for the revival of the Palestinian economy can serve as a useful frame of reference for efforts aimed at enhancing the contribution of this source of income to economic growth and development.

51. The second major external source of finance, that is, private and official transfers, has also become increasingly important in recent years. It has, in fact, reduced the total reliance on the factor income of Palestinian workers in Israel. Combined with factor income it gives the overall scale of external financial flows an even greater significance. Such transfers include flows from Israeli government institutions, Palestinians who have emigrated from the territories since 1967 and official aid from Arab and non-Arab sources.

52. While the level of transfers from Israel has increased, that of the territories to Israel has increased at a faster rate, thus indicating a negative net transfer from the territories vis-à-vis Israel. This situation supports the claim that the territories are in effect paying an occupation tax. The occupation authorities thus obtain more resources from the territories in the form of taxes and other payments than they transfer to it. The present deteriorating state of the territories' economy can hardly support such a development.

53. As with factor income to residents of the territories working in Israel and elsewhere, the remittances of Palestinian migrants who maintain family ties with the territories constitute another significant element in the total of external resources. According to non-Israeli statistics, this source of income has provided the territories with a sizeable amount annually since 1980. This indicates an even greater degree of involvement of migrants' remittances in the local economy than reported by Israeli statistics and consequently a greater degree of reliance on non-domestic sources of finance.

54. Other Arab and non-Arab international support has increasingly served as a substantial source of finance to the territories, reflecting a continued expression of humanitarian assistance and of political will and commitment on the part of the international community. However, given the present status of the territories, the magnitude of and areas for deployment of such resources are likely to be influenced by a wide range of factors that lie beyond the control of the territories.

55. As for Arab sources of finance, the assistance of the Jordanian Government has continued to flow to the territories since 1967 in the form of wages and salaries of Palestinian civil servants, rent paid on government premises, subsidies to municipalities, guarantees on bank loans to local Palestinian institutions, direct grants, and provision of education, health and other services. This is complemented by assistance from Jordanian semi-official charitable institutions. Other Arab and Islamic sources include transfers from the Jerusalem Fund, the Arab Fund for Economic and Social Development and the Jordanian-Palestinian Joint

Committee. That Committee, which was created in 1978, serves as an institutional arrangement to channel Arab aid for the "steadfastness" of the Palestinians in the territories.

56. The Joint Committee has been able to channel significant amounts of Arab funds into various socio-economic sectors of the territories and to manage those funds. The share of the Committee in total Arab funding in the territories had reached four fifths. However, aid from this source began to decline in recent years owing primarily to unfulfilled commitments of donors. Nevertheless, the magnitude and breadth of its operations, coupled with the active role played by local Palestinian institutions in development projects, illustrate the capacity of the Palestinian people to direct and manage resources in different social and economic activities. Much of the resources channelled have gone into education followed by health services, municipalities, welfare, housing, agriculture, small industries and artisans. Through its vast experience and relations with a large number of institutions, both in and outside the territories, the Committee has, in effect, served as a development agency and has increasingly provided a forum for stimulating an integrated approach to dealing with economic and social issues confronting the territories.

57. Despite these successes, however, the work of the Committee has suffered from a number of difficulties. These include the constraints imposed by the occupation authorities on the entry of funds into the territories, staffing and managerial inadequacies, problems related to project formulation, a total freeze in Arab contributions, implementation and evaluation of loans including field supervision, and others. These shortcomings deserve serious examination at this critical time and especially as resources have again begun to be made available to it for investment in the territories. Both within the framework of the Joint Committee and local Palestinian institutions, there exists a great potential for further development of the indigenous capacity to formulate, evaluate, programme and co-ordinate present and future international aid efforts to the territories.

58. Non-Arab international sources of finance comprise mainly those of the United Nations system and international private voluntary organizations that also disburse much of the official aid from the United States of America and European countries to the territories; recently the European Economic Community has also emerged as a separate source, however small. The bulk of assistance under these sources has continued to be provided by the United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA) in such social welfare and development areas as education, health, shelter, sanitation and other basic welfare services to refugees throughout the territories. The contribution of UNRWA is increasingly being supplemented by contributions from other United Nations organizations, including the special programme of the United Nations Development Programme, which has been concentrated on education and infrastructural activities, and those of other agencies in various areas within the context of a United Nations programme of economic and social assistance to the Palestinian people as called for by the General Assembly. Private voluntary organizations have also stepped up their assistance in various areas through a large number of projects ranging from humanitarian to welfare and some developmental activities benefiting agriculture.



59. It should be noted, however, that irrespective of the source, the approval of the number and nature of proposals for funding has often reflected considerations not in line with the apparent ranking of priority needs of the territories. Therefore, while locally perceived and expressed priorities have an initial effect in determining the pattern of deployment of external aid in the territories, the final outcome has been altered by various other factors. These include donors' preferences, operational and technical considerations and the policies of the occupation authorities towards the nature and direction of external aid.

60. On the whole, external aid has largely consisted of grants, primarily because of the lack of institutional finance facilities to assist in making local counterpart funds available whether at the public or private sector level. The loan component of projects was originally witnessed in the territories in funding by the Joint Committee. Only recently have direct or revolving fund arrangements also been considered a suitable tool for the delivery of external aid through private voluntary organizations. However, the amount of resources that could be allocated for the revolving fund arrangements has been rather limited.

61. An increase in the use of external aid is dependent not only on the relaxation of procedures for the approval of projects but also on the creation and development of local financial institutions capable of providing local counterpart funds. Along with greater involvement of local financial institutions in the channeling and management of factor income and remittance flows and a strengthening of the local Palestinian capacity to influence the deployment of aid to the territories, increased local participation in financing development efforts can assist in providing a more effective utilization of external financial resources.

#### Notes

a/ The present text is chapter V of the study entitled "The Palestinian financial sector under Israeli occupation". The complete text will be circulated as a document of the United Nations Conference on Trade and Development under the symbol UNCTAD/ST/SEU/3.

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