



Palestinian Fiscal Revenue Leakage to Israel under the Paris Protocol on Economic Relations



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Executive Summary

The Protocol on Economic Relations, also known as the Paris Protocol, was signed in 1994 between the Palestine Liberation Organization and the Government of Israel. It remains the general framework that governs Palestinian trade relations and economic, business and tax policies. The chronic structural distortions and problems arising from this framework were not limited to the general performance of the Palestinian economy. Rather, the framework determined the main sources of Palestinian fiscal revenue by placing the trade relations in the context of a unilateral, semi-customs union. More important still is the unilateral and selective application by Israel of the basic conditions of the Protocol. This gives the Israeli Government a disproportionate influence on the collection of Palestinian fiscal revenue, leading to deficiencies in the structure and collection of customs duties resulting from direct and indirect importing into Palestine.

This study focuses on the Paris Protocol sections dealing with imports, customs and value added tax (VAT) policies, highlighting its main shortcomings. These stem mainly from the fact that the Protocol is outdated and related to a transitional period that was supposed to end in 1999. As a result, it no longer addresses the current challenges before the Palestinian economy or its prospects within an independent Palestinian State; neither does it mention the lack of Israeli commitment to the terms of the Protocol, such as the obligation to transfer to the Palestinian National Authority its full financial entitlements to the collection by the Government of Israel of purchase taxes and customs duties on Palestinian imports cleared through Israeli ports of entry.

The study reviews in detail all the tax and customs policies arising from the Paris Protocol and the Israeli tax system which it embodies, as applied in the Occupied Palestinian Territory. The policy framework has caused continued instability and uncertainty for the Palestinian treasury, fiscal leakage resulting from a restrictive trade relationship that allows for indirect imports through Israel, minimal Palestinian control over the flow of external trade, inconsistencies in the working mechanism for collection of purchase taxes and evasion of customs duties. The study finds that these problematic issues are largely caused by the type of trade relationship engendered by the Paris Protocol and the Israeli logic in applying it.

The study also proposes a methodology to estimate fiscal leakage resulting from importing from or through the Israeli market, and the ensuing evasion of customs duties. This estimate is made on the basis of official Palestinian statistics of total imports from Israel. Customs duties evasion is estimated by identifying relevant percentages and indicators from the available data. The analysis shows that fiscal leakage from the aforementioned sources exceeded \$310 million in 2011, equivalent to 3.6 per cent of total gross domestic product (GDP) and 18 per cent of the tax revenue of the Palestinian National Authority. Around 40 per cent of the fiscal leakage is related to direct and indirect imports from Israel, and the remaining 60 per cent is in the form of evasion of customs duties.

The study suggests a number of recommendations pointing to the pressing need to change the modus operandi of the Palestinian import regime to ensure Palestinian rights in all economic, trade, financial and taxation areas. This will require new trade arrangements that cover borders, customs and a tax collection mechanism to prevent fiscal leakage to

Israel. With regard to indirect imports, information should be exchanged regularly between the Palestinian and Israeli authorities, customs and monitoring systems should be developed and the Government of Israel should acknowledge Palestinian financial entitlements to purchase taxes on goods made in Israel and sold on the Palestinian market and to the customs duties and purchase tax revenue collected on products indirectly imported through Israel.

Abbreviations

GDP	gross domestic product
ILO	International Labour Organization
IMF	International Monetary Fund
MAS	Palestine Economic Policy Research Institute
PCBS	Palestinian Central Bureau of Statistics
VAT	value added tax
WTO	World Trade Organization

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Chapter I – Motivation and Approach

A. Background

The signing in April 1994 of the Protocol on Economic Relations (Paris Protocol) between the Government of Israel and the Palestine Liberation Organization, also known as the Paris Protocol, signalled a new era of economic and trade relations for the Occupied Palestinian Territory. Thereafter, Palestinian trade and economic policies became formally governed by the Protocol's framework. These were related to taxation, customs and trade; import and export procedures; standards and criteria; and certificates of origin. Theoretically, the Protocol was designed along the lines of a customs union, with the intent to strengthen Palestinian economic relations internationally and benefit from the economies of scale that might emerge from trade with Israel. The reality, however, is different, as this relationship became an incomplete and one-sided customs union, or at best a "semi-customs union", as Israeli actually controls trade policies. As a result, the Palestinians have no autonomous financial and trade policy space.

Since 1967 Israel has been the biggest channel for Palestinian imports and exports, and the main trading partner of Palestine. Data show that the share of Palestinian trade (total imports and exports) with Israel was between 70–90 per cent of total Palestinian trade between 2007 and 2011. At the same time, the Palestinian trade deficit with Israel increased from \$2.3 billion to \$3.2 billion, accounting for 75 per cent of the Palestinian trade deficit (UNCTAD, 2012).

This study addresses the negative effects of the Paris Protocol on the fiscal revenues of the Palestinian National Authority, the manner in which the Israeli authorities apply it and the additional constraints unilaterally imposed by Israel. The study focuses on fiscal leakage from the revenue flows that the Palestinian treasury should be able to collect from indirect taxes imposed on Palestinian imports. Total indirect taxes amount to over 85 per cent of total tax revenues of the Palestinian National Authority from two main sources: the first is value added tax (VAT) on all goods, including those imported from Israel, and the second is the import tax on goods imported from countries other than Israel. The second source is of utmost importance in terms of its contribution to total revenue, amounting to over 40 per cent of total indirect taxes; this figure could rise should imports from Israel be replaced with direct imports from other countries.

There has been growing debate on Palestinian fiscal leakage to the Israeli treasury resulting from Palestinian imports from or through Israel. Therefore, the study focuses on identifying the scale of indirect imports from Israel. In the Palestinian case, indirect imports concern the entry of goods classified as non-Israeli goods – though produced in Israel or meet the condition of being of Israeli origin – to the Palestinian market. These are imported by an Israeli trade intermediary and re-exported to the Occupied Palestinian Territory as goods of Israeli origin. Therefore, the Israeli treasury, not the Palestinian treasury, receives taxes and customs fees on these goods. The study also estimates the value of goods – produced in Israel or elsewhere – that are smuggled from Israel to the Palestine, and identifies the scale of another significant source of Palestinian fiscal leakage to the Israeli treasury.

Therefore, Palestinian fiscal leakage to Israel arising from these types of imports has been an issue of concern to Palestinian researchers and decision-makers as well as

international organizations since the Protocol went into force. Several attempts were made to estimate the scale of these revenue losses – some by academic researchers, others by international organizations. However, the estimation methodologies adopted in most of these attempts depended on rough estimates and were not accurate enough to serve as a reference that could be used officially. This study therefore addresses in detail the fiscal leakage resulting from direct and indirect imports from/through the Israeli market. It uses a practical yet rigorous methodology to reach more accurate estimates. The study, however, does not take into consideration other major sources of fiscal leakage.

B. Importance, objectives and dimensions of the study

This study is the first analytical attempt to address this topic by using a statistical methodology based on a sequential series of official data from multiple complementary sources. It also aims to settle the continuing controversy over fiscal leakage estimates. The study can also serve as a reference document that explains the nature of the Palestinian tax and trade systems by offering a detailed presentation of the Palestinian indirect tax system within the framework of the Paris Protocol. The study aims to achieve the following objectives:

- Help identify the amount of Palestinian fiscal leakage and develop a mechanism to prevent it. This should support more efficient trade and taxation policies and mitigate public financial instability and consequently assist policymakers in making decisions that serve Palestinian economic interests;
- Present methodologically sound and more accurate estimates to assist in future negotiations and discussions relating to Palestinian financial conditions;
- Identify the underlying reasons for this leakage in the context of the Paris Protocol framework so as to put forward better alternatives for future trade relations between the States of Palestine and Israel.

Accordingly, this study focuses on the estimation of fiscal leakage caused by direct and indirect imports from Israeli and certain aspects of the Paris Protocol, particularly with regard to indirect taxes, taxation policies and their impact. However, the study does not explore the following points:

- Financial leakage from direct taxes imposed by Israel on the income of the Palestinian labour force working in Israel and Israeli settlements;
- Monetary aspects and losses incurred by use of the dominant Israeli currency;
- Tax evasion through undervaluation in declaration of the actual value of imported goods;
- Fiscal losses on flows of services and goods imported by the Palestinian public sector from Israel such as petroleum, electric power and water;
- A range of fiscal losses resulting from the lack of sovereignty over natural resources such as land, water and minerals.

C. Methodology

The methodology described below was used to estimate the value of VAT and purchase tax losses, and losses of taxes and customs duties resulting from indirect importing:

- Reviewing previous research to confirm the basic contours of losses, notwithstanding the estimated amounts of those losses, as well as reviewing earlier studies, especially those carried out by Israel, to evaluate the amount of indirect imports (imports through Israel of non-Israeli origin).
- Incorporating clearance revenue data from the Palestinian Ministry of Finance and data from the Palestinian Central Bureau of Statistics (PCBS) to identify the actual amount of trade with Israel and then analyse and convert these data from the Standard International Trade Classification into the Harmonized System that uses eight digits. This process is helpful for two reasons: first, to identify all goods coming from/through the Israeli market to the Palestinian market, regardless of their origin; second, to establish a database that can be used in applying taxation and customs accounting rules based on the nature and type of taxes and the nature of the customs duties that apply to each good, and then obtain the value of all types of revenue that should be collected if there was no leakage;
- Identifying all goods imported from Israel that are subject to purchase tax and consumed in the Palestinian market, and applying the equation for calculating the relevant purchase tax to calculate the amount of fiscal leakage caused by failure to tax those goods;
- Using data from the Customs and Excise Police Force to identify the amount of tax evasion accounted for and estimate the amount of goods smuggled and the amount of fiscal leakage resulting from smuggling.

D. Main components of the study

The study is presented as follows:

- Chapter I is an introduction to the study, featuring a description of the methodology and definitions of key concepts used in the study.
- Chapter II discusses the Palestinian trade and taxation system, and the direct and indirect taxes in the framework of the Paris Protocol. It provides an analytical assessment of the Protocol, its weaknesses and the overall performance of the Palestinian economy resulting from its application.
- Chapter III describes the different types of indirect taxes, mechanisms of their collection, their importance to the Palestinian treasury and contribution to public revenues and budget indicators.
- Chapter IV focuses on the types and sources of fiscal leakage, purchase taxes, customs and excise duties and the evasion of customs duties. The chapter also discusses all types of indirect imports and explains the causes of fiscal leakage;

- Chapter V focuses on the mechanism used to estimate each source of fiscal leakage listed below, provides an analysis of the estimates and compares them with budget and other economic indicators :
 - ✧ Leakage resulting from purchase taxes and custom duties on goods imported from Israel;
 - ✧ Leakage of indirectly imported goods;
 - ✧ Losses resulting from smuggling with regard to VAT, customs duties and purchase taxes.
- Chapter VI summarizes the conclusions, results and recommendations of the study.

E. Definitions

Indirect imports: Imported goods that are registered and treated by Israeli authorities as being produced in Israel, while in fact they are of non-Israeli origin (from a third party), or the proportion of Israeli value added is less than that in the agreed rules of origin (40 per cent of the production cost of the good).

Third party imports: Goods imported directly from countries other than Israel.

Customs declaration: Official customs document accompanying goods imported from a third party.

Clearance invoice: Official document (trade invoice) needed to import directly from Israel, which has to accompany goods transported between Israel and Palestine, as set out in the Paris Protocol.

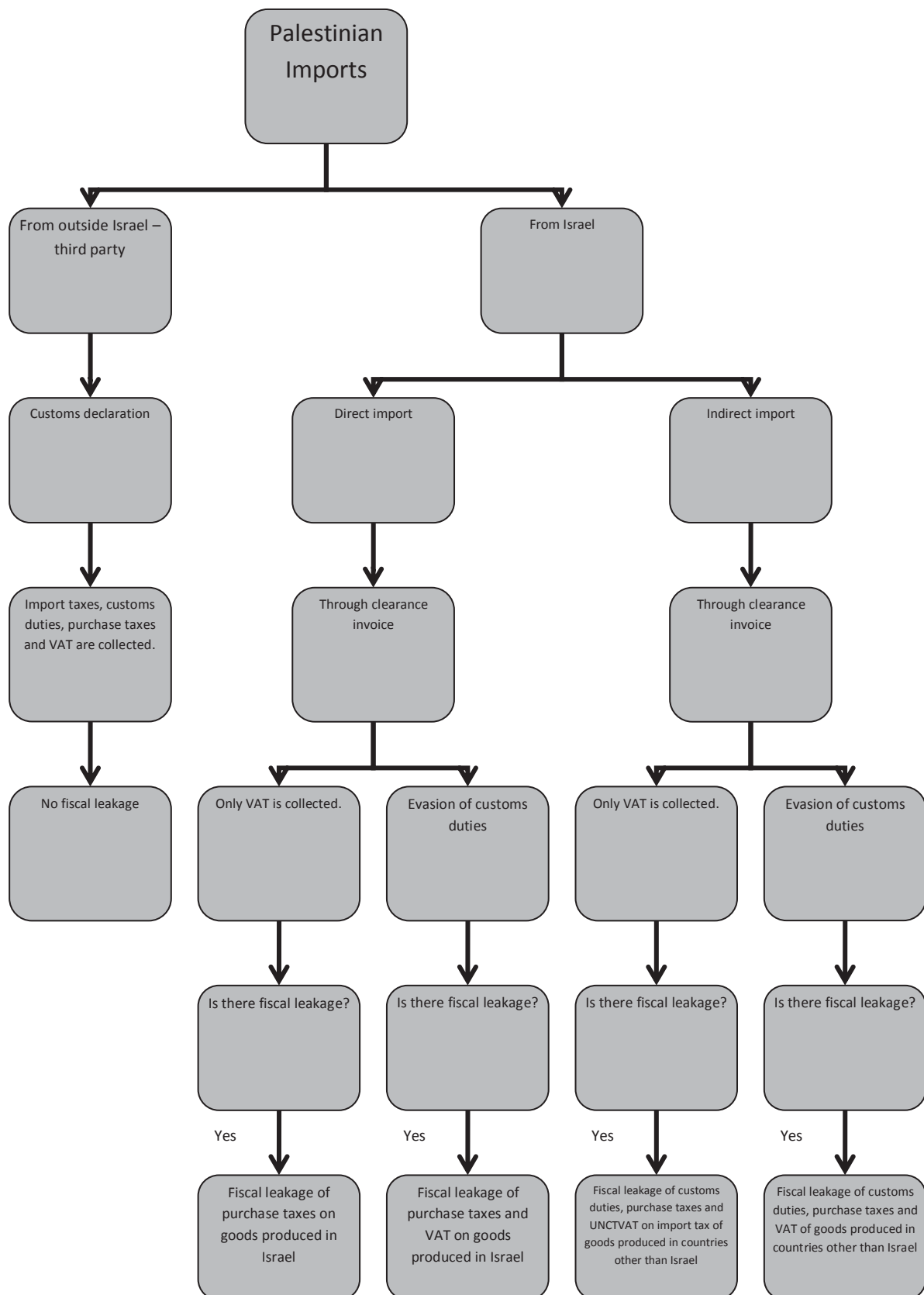
Import taxes: Taxes levied on goods imported from a third party: customs duties, purchase taxes, VAT and protection taxes.

Purchase taxes: Indirect taxes imposed by Israel on certain goods. The tax rate depends on the nature of the good (luxury goods, for example) and does not distinguish between locally produced or imported goods.

Customs fees: Customs duties are imposed in various percentages on goods imported from third parties, depending on the Israeli tariff structure.

VAT: Indirect tax (16 per cent) imposed on any commercial transaction. For imported goods, the tax is imposed on the total cost of the goods, which includes the cost of custom duties and purchase taxes, in addition to the cost of the imported goods at the port of arrival (including transport and insurance – cost, insurance and freight).

Figure 1. Movement of imported goods from or via Israel



Chapter II – The Palestinian Trade System and the Paris Protocol

A. Origins of the Protocol

The Paris Protocol was signed by the Palestine Liberation Organization and the Government of Israel on 29 April 1994. It was included as Annex IV to the Gaza-Jericho agreement of 4 May 1994. The Protocol, part of the Oslo Accords, serves as the main policy framework for the Palestinian National Authority's management of economic affairs under its jurisdiction, not only in terms of external trade relations, but also in terms of financial, monetary and other economic relations with Israel.¹

The Protocol consists of 11 articles on many aspects relevant to economic, trade and taxation policies, as well as policies relating to importing, banking, insurance, standards, specifications, agriculture, water, energy and petroleum. As such, the Protocol established the main framework governing the economic relations between the Palestinian National Authority and the Government of Israel with regard to the West Bank and Gaza Strip for a transitional period that was intended to last only five years. It was agreed to establish a Palestinian-Israeli Joint Economic Committee to follow up on the implementation of the Protocol and address any related problems, including the option for either party to request a review of the Protocol by this committee.

The provisions of the Protocol came with a number of policies aimed at reducing the subordination of the Palestinian economy to that of Israel. These policies made tangible differences in the daily economic life of Palestinians. They were given a number of instruments to manage some aspects of economic, trade and taxation policies. This started a precedent that could be built on in the future, as the Protocol affirmed Palestinian economic rights that had been previously unacknowledged, such as the right to impose direct taxes and renew direct Palestinian trade with Arab countries through provisions granting the right for the first time since 1967 to import some goods (cement, iron, petroleum) from Arab markets based on differential Palestinian trade policy treatment. The Protocol also allowed the establishment of an autonomous Palestinian Monetary Authority for the interim period to perform some limited tasks of central banks, such as financial sector supervision and regulation. However this did not include issuing national currency.

However, due to lack of, and difficulties in, the implementation of the reference Oslo Accords, the Paris Protocol has exceeded the transitory time limit for which it was designed and has been violated numerous times, especially by Israel ignoring, limiting or selectively interpreting many of the Palestinian rights under the Protocol. This has led to a

¹ The Oslo Accords were negotiated in Norway and launched with the Declaration of Principles. It was the first direct official agreement between the Government of Israel and the Palestine Liberation Organization, and was signed in Washington, D.C. on 13 September 1993. The agreement calls for the establishment of a transitional authority and a Palestinian legislative council through elections in the West Bank and Gaza Strip. It stipulates that negotiations must be completed within five years, covering the issues of Jerusalem, refugees, settlements, security arrangements and borders, as well as the relations and cooperation with other neighbouring countries. With the signing of the Gaza-Jericho Agreement in May 1994, and in accordance with this agreement, the authority and transfer of organizational responsibility of Area A to the Palestinian side began. In 1995, the Israeli-Palestinian Interim Agreement on the West Bank and the Gaza Strip was signed, and two new concepts emerged on the distribution of jurisdictions: Area B was placed under Palestinian administrative and organizational sovereignty without the security aspect, while Area C was left under Israeli administrative, organizational and security control. Area A (complete Palestinian sovereignty) covered 2.8 per cent of the West Bank and Area B, 23.7 per cent. In March 2001 Areas A and B spanned over approximately 40 per cent of the West Bank.

multitude of economic difficulties in the Occupied Palestinian Territory, which continue to exist today.

In reality the Protocol formalized the economic relations between the Palestinian National Authority and the Government of Israel in the framework of a customs union based on the Israeli customs and trade system, including taxation, while allowing some exceptions in the goods lists such as importing vehicles and petroleum (Al-Jawhari, 1995; Al-Naqib, 1996). With implementation on the ground, it became apparent that the customs union became a one-sided or a semi-customs union. With the complete use of the Israeli tariff structure, the Palestinians were not able to fully benefit from the exceptions allowed for goods imported from Jordan, Egypt or other Arab countries (Misryef, 2000).

With regard to direct trade relations with Israel, the Joint Economic Committee, which was composed of equal numbers of official experts from both sides, was supposed to solve any disputes that might arise between the two parties and make amendments to the agreement through negotiations. The Committee, however, did not perform the tasks for which it was established because Israel tied economic issues to its political and security concerns (Khalidi and Rad, 2009), which paralyzed the work of the Committee.

The Committee has been almost completely inactive since 2000, and only one brief meeting was held at the ministerial level in September 2009. At the same time, the Joint Civil Affairs Committee was formed, originally tasked with transferring some of the functions of the Israeli civil administration to the Palestinian National Authority. Instead of this Committee being dismantled when it completed its handover tasks, it continued working as a vital committee with broad tasks. It became more powerful than the Joint Economic Committee because of the Israeli political and security interests in making it the main operational framework for cooperation (El-Ja'fari, 2000; Abd Al-Razeq and Misryef, 2004). The implementation of the Protocol was hence based on imposing fait accompli instead of using negotiations and exploring mutual benefits between a small economy and a larger economy. The small subordinate Palestinian economy could not easily accommodate the liberalization path taken by the Israeli economy (Khalidi and Rad, 2009).

These disappointing realities contrasted sharply with the ambitious goals of the Protocol, originally expected to be achieved within a five-year period:

- To promote the development of the Palestinian economy and Palestinian manufacturers through freedom of movement of goods and market access, especially to the Israeli market, without obstacles;
- To create the conditions and an environment for trade growth through market diversification based on equal relations and fair trade;
- To tackle the structural problems of the Palestinian economy and transforming it from a distorted economy dependent on Israel to a productive self-reliant economy by implementing appropriate financial and trade policies and exploiting the exceptions and margin allowed under the Protocol.

Nonetheless, difficulties soon emerged; after a few years of economic improvement and growth, the economy slowed down; growth in exports ceased. There was no diversification of external markets, and the Palestinian economy remained subordinate to the economy, trade policies and security procedures of Israel. Various studies of the

Protocol identified the reasons for its growing failures, and many proposals were made on how to improve and develop it. However, policymakers did not take the shortcomings seriously enough to prompt negotiations to amend the terms of the Protocol or improve its implementation (Khalidi and Rad, 2009; World Bank, 2009; Palestinian Monetary Authority, 2005 and 2007).

B. Major weaknesses of the Protocol

The Protocol included a preamble considered to be an integral part of the agreement. Article I revolves around the framework, objectives and scope of the Protocol. Article II addresses the tasks and rules of procedure of the Joint Economic Committee. The subsequent articles focus on organizing external trade relations and economic policies, including import policies and taxes, clearance mechanisms, customs issues, and direct and indirect taxes. Article IV focuses on banking, money and monetary policy, while the remaining articles discuss cooperation and coordination in labour, agriculture, industry, tourism and insurance.

1. General principles of the Protocol

The economic agreement came as an annex to the Oslo Accords and Gaza-Jericho Agreement and their security aspects. This indicates that the negotiations were not based on a purely economic framework, but rather were part of a broader political agreement. The Protocol avoided the establishment of trade borders between the two sides and instead adopted a customs union. Additionally, the agreement did not depend on clear rules to solve trade disputes and left it to the dysfunctional Joint Economic Committee.

The Protocol stressed that the West Bank and Gaza Strip were a contiguous geographic unit, which implies the freedom of movement of people and goods within the Occupied Palestinian Territory, and free access to Israeli port facilities and crossing points to Arab countries. However, instead of allowing the movement and transportation of goods between the West Bank and Gaza Strip, the two areas were completely separated, and procedures obstructing movement were imposed, including an almost continuous closure policy imposed on the Occupied Palestinian Territory with a complete economic siege in Gaza since 2007. Palestinian businessmen, clearance agents and customs officers are denied entry to Israeli ports to clear Palestinian imports.

The most favoured nation principle was not taken into consideration, and Palestinian trade relations were bound to Israeli trade relations with the rest of the world.² Israel has refused to recognize the trade agreements signed by Palestine with other countries. The Palestinian economy was not treated as a weaker economy with a different structure than that of Israel, as the same tariffs and pace of liberalization applied in Israel were imposed on the Palestinian National Authority.

The Protocol was structured as if the economic relationship between the two sides were a customs union. While that was theoretically the case when viewed practically, it is clearly a one-sided and deficient customs union whereby the Palestinian side cannot fully practice customs operations, and there is no Palestinian presence on the borders and crossings. Additionally, the Joint Economic Committee, which is the decision-making

² The most favored nation principle is one of the cornerstones of the trade rules of the World Trade Organization (WTO). It obligates WTO members to give all members the same treatment and benefits, such as lower customs tariffs. Some exceptions are allowed for developing countries, regional free trade zones and customs unions.

mechanism, is effectively subject to an Israeli security veto. Therefore, the only mechanism for making joint economic decisions is defunct, leaving the Palestinians no margin for movement. Consequently, by the early 2000s they had lost confidence in ever witnessing a faithful implementation of the Protocol (El-Ja'fari, 2000; Abd Al-Razeq and Misyeef, 2004).

2. Financial, trade, tax and customs policies

Article III of the Protocol addresses issues relating to import, export, trade and tax policies relevant to moving Palestinian goods between and through Israel. The Protocol imposed on the Palestinian National Authority Israeli policies on customs, customs tariffs, indirect taxes, standards, specifications and health requirements, with some exceptions that allow the Palestinian National Authority to impose a minimum price on petroleum products, with prices as much as 15 per cent lower than Israel. Additionally, Palestinian VAT should not be less than 2 per cent than that applied in Israel, while both parties apply the same purchase tax percentages on domestic and imported goods.

In the same context, a limited margin of manoeuvre was made available to Palestinians in relation to the expansion of the exempted goods lists, freedom of movement, the use Israeli ports and crossings, and the responsibility of the Palestinian customs authorities in facilitating and processing customs procedures. Israel practices a discriminatory policy whereby no Palestinian importers, clearance agents or customs employees are allowed to be present at Israeli ports or crossings. Additionally, the cost of Palestinian production increased, as the same customs rates and purchase taxes were applied to Palestinian imports. This, however, does not take into account the gap between both economies and has made it difficult for the Palestinian economy to compete locally and access international markets, all of which run counter to the objectives of the Protocol (El-Ja'fari and Al-Ardah, 2002).

This led to the diminished welfare of Palestinian consumers and encouraged further importing from Israeli markets, and Israeli importers by importing of non-Israeli goods indirectly or consuming smuggled goods from or through Israel. Therefore, the financial resources of the Palestinian National Authority composed of taxes on imports are actually leaking at several points, whether by indirect importing through Israel or smuggling and tax evasion (Al-Naqib, 2003).

Annexing the Paris Protocol to the Oslo Accords ruled out the possibility of the Palestinian National Authority developing its own financial, trade and taxation policies, as it must observe changing Israeli customs tariff rates and procedures. Further, the Palestinian National Authority has been deprived of the right to develop its own customs tariff structure or to reduce the VAT by more than 2 per cent in a manner reflecting the development interests of the Palestinian economy. This has deepened the dependency of the Palestinian trade sector on Israel, which has stunted the autonomous growth of the Palestinian industrial sectors and their ability to create job opportunities, thus reinforcing Palestinian dependency on work in Israel. Additionally, the high costs and limits placed upon the import of intermediate and capital goods has pushed up prices of Palestinian agricultural and industrial goods and dampened competitiveness (World Bank, 2002).

3. The Paris Protocol and Palestinian economic performance

An honest evaluation of the Protocol cannot turn a blind eye to Palestinian economic performance since the 1990s. Despite the growth rates achieved by the Palestinian

economy in some periods, it was unable to achieve sustainable growth due to enforced dependency on international aid and grants, continually shrinking production capacity, rising unemployment, the lack of public fiscal sustainability and the chronic structural disorders.

The majority of studies, reports and statistical data confirm that the Palestinian economy has undergone a sharp decline during the past decade in particular. As of the end of 2000, the structural distortion of the Palestinian economy became very clear, and numerous economic disorders led to increased Palestinian dependency on donor aid (World Bank, 2009).

Reports produced by the International Monetary Fund (IMF, 2012a and 2013) indicate that the economy has clearly deteriorated, and the fiscal position is on an unsustainable path. This can be attributed to continued Israeli restrictions, increased political instability, a deep public finance liquidity crisis and a surge in local arrears and government debt, all of which have adversely affected basic government operations. The reports show that it is urgent for the Palestinian National Authority, the Israeli Government and donors to take measures to achieve fiscal stability and revive economic growth (IMF, 2013).

The deteriorating economy of the past decade has been consistently reported by international organizations such as UNCTAD, especially in reports issued in the past four years. Consider the following developments:

- Dependence on the Israeli market has continued, with imports from Israel reaching over 80 per cent of total Palestinian imports of \$3.5 billion in 2011, while exports to Israel of \$750 million accounted for 90 per cent of total Palestinian exports;
- The trade deficit with Israel has grown, reaching more than \$3.7 billion in 2012 – over one third of GDP – compared with \$1.5 billion in 1999;
- The rising overall unemployment rate reached 27 per cent in 2012 and that of youth, 35 per cent. The number of registered Palestinian workers in Israel decreased from 160,000 in 1999 to 60,000 in 2012;
- The swelling budget deficit caused by increased government expenditures and low revenues reached \$1.7 billion in 2012, compared with \$260 million in 1999;
- Increased dependency on external aid and grants reached \$1.4 billion in 2010, compared with around \$300 million annually prior to 2001, powering aggregate demand and growth and effectively covering the budget deficit;
- Competitiveness of Palestinian goods declined because of the restrictive provisions of the Protocol and Israeli procedures. The Palestinian National Authority was unable to support infant industries, impose protective duties to encourage local production or withstand the increase in transaction and production costs as a result of Israeli-imposed restrictions and the attrition of at least one third of the productive base since 2000;
- Israeli border procedures have limited the Palestinian National Authority's ability to enjoy a variety of trade relations and markets with the rest of the world, especially Arab countries. This has further contributed to weakening the productive base and

increasing dependency on the Israeli occupation in all legal, administrative and economic areas of life;

- The UNCTAD publication entitled “*Rebuilding the Palestinian Tradable Goods Sector: Towards Economic Recovery and State Formation*” (2011a) showed how Palestinian trade over four decades suffered from the relationship between two unequal partners. UNCTAD has also shown that the convergence in the income levels between the two partners that was expected by conventional trade theory to result from the application of the Protocol never occurred; on the contrary, the gap widened and divergence has continued (Khalidi and Rad, 2009).

Therefore, the Protocol failed to promote a positive transformation of the Palestinian economy and/or correct the imbalance in economic and trade relations between Israel and the Occupied Palestinian Territory (UNCTAD, 2001). Some studies have stressed the necessity of strengthening the capacity of the Palestinian private sector, supported by an active role of the State in protecting its productive capacity and promoting and facilitating freedom of trade, which cannot be achieved under the current economic framework. Israeli customs tariff and trade policies are not in line with Palestinian economic and trade capacities, while the Palestinian National Authority is not allowed to benefit from the available margins and exceptions relating to the commodities and goods lists, specifications, standards and quantities (World Bank, 2011; IMF, 2011; UNCTAD, 2011a).

C. Proposals for amending the Paris Protocol

As stated previously, owing to the asymmetric relationship between the two parties, the Palestinian economy has become subordinate to and completely dependent on the Israeli economy, which has constrained its development prospects. In addition, growth in exports has slowed considerably, and economic policy tools remain subject to the Israeli economy and security prerequisites. To remedy this situation, some studies have stressed the need to strengthen the capacity of the Palestinian private sector, supported by an active public sector role in protecting productive capacity and promoting and facilitating freedom of trade, all of which cannot be achieved under the current economic framework and one-sided customs union (World Bank, 2011; IMF, 2011; UNCTAD, 2011a). In the same vein, an independent economy will be elusive unless the Palestinian National Authority enjoys complete, direct and natural control over trade, monetary and tax policies.

In light of the generally poor performance of the Palestinian economy, it is unreasonable for the Government to remain subject to an interim agreement signed 18 years ago, the framework of which is inadequate and distorted. There appears to be an urgent need to find new economic and trade arrangements that produce maximum benefits for the Palestinian economy by reconsidering the terms of the Protocol and gradually leaving the closed circle imposed by this agreement. This calls for a series of decisions to establish a sound new basis for the economy, along with appropriate economic, trade and monetary arrangements. A feasible Palestinian economic developmental vision calls for economic cooperation with Israel through a mutual recognition of the rights of two independent economies to manage their own economic affairs. Likewise, the capacity of Palestinian economic decision-makers to control their own borders and develop and control economic, trade, financial, monetary, fiscal and

investment policies reflecting the realities of the Palestinian economy and its special needs should be recognized.

Until a comprehensive national framework aimed at achieving complete economic independence for the State of Palestine can be drawn up, it would be advisable to look towards new trade and economic arrangements that take the following points into consideration:

- The need to pursue a strategic approach to dismantle Israeli economic control and gradually break away from it, while adopting policies and arrangements that promote Palestinian economic integration in Arab, regional and international economies in order to establish economic independence;
- To guarantee the support of the international community in raising awareness of the need for Palestinian economic independence and ensure its preparedness to support Palestinian development initiatives aimed at facilitating trade and promoting geographic and economic unity;
- Enforce paragraph four of the Quartet Statement of 23 September 2011, which establishes the grounds for the Palestinian National Authority to practice further (economic) sovereignty as follows: “...Quartet will consult to identify additional steps they can actively support towards Palestinian statehood individually and together, to secure in accordance with existing procedures significantly greater independence and sovereignty for the Palestinian National Authority over its affairs”.³

In this context, the following suggestions are made to allow for the gradual easing of the restrictions imposed by the Paris Protocol:

- In the short term:
 - To stress the Palestinian National Authority’s right to practice its own decision-making in all economic, trade, financial, taxation, infrastructure and natural resources in all areas of the territories occupied since 1967. This includes many issues, such as placing Area B and Area C under Palestinian jurisdiction and the right to invest and build infrastructure in these areas, issue Palestinian currency, set customs and taxing policies and use natural resources;
 - To agree on trade crossings with Israel and international trade crossings that facilitate the movement of goods and identify the Palestinian working mechanism at these crossings, including the right to have Palestinian officials present at these crossings to organize and control the movement of persons and goods;
 - To make preparations for the establishment of customs zones, including customs warehouses in the Occupied Palestinian Territory within a transit system to move goods from Israeli borders to Palestinian areas and complete all customs documents in these zones;
 - To take steps to guarantee the freedom of movement of persons and goods on the borders with Jordan and Egypt for merchants, without any obstacles, customs or

³ See http://www.un.org/News/dh/infocus/middle_east/quartet-23sep2011.htm (accessed 11 June 2014).

other, based on WTO rules and standards, the provisions of the Paris Protocol and the principles of the Agreement on Movement and Access (2005) under the supervision of the European Union; to implement them at the Rafah and Al-Karamah border crossings;

- To draft a set of new trade, financial and monetary policies that take into account the special conditions of the Palestinian economy, by:
 - ✧ Identifying the policies on direct and indirect taxes, including the customs percentages, purchase tax, and others;
 - ✧ Developing a fiscal policy on revenues and collection mechanism that is based on exchanging information between the Palestinian and Israeli sides to guarantee the collection of all revenues to overcome the problem of indirect imports through Israel and the fiscal leakage resulting from it;
 - ✧ Strengthening trade relations and agreements with the outside world, especially Arab countries and Europe;
- To develop technical and institutional skills to issue a Palestinian currency under optimal conditions and manage an autonomous macroeconomic policy;
- To carry out special institutional building for external trade and establish the conditions to organize this sector in terms of the following factors:
 - ✧ Managing the borders for the movement of persons and goods;
 - ✧ Customs and control staff and systems on goods, revenues and efficient direct collection;
 - ✧ Administrative systems in accordance with international standards and based on the best practices principle and the standards of WTO and the World Customs Organization;
- In the medium term:
 - Enforce the safe trade passages between Israeli ports and territories of the Palestinian National Authority;
 - Work on preparing the legal environment for external trade and establishing relations with international and regional organizations, including WTO, the World Customs Organization and Arab economic organizations;
 - Identify the necessary strategic trade and related transport infrastructure based on sovereignty over natural resources and full jurisdiction over the Palestinian territory including Area C.

After evaluating the overall performance of the Palestinian economy and the distorted economic relation with Israel under the Paris Protocol, it is clear that the expected economic growth and improvement has yet to materialize. Therefore, new directions are needed if any economic and trade agreement is going to be able to raise Palestinian living standards and achieve independence. This may have been what the Palestinian negotiators in Paris had tried to achieve. However, after two decades of applying the Protocol from the

Israeli perspective, the only reasonable deduction is that the Palestinian economy must be liberated from Israeli occupation and that the Protocol must be reconsidered in the light of Palestinian economic realities that have greatly changed since 1994.

Chapter III – The Palestinian Taxation System

The Palestinian taxation system is based on the structure of that of Israel as codified in the Paris Protocol. The system is composed of two parts: direct taxes and indirect taxes. The latter are the focus of this research.

A. Direct taxes

Direct taxes consist of income and property taxes. Property taxes are imposed on the tax base according to the income of an individual or a corporation or in terms of real-estate ownership, which is subject to direct taxes whether or not income is generated. In contrast, income tax is imposed on profits, salaries or labour deductions. The Protocol regulated direct taxes in article V, which stipulates that “Israel and the Palestinian National Authority will each determine and regulate independently its own tax policy in matters of direct taxation, including income tax on individuals and corporations, property taxes, municipal taxes and fees”. The same article states that Israel will transfer 75 per cent of the income taxes collected from Palestinian workers in Israel and 100 per cent of the taxes collected from Palestinian workers in Israeli settlements, while Israel also deducts social security taxes and health insurance from Palestinian workers in Israel. These deductions are not transferred to the Palestinian National Authority treasury despite the fact that the workers do not receive social security or health insurance benefits in return for these taxes. This means that millions – if not billions – of dollars of acquired rights of Palestinian workers in Israel are lost to the Palestinian treasury.

B. Relative importance of direct and indirect taxes

Direct taxes on income are of great importance in both advanced and developing countries. The percentage contribution of direct taxes to revenues is an indicator of a country's economic advancement. They are more significant in advanced countries than in developing ones; they contribute up to 50 per cent of public revenues in advanced countries, but do not exceed 30 per cent in developing countries (Al-Wadi, 2007; Khalaf, 2007). Advanced countries mainly rely on direct taxes to fund general expenditures, unlike developing countries, which rely more on indirect taxes because direct taxes are dependent on the production and exporting capacity of persons and corporations, thus their ability to pay taxes. These taxes are characterized by abundant collection due to the broad taxation base in advanced countries.

Indirect taxes, however, mainly focus on the trade sector, and the end user is the one who pays for those imports. There are several reasons why developing countries depend on revenue from indirect taxes to fund their current expenditures:

- Weak production and industry and low salaries in the public sector sometimes make a country more of an importer rather than a producer. Therefore, the contribution of external trade to GDP grows, leading to larger customs revenues (Taqa and Al-Azawi, 2007);
- Easier collection of indirect taxes, especially since a large portion of them are collected on imported goods at borders through customs documentation;

- Low taxation awareness in developing countries and lack of commitment in paying direct taxes and announcing them due to negative public opinion towards government services and its weak collection abilities;
- Because of the low levels of household income and poor income distribution of income in many developing countries, taxation policies tend to focus on indirect taxes.

Since Palestine is characterized as a developing economy with low income levels, the Palestinian National Authority has reconsidered income tax laws to reduce the taxation burden on citizens. Personal income taxation rates were changed so as not to exceed 25 per cent, compared with ceilings of 38 per cent in Israel (Palestinian Income Tax Law of 2005). The contribution of indirect taxes to the total tax revenue of the Palestinian National Authority exceeds 85 per cent of total revenue, while direct taxes contribution to the Palestinian National Authority treasury in the period 1996–2011 varied from 4–6 per cent of total tax revenues. This confirms that many obstacles remain to developing Palestinian taxation policies, public awareness and commitment (Sabri, 2004; Othman, 2007).

The Paris Protocol did not impinge on the Palestinian National Authority's direct taxation policies except those relating to Palestinian workers in Israel, taking into consideration the existence of illegal, undocumented workers in Israel, as the Protocol did not address this issue. As a result, the Palestinian National Authority did not collect income tax from these workers. Some studies estimate that around 30 per cent of workers enter Israel without a work permit, which leads to yet another channel of fiscal leakage from the Palestinian National Authority treasury (Palestine Economic Policy Research Institute (MAS), 2013). Additionally, the Israeli policies of siege, closure, confiscation of land and control over Palestinian water resources have led to diminished investment, production and employment, and in turn, a shrunken tax base and smaller direct tax revenues for the Palestinian National Authority treasury.

C. Indirect taxes

Indirect taxes (customs duties on imports, purchase taxes, VAT and excise taxes) are those taxes that are imposed on goods and services when they are produced, sold, purchased, traded, consumed or imported. These taxes directly and indirectly are reflected in prices; therefore, they are the consumers' disposable income, especially that of the middle and lower strata of society. A large portion of the Palestinian National Authority's fiscal leakage originates from these taxes due to importing from or through Israel. Palestinian indirect taxes can be broken down into two categories:

- Indirect taxes on imports from Israel. According to article VI of the Paris Protocol, VAT resulting from purchasing products from the Israeli market should be calculated based on the clearance bill mechanism, a document that proves purchase or sale of goods between the two markets and is a condition for clearance revenue between the two sides. This bill with both the Israeli form (I) and Palestinian form (P) is the only official trade document accompanying the movement of goods and services flowing between the two markets. Additionally, the purchase tax on locally produced goods is subject to clearance between both sides based on the principle of collecting tax according to the intention or end use of the good.

- Indirect taxes on imports from countries other than Israel. Article III (15) of the Paris Protocol states that all revenues from taxes on imports from countries other than Israel, that come through Israeli crossings, must be transferred to the Palestinian National Authority within six working days, as long as the end use is the Palestinian territory. These revenues include all taxes and duties listed in the customs declaration accompanying the imported goods (customs duties, purchase taxes, VAT and excise taxes).

1. Customs

The customs regime is concerned with applying the State's trade, industrial and fiscal policies. It is used to imposing customs duties on goods coming in and out of the country. In accordance with the law, the customs regime could be used to encourage local production of some goods, limit imports of others, raise fiscal resources for the country, or control the importation of certain types of goods. Customs duties are different from other taxes. They are more flexible, have certain exemptions and different rates applied to different commodities in accordance with the law, trade agreements between countries and the global multilateral trade system (Othman, 2007).

All types of customs duties are listed in the customs tariff book, which contains a set of provisions, procedures and rates that regulate customs in any country and is the guiding document for trade and customs policies. The tariff book also aims to simplify and organize external trade and facilitate the compilation of accurate statistics on the movement of goods to help draft trade policies of the country. The customs tariff table includes the names and descriptions of tariffs as well as the form and average rate of customs duties for each good separately. (Al-Sudani, 1996; Al-Sareeti, 2008).

As stipulated in the Paris Protocol, the Palestinian National Authority customs tariff structure is the same as that of Israel, which also includes additional taxes (columns) such as the purchase tax, protection fees, and a "raising" percentage. This tariff system was imposed on the Occupied Palestinian Territory during the 1967 occupation and eventually formalized as part of the Protocol's one-sided customs union. As mentioned previously, the Palestinian National Authority has little leeway to determine the rates of fees in the customs tariff table, which is limited to determining the tariff on some goods imported from Jordan, Egypt and some other Arab countries (not exceeding 24 items). However, the majority of customs and tax rates are set and modified over time according to the needs and evolution of the economic situation in Israel without considering Palestinian needs, thus exclusively serving the interests of the Israeli economy.

Customs duties are an important financial resource for developing countries, usually constituting between 20 and 50 per cent of total public revenues. Therefore, any decrease in the tariff rate or fiscal leakage from this source can harm the economic interests of any country, specifically leading to a decline in public spending. In the Occupied Palestinian Territory, customs revenues account for a quarter of total public revenue. Any decrease in revenue from this source has a negative effect on Palestinian economic growth by reducing the means of public investments in health, education, infrastructure and communications that are complementary to crowding in private investment (UNCTAD, 2011b).

2. *Purchase tax/production tax*

Taxing specific goods such as alcohol or cigarettes, whether produced locally or imported, has drawn the attention of economists and policymakers in the past few decades as a tool to achieve various social, fiscal and environmental goals. Such taxes are imposed on goods directly after they are produced, when purchased, or when imported. These taxes are calculated as an additional part of the cost of goods, leading to an increase in the price of the good. As such, consumers and producers carry the burden of these taxes in different rates, depending on the elasticity of supply and demand. This type of tax sometimes aims at maintaining a certain level of revenue from imported products that are not produced locally. For example, the purchase tax on vehicles in Israel is 75 per cent despite the fact that these vehicles are imported and not produced in Israel. But this tax is not part of the customs tariff book and thus it does not affect average customs tariff rates, nor does it violate WTO trade liberalization rules.

The purchase tax has been imposed in the Occupied Palestinian Territory since 1967 in accordance with Israeli military orders 31, 643 and 740, the Israeli purchase tax law of 1952, law No. 1/1962 and other Israeli laws (Alawneh, 2000; Sabri 2004). To avoid confusion, the term “purchase tax” will be used in this study to refer to purchase, production or excise taxes in line with the terms used in official taxation documents.

While the purchase tax is paid by the importer, a part of this tax is paid by the end user of the good because it is part of the production cost or a part of the sales price and is reflected in the price paid by the end user. The purchase tax is part of the applied tariff table with the addition of what is called an “uplift rate” only on some imported goods.⁴ However, the uplift rates are not applied to local goods, which could be a way to protect local production and avoid dumping.

The purchase tax is different in terms of concept and characteristics from customs and VAT. It is levied only once on some goods and is included in the price of the good,⁵ unlike VAT which is paid at every transaction and added to the price of the good. It is also different from customs that are imposed on imported products only; it is imposed in high rates on goods that have negative effects on the environment and health, it is also imposed on complementary goods and goods with high profit margins such as cars, car parts, cigarettes, alcohol, fuels and cosmetics. (Misryef, 2003).

Israel applies this tax in accordance with the Purchase Tax Law of 1952, which helps protect local production and maintain Israeli economic and fiscal interests. Levying this tax has effectively weakened the competitiveness of similar Palestinian goods. Although it is imposed on both Palestinian and Israeli goods and imports to both markets, Israeli goods do not suffer from trade complications, high transportation costs or the lack of appropriate infrastructure. Further, Israeli goods, unlike their Palestinian counterparts, can benefit from economies of scale. As a result, the Palestinian Ministry of Finance issued several decisions and instructions between 1999 and 2005 not to collect the purchase tax on

⁴ Raising or uplift percentage: a percentage of the purchase tax rate applied on imported goods only with different rates based on the type of good in order to increase the purchase tax rate or percentage for protection objectives and to maintain competitiveness of local products by allocating a column for this rate in the Israeli tariff table.

⁵ VAT is imposed on all transactions or sales, meaning that it can be transferred from one merchant to another ; therefore, it is referred to as a “transfer” or “moving” tax until it reaches the end user, who pays it at the end. The purchase tax is imposed only once when the good is produced or imported, and the end user also pays part of it.

chemicals and pharmaceuticals as well as most Palestinian goods, except for cigarettes and alcoholic beverages. (Misyef, 2003).

3. Israeli amendments to the tariff and purchase tax structure and effects on fiscal leakage

Israel amends its trade and taxation policies frequently. Through these amendments, changes are introduced to the structure of the customs tariff table and purchase tax policies. However the amendments ignore the Protocol provision stipulating that trade and economic policies are to be coordinated between the two parties. This further shrinks the Palestinian National Authority's trade and economic policy space, makes it increasingly difficult to plan and predict revenue, and dampens competitiveness.

In the four years leading up to the Paris Protocol, Israel made major amendments to the customs tariff structure on some customs duties and purchase taxes, including a reduction concerning goods that are easy to smuggle, such as small audio and office equipment, computers, telephones, printing equipment and some electric devices. A structural amendment was also made to the tariff table by adding a column for trade agreements for all countries that have trade agreements with Israel. This amendment also included the structure of customs and tax rates in accordance with Israel's membership of WTO and the World Customs Organization. The effect of these amendments was to raise Israeli consumption of these goods, increasing trade flows and thus indirect revenue in Israel by 7 per cent in 1994.

Israel continued to amend its trade policies after signing the Paris Protocol without reference to this bilateral agreement and its direct Palestinian partner in economic relations. Therefore, it has absolved itself of all commitments regarding coordination and consultation through the Joint Economic Committee, even though articles II and III of the Protocol stipulate that any changes in import taxation policies are to be made known beforehand and in consultation between the two parties.

Israel suddenly cancelled or reduced the purchase tax on some essential goods on 15 August 2000. This came after two years of preparations and negotiations by the Palestinian National Authority concerning purchase tax revenue due to it; great efforts were made in cooperation with international partners to settle all pending economic issues in the interim period, most importantly the purchase tax. However, these efforts were in vain, as the Government of Israel decided two years after it had signed the Wye River Memorandum⁶ to cancel or reduce the purchase tax on a large number of goods. The amendment covered 630 goods out of 1300; 321 were completely exempted from this tax and the tax was reduced by around 25–75 per cent on 309 other goods. This decision served the interests of Israeli trade liberalization and structural adjustment, as the then Israeli Minister for Finance at that time had affirmed that the decision was grounded on the need to reduce the prices of certain goods to save Israeli households NIS 5,000 annually, while also reducing public revenue by NIS 1.1 billion. Overall, however, this measure has not affected the Israeli budget, as it recorded a surplus of NIS 5 billion in

⁶ The Wye River Memorandum was an agreement between the Palestinian National Authority and the Government of Israel negotiated in 1998 in Wye River, United States of America, to resume the implementation of the 1995 Oslo Accords, promote Palestinian economic development and enhance the economic relations between the two parties.

1999. The negative effects were only felt by the Palestinian economy and treasury. Palestinian companies suffered great losses in terms of the warehoused goods that had been exempted from the purchase tax or where the tax had been reduced. The value paid in purchasing these goods became less than the market value after the amendment was introduced, leading to estimated losses of \$30 million (Palestinian Ministry of Finance, 2000).

In 2000, the Palestinian National Authority determined that out of the 650 Israeli goods subject to the purchase tax, 93 enter the Palestinian market on a large scale: glass, iron, carpets, batteries, cosmetics, sanitary ware, automotive parts and so forth. It is estimated that the purchase tax on these products could reach \$72 million annually (Palestinian Ministry of Finance, 2000). Subsequently, an agreement was made on the use of a clearance system similar to the VAT clearance system, based on Form 132 on purchase tax clearance rather than a VAT clearance bill.⁷ Therefore, the Palestinian National Authority still hopes to collect the purchase tax on goods produced in Israel in accordance with article VI of the Paris Protocol and the Wye River Memorandum.

The Palestinian National Authority took steps to implement the purchase tax clearance mechanism in 2000. However, this did not meet expectations for several reasons, including the increase in smuggling and tax evasion, the lack of commitment by Israeli companies to submit the purchase tax clearance form and the failure of the Israeli customs authority to obligate Israeli exporters to fill out the form. It was subsequently revealed that while only four Israeli companies used the purchase tax clearance form, the goods of these companies were smuggled into the Palestinian market, although the official Israeli list recognized for purchase tax clearance included 50 Israeli companies. On the other hand, the official Palestinian list of Palestinian companies included seven companies, all of which have been submitting the purchase tax clearance form.

Indeed, the purchase tax is a significant source of Palestinian fiscal leakage stemming from indirect taxes. Iron, for example, is a crucial commodity subject to the purchase tax. Official statistics show that annual Palestinian market consumption of iron was around 200,000 tons, 100,000 tons of which are imported from Israel and 10,000 tons, from the rest of the world. Some 40,000 tons are produced locally, and the rest is smuggled from Israel (PCBS, 2000). Available data indicate that some 50,000 tons – 25 per cent of iron consumed in 2000 – were not recorded. This reflects the extent of smuggling one product only. It also indicates that the purchase tax on about 75 per cent of the iron consumed in the Occupied Palestinian Territory is leaked to the Israeli treasury instead of being transferred to the Palestinian treasury. There is no doubt that this amount today is much greater than in 2000, considering the increased construction activity in recent years.

Unilateral amendments by Israel to the purchase tax continue to this day. In 2012, for example, the number of goods subject to the purchase tax was brought down to only 49. Therefore, the purchase tax is only collected from imported goods that are included in the customs declaration form of goods intended to reach the Palestinian National Authority, but not from imported goods made in Israel. The latest amendment to the Israeli customs

⁷ The purchase tax clearance form is an official government form filled out by the company producing goods subject to the purchase tax and includes information on the company and the nature of the goods produced. It is attached to the clearance bill when goods are moved between the two markets. The form is submitted to the official customs and excise offices at both sides for clearance and payment.

book was issued in March 2013, cancelling all customs duties on shoes and clothing, and this sector has now become almost completely duty free.

4. Value added tax and clearance system

VAT is defined as an indirect tax levied on each transaction, whether it involves a good or a service. It is a tax imposed on the increase in the value of the transaction, meaning that it is levied on the difference between the buying price and the selling price (profit) at all stages of the transferral of goods or services from one seller or manufacturer to another until it reaches the end user.

Israel levied this tax in the West Bank and Gaza Strip in July 1976 in accordance with military order No. 658, basing it on the Law on Fees on Local Products No. 16 (1963). This system was amended in 1985, and the signing of the Paris Protocol in 1994 legitimized this tax in Palestine. The provisions of the Protocol stipulate the following:

- Article VI (1–3): the Palestinian National Authority shall collect the VAT at a fixed rate for all goods and services produced locally and for Palestinian imports whether the goods are produced locally or imported from abroad. The tax can be imposed in a range of 15–16 per cent, which means that the Palestinian National Authority has the right to set VAT at no more than 2 per cent less than Israel.
- Article VI (5): the VAT on the purchases of businesses registered will accrue to the tax administration where the businesses are registered for the purposes of this tax. Businesses shall register at the tax office in their area for the purposes of this tax and there will be clearance for the VAT revenues between the tax administrations in Israel and those of the Palestinian National Authority.

The clearance system ensures the transfer of all direct and indirect customs and tax revenues collected by the Government of Israel on behalf of the Palestinian National Authority. These revenues are composed of the income taxes on labour in Israel and the settlements, the VAT on products imported from Israel recorded in a clearance bill, as well as the purchase tax on goods produced in Israel, and the import taxes on goods imported from countries other than Israel as reflected in the customs declaration.

The clearance system was established under articles III, V and VI of the Paris Protocol in accordance with the conditions regarding the official documents accompanying the goods, which are the clearance bill and the customs declaration form as proof of the goods. As for transferring the income tax, 75 per cent of the income tax collected from labourers working in Israel and 100 per cent of the income tax of labourers working in settlements are supposed to be transferred to the Palestinian National Authority.

VAT is an important financial resource and tool that can help set economic policies of the Palestinian National Authority, especially in the absence of monetary policy tools. However, the Protocol left a very small margin for amending this tax rate. VAT clearance is done through the agreed mechanism in the Protocol that stipulates that the officially registered companies on both sides register their transactions in special invoices (the unified invoice or the clearance bill) where each side submits a list of the valid invoices at a monthly meeting for accounting and clearance.

Table 1 shows the amount of revenue from clearance in recent years and the percentage of its contribution to the budget and GDP. It shows that clearance revenues reached \$1.5 billion in 2011, some 20 per cent above the year before, due to the 19 per cent increase in the amount of clearance from VAT and the 16 per cent increase in import taxes. Clearance revenue from fuels constitutes one third, customs duties, another third, and VAT, the remaining third.

Table 1. Clearance revenue, 2009–2011
(*Million dollars*)

<i>Type of revenue</i>	<i>2009</i>	<i>2010</i>	<i>2011</i>
Total revenue clearance	1090	1233	1489
Import taxes and customs	386.6	434.2	503.7
Value added tax	336.5	379.7	452.5
Purchase tax	3.7	3.8	0.0
Excise on fuels	358.3	437.4	456.8
Income tax	15.4	4.0	8.24
Other revenues	2.6	3.2	1.9
Total clearance revenues as a percentage of total budget revenues	70	67	69.5
Total clearance revenues as a percentage of gross domestic product	16.2	14.8	15.2

Source: Palestinian Ministry of Finance, Customs and Excise, Clearance and Financial Accounts.

Chapter IV– Fiscal Leakage from Indirect Imports

A. Previous estimates of Palestinian fiscal leakage

The previous discussion shows that the economic and trade policies framework resulting from the Paris Protocol severely restricted all aspects of Palestinian fiscal policymaking. The Palestinian treasury has been deprived of many of its legitimated financial resources under the Protocol and has been suffering repeated suspensions and delays in transferring clearance revenues for political reasons. Various studies shed light on the negative effects on the Palestinian economy due to the instability, uncertainty and the loss of portions of the fiscal revenues that leak to Israel. Moreover, the chronic Palestinian fiscal crisis has been a concern to economists, decision-makers and international organizations, and several studies have addressed the crisis and related aspects of the fiscal leakage. Among these studies are:

1. UNCTAD reports, 2009–2012

UNCTAD reports dealt with the fiscal crisis and resource leakage as well as their effects on the Palestinian economy and highlighted a number of persistent and recurrent problems.

The persistence of the fiscal crisis despite the Palestinian National Authority's far-reaching reforms. The Palestinian National Authority continued its long-term efforts since 2008 to reduce the budget deficit, achieve financial sustainability and reduce dependence on donor aid. These efforts were implemented in an unfavourable environment characterized by declining aid, falling development expenditures and internal political divisions. At the same time, the private sector remained incapable of reducing the burden of the Palestinian National Authority by expanding investment and production, and thus create jobs, increase the Palestinian National Authority's tax revenue and reduce the pressure on its social spending. In this regard, for example, to reduce net lending to municipalities, the Palestinian National Authority applied a unified electricity tariff system and the prepaid electricity meter system that improved utility bill collection rates (see table 2).

Despite serious efforts by the Palestinian National Authority, the budget deficit continued, and the overall fiscal situation deteriorated as tax revenues failed to increase sufficiently to catch up with expenditures while donor funding remained below expectations. The Palestinian National Authority's fiscal reform succeeded in narrowing the budget deficit by about 11 per cent between 1999 and 2011 to reach 12.4 per cent of GDP. During the same period, the revenue of the Palestinian National Authority rose from \$1.8 billion to \$2.2 billion but remained below projections, owing to well-below-potential GDP growth in the West Bank and revenue-neutral GDP growth in Gaza.

Increased financial fragility and uncertainty regarding donor aid. Total current transfers to the Occupied Palestinian Territory – mostly donor funds – reached \$2.4 billion in 2011, 27 per cent less than the previous two years. Budget support stood at \$980 million, which was half a billion dollars less than the external budget support needs of the Palestinian National Authority for that year. This forced the Palestinian National Authority to borrow from local banks and accumulate arrears to private sector contractors and the pension fund. While the arrears grew to \$540 million, debt to local banks increased by

\$140 million to reach \$1.1 billion – 50 per cent of total revenues – by the end of 2011. With the situation remaining as it is, the Palestinian National Authority has no alternatives to reducing expenditures other than cuts in key services and further reliance on the increasingly difficult borrowing from domestic banks as well as building up arrears to the already weakened private sector. This constitutes a serious threat to the sustainability of the Palestinian National Authority itself unless donors disburse sufficient aid and the constraints imposed by the occupation on economic growth are removed (UNCTAD, 2012)

Uncertainties regarding clearance revenue flows. In May and November 2011, Israel suspended Palestinian clearance revenues, as it had done in 2002 and 2006. Despite the eventual release of the revenues, this practice undermines the economic and financial stability of the Palestinian National Authority, especially since public expenditure is a key source of economic growth and clearance revenues constitute 70 per cent of total revenue (World Bank, 2012). Suspension of clearance revenue limits the Palestinian National Authority's ability to meet its contractual obligations to the private sector and the salaries of public sector employees on time. It also limits the prospects of private investment by fostering a climate of uncertainty and increased risks to private sector contractors and creditors. Furthermore, the Palestinian National Authority's ability to plan its finances is undermined by Israel's unilateral deductions from clearance revenues to cover unpaid energy purchases of the Palestinian National Authority from Israel.

Low development expenditures. Another key element of the Palestinian fiscal crisis is the extremely low development expenditure, which was only \$215 million (or 3.4 per cent of GDP) in 2008. Expenditures on development expanded slightly in 2011 to reach \$368 million, or 4.2 per cent of GDP. The long-term costs of consistently low expenditures on development are high in light of the multiple constraints and weakened Palestinian production base.

The taxation system and trade regime enshrined in the Paris Protocol impose losses through the leakage of resources to Israel and lack of sovereignty in collecting taxes and generating accurate taxation data to enhance revenue collection. This in turn leads to a smaller tax base and lower collection rates combined with frequent additional pressures on the expenditure of the Palestinian National Authority to mitigate the impact on the recurrent humanitarian and economic crises. The Palestinian Ministry of National Economy (2011) estimates that the economic cost resulting from occupation, in terms of foregone GDP, was as high as \$6.9 billion in 2010, or about 82 per cent of GDP. Had it not suffered this loss, the Palestinian National Authority's fiscal situation would have been sound, and abundant resources for development would have been available.

2. *Other studies on fiscal leakage and the financial crisis*

In a study prepared by the European Union in 1999, Dumas estimated that the fiscal leakage resulting from the flaws in the clearance system ranged between \$90–140 million annually since 1997. This constitutes 2.6–4.2 per cent of Palestinian GDP. This estimate, however, does not include the fiscal leakage from smuggled goods that enter the Palestinian market from Israel without documentation. (MAS, 2011 and 2012)

In another study, the World Bank stressed that re-exporting goods to the Palestinian market had negative effects on the Palestinian treasury and on prices in the Palestinian market. According to World Bank estimates, one third of imports from Israel are “indirect imports” of goods produced in a third country. The fiscal leakage resulting from the trade

relation was estimated at \$133 million annually, equivalent to about 3.2 per cent of GDP, but this also does not include smuggling (World Bank, 2002).

In a study issued by MAS, Al-Jawhari (1995) estimated the Palestinian fiscal leakage at \$126–\$155 million or about 4–5 per cent of GDP; as 60 per cent of recorded Israeli exports to the Occupied Palestinian Territory are goods of non-Israeli origin. Al-Naqib (1997) estimated that the fiscal losses exceeded 15 per cent of GDP, including all channels of fiscal leakage as well as smuggling.

A document issued by the Palestinian Ministry of Finance (1998) estimated the average annual fiscal leakage for the period 1995–1997 at \$334 million, about 10 per cent of GDP. This estimate was based on several assumptions, namely that 50 per cent of Palestinian imports are of non-Israeli origin, and that customs and purchase tax rate was 12 per cent of the imports value. According to senior officials at the Palestinian Ministry of Finance, Palestinian losses resulting from indirect imports from Israel and tax evasion exceed 30 per cent of total clearance revenues.⁸

A Bank of Israel (2010) report shows that Palestinian indirect imports through the Israeli commercial sector was at least 58 per cent of the total transactions reported as exports to the Palestinian National Authority from Israel in 2008, or 38 per cent if petroleum and energy exports are excluded. This estimate is not the first to be issued by the Bank of Israel, as it mentions the findings of a report it issued in 1988 before the Oslo Accords that “goods of non-Israeli origin constitute 70–75 per cent of the Israeli exports to the Palestinian market” (Al-Naqib, 1996).

⁸ Based on oral interviews with Yousef Al-Zumor, Palestinian Ministry of Finance and Chair of the Revenues Board and Ahmad Al-Hilu, General Director of the Customs, Excise and VAT Department in 2012.

Table 2 The Palestinian economy: Key indicators

	1995	1999	2002	2005	2009	2010	2011 ^a	2012 ^a
Macroeconomic performance								
Real gross domestic product growth (percentage)	6.0	8.8	(13.3)	8.6	7.4	9.3	12.2	5.9
Gross domestic product (million dollars)	3 220	4 179	3 433	4 634	6 720	8 331	9 775	10 255
Gross national income (million dollars)	3 699	4 932	3 656	4 992	7 252	8 930	10 484	10 973
Gross national disposable income (million dollars)	4 099	5 306	4 708	6 120	9 393	10 921	11 730	12 090
Gross domestic product per capita (dollars)	1 400	1 493	1 125	1 410	1 815	2 185	2 489	2 534
Gross national income per capita (dollars)	1 608	1 763	1 199	1 519	1 959	2 342	2 670	2 711
Real gross national income per capita growth (percentage)	0.7	4.1	(16.7)	7.5	2.2	5.4	9.0	3.6
Population and labour								
Population (millions)	2.34	2.96	3.23	3.51	3.94	4.05	4.17	4.29
Unemployment (percentage) ^b	32.6	21.7	41.2	29.0	30.1	30.0	25.8	26.7
Total employment (thousands)	417	588	452	603	718	744	837	858
Public sector	51	103	125	145	181	179	188	195
Israel and settlements	68	135	42	56	73	78	84	83
Fiscal balance (percentage, gross domestic product)								
Revenue net of arrears/clearance withheld	13.2	23.9	8.5	29.5	23.8	22.6	20.9	20.2
Current expenditure – commitment basis	15.3	22.6	29.0	43.0	47.5	36.9	33.1	32.4
Total expenditure – cash basis	25.6	29.9	35.4	49.2	50.1	41.5	31.3	29.1
Overall balance – cash basis	(12.3)	(6.1)	(27.0)	(19.7)	(26.3)	(18.9)	(10.4)	(8.9)
External trade								
Net current transfers (million dollars)	400	374	1 052	1 128	2 141	1 991	1 246	1 116
Exports, goods and services (million dollars)	499	684	380	613	905	1 152	1 510	1 670
Imports, goods and services (million dollars)	2 176	3 353	2 519	2 864	4 385	4 626	5 775	6 467
Trade balance (million dollars)	(1 677)	(2 670)	(2 139)	(2 250)	(3 480)	(3 474)	(4 266)	(4 797)
Trade balance (percentage, gross domestic product)	(52.1)	(63.9)	(62.3)	(48.6)	(51.8)	(41.7)	(43.6)	(46.8)
Trade balance with Israel (million dollars)	(922)	(1 598)	(886)	(1 945)	(2 558)	(2 818)	(3 203)	(3 712)
Trade balance with Israel (percentage, gross domestic product)	(28.6)	(38.2)	(25.8)	(42.0)	(38.1)	(33.8)	(32.8)	(36.2)
Palestinian National Authority trade with Israel/total Palestinian National Authority trade (percentage) ^c	92.3	68.6	53.5	82.7	73.9	77.5	68.8	67.3
Palestinian National Authority trade with Israel/total Israeli trade (percentage) ^c	4.3	3.7	1.8	2.5	2.9	2.8	2.7	2.9

Sources: PCBS, Palestinian National Authority Ministry of Finance, IMF, International Labour Organization, Israel Central Bureau of Statistics.

Note: Except for the population figures, data regarding key indicators exclude East Jerusalem, given that PCBS has no access to the city.

^a Estimates.

^b A relaxed definition of unemployment by the International Labour Organization includes discouraged workers.

^c Palestinian and Israeli trade data refer to goods, and non-factor and factor service.

B. Sources and causes of fiscal leakage

Other sources of fiscal leakage, such as the fiscal leakage resulting from the movement of travellers to Jordan through the Al-Karama crossing, are not included in this study or in the calculations below. Recent estimates show that the Palestinian National Authority loses \$5 million annually from the fees paid to Israel by Palestinian travellers going to Jordan through the Al-Karama crossing. The fees collected by the Israeli Government are not transferred to the Palestinian National Authority, which represents a significant loss. (MAS, 2013).

The main cause of fiscal leakage is the nature of the economic relationship resulting from the structure of the Protocol and the clearance system with all its constricting conditions as explained above. The principal sources of fiscal leakage are as follows:

1. *Fiscal leakage from the VAT collection system within the framework of the customs union*

As previously indicated, the transfer of VAT revenues to the Palestinian National Authority is conditional on a clearance bill that is recognized as proof of transaction. However, this mechanism has a number of shortcomings, resulting in sustained losses in Palestinian tax revenues. These losses were mainly the result of smuggling and tax evasion as follows:

- *Non-submission of clearance bills to the Palestinian tax offices.* This is motivated by withholding information and tax evasion whereby VAT on invoices from purchases from Israel is paid to the Israeli merchant who in turn pays it to the Israeli treasury, and revenues are not transferred to the Palestinian treasury through clearance. The Ministry of Finance estimates the cost of VAT evasion at NIS 60 million annually – around \$17 million (Palestinian Ministry of Finance, 2012). However, the Ministry of Finance estimates are well below those of IMF, which indicates that the proportion of Palestinian bills not submitted ranges between 30 and 70 per cent. Based on a sample of six large and medium-sized companies that import mainly from the Israeli market, 47 per cent of bills were not submitted. This is corroboration from yet another source of the presence of significant fiscal leakage stemming from Palestinian imports from the Israeli market (see table 3).

The main motive for not submitting clearance bills and concealing purchases is to conceal actual levels of sales, thereby reducing income tax obligation. The Palestinian National Authority's loss multiplies since it loses revenues from the taxes on imported goods, as well as income tax. The Paris Protocol states that the Palestinian National Authority cannot claim any clearance bill that is more than six months old, as the Government of Israel does not acknowledge any revenue related to such invoices even if the validity of the invoice is recognized.

Table 3. Sample of clearance bills issued by Israeli companies to Palestinian companies (1 January– 9 September 2010) and the rate of declaration by Palestinian companies

<i>Sample number</i>	<i>Number of bills issued by Israeli companies</i>	<i>Number of bills declared by Palestinian companies</i>	<i>Bills declared (Percentage)</i>
1	306	182	59
2	60	42	70
3	1079	523	48
4	74	4	5
5	59	18	30
6	160	58	36

Source: IMF, 2010, p. 37.

- *Forgery and manipulation of clearance bills.* As indicated by staff from the Palestinian Ministry of Finance, this includes printing fraudulent clearance bills that are not acknowledged by the Government. These bills are then used between merchants and they cannot be submitted at the clearance sessions. In addition to manipulating the value of products to minimize tax dues, trading in clearance bills of fake transactions is the most important issue from a tax point of view. Clearance bills of fake transactions are sold to an Israeli counterpart in return for a percentage that varies between 3 and 7 per cent in order to deduct the value of items listed in the fake transaction bills from the VAT. Therefore, the Israeli merchant who buys the bill benefits because the deduction becomes large, and the merchant benefits by obtaining cash without any actual transaction having taken place. The Palestinian treasury loses part of the VAT because Israel does not pay the tax of those bills to the Palestinian National Authority. The Palestinian National Authority losses are in the range of NIS 25 million (about \$7 million) annually from this type of manipulation. (Palestinian Ministry of Finance – Cases and Auditing Department, 2011).
- *Tax and evasion of customs duties.* This entails the movement of goods from the Israeli market and settlements to the Palestinian market without any documentation, which results in purchase tax and VAT losses. Officials and experts from the Ministry of Finance estimate that more than 30 per cent of goods enter the Palestinian market without clearance bills, since the borders between the West Bank and Israel are porous, and trade between the two sides is carried out under the terms of the customs union. This is the practice, despite the fact that Israel obliges Palestinians to bring goods into the West Bank through four crossing points that the Palestinian side does not recognize because they are not on the 1967 borders. Imported goods entering through these four crossing points represent only a fraction of the Palestinian imports from Israel or entering through Israeli ports (IMF, 2012b).

Table 4 shows the duties lost on high-value goods smuggled from Israel based on records of the Palestinian Customs Police Force. Indeed, a large portion of these goods are not produced in Israel. For example, cell phones, clothing, shoes, car parts, as well as parts of other goods such as construction materials, drinks and cosmetics, are not produced in

Israel. This shows that many goods entering the Palestinian market are not of Israeli origin and are indirectly imported and enter the Palestinian market through smuggling.

Table 4. Customs and purchase tax rates on key smuggled goods, 2010–2011

<i>Items</i>	<i>Customs and purchase tax rates (percentage)</i>
Food supplies and meat	8
Construction materials	10
Cigarettes	250
Cell phones	15
Clothing and shoes	12
Drinks and sweets	85
Car parts	5
Medications and cosmetics	12

Source: Palestinian Customs and Excise Police Force, 2010 and 2011, Smuggled goods, collected reports.

2. *Leakage from indirect imports*

Indirect imports result in the entry of products of non-Israeli origin to the Palestinian market as if they were produced in Israel, or Israeli goods that do not meet the rules of origin to qualify as Israeli exports. Indirect imports are goods imported by an Israeli shipper. Customs duties on them are paid to the Israeli treasury, and they are re-exported to the Palestinian market. According to the Paris Protocol, since such goods are perceived to be made in Israel, they enter the Occupied Palestinian Territory duty free. Since trade taxes constitute a significant part of Palestinian revenues, this results in the loss of access to legitimate fiscal resources by the Palestinian National Authority, but a number of other serious adverse effects on the Palestinian economy.

Throughout the post-Oslo period, Palestinian trade was characterized by the dependence of Palestinian companies, importers, wholesalers and retailers on Israeli traders who import products from all over the world. Part of the shipment of products imported by Israeli traders is sold in the Israeli market and part is re-exported to the Palestinian market. This means that Israeli traders normally list imports actually destined for the Occupied Palestinian Territory as part of imports to Israel. This has historically been because some Palestinian traders need relatively small quantities of certain goods that are most easily imported by an Israeli trader or are purchased directly from the Israeli market. In all cases, this is indirect importing. The forms of indirect importing are summarized in the following cases:

- **Complete indirect importing:** This is the case when a good (and all its components) is imported to the Israeli market without any changes or modifications in Israel. Then it is resold in the Palestinian market in accordance with a clearance bill. This is where fiscal leakage of taxes occurs; instead of being collected and deposited in the Palestinian treasury, they go to the Israeli treasury.
- **Masked indirect importing:** In this case, the components of the good are completely or partially imported to Israel from abroad. The item is then produced with non-Israeli raw materials and production inputs, some

modifications are made, or the good is assembled or packaged to take its final form in Israel, then resold to the Palestinian market accompanied by a VAT clearance bill. Based on the rules of origin, a minimum of 35–40 per cent should be added to the good to qualify as an export from the country. However, it is difficult for the Palestinians to obtain information on the percentage of the Israeli value added of the final product. This is one of the channels of Palestinian fiscal leakage. While the production process, assembly, packaging and remanufacturing opportunities create employment opportunities in Israeli, they do not generate growth or employment in the Occupied Palestinian Territory.

- Goods imported by Israeli and Palestinian traders: A key feature of Palestinian trade is the Palestinian National Authority's lack of control over crossing points. Imports go through Israeli ports, and customs clearance is performed by Israeli customs offices and clearance agents. This situation makes it costly for Palestinian traders to import relatively small quantities of goods directly to the Occupied Palestinian Territory. One way to deal with this is by importing based on informal agreements with Israeli traders. Under this type of arrangement, the customs declaration states that the goods are destined for the Israeli market, but the Palestinian trader gets a share of the imports, and the goods are delivered to the Palestinian trader with a clearance bill that includes VAT, but does not include import taxes. Palestinian traders resort to this arrangement to reduce shipping and importing costs and circumvent Israeli obstacles and security complications on Palestinian shipments.
- Indirect importing by transferring ownership (*Autonomia*): In this case, Israeli importers import goods from abroad by using a customs declaration for the Israeli market. Then the Israeli trader sells the goods to the Palestinian trader at the Israeli port and transfers the ownership of the goods and customs declaration to them. This process is completed before clearing the goods to save time and avoid delays and trade obstacles. The modified customs declaration clearly states that the final destination is the Palestinian territories, and this is called an *autonomia* customs declaration. Import taxes are transferred to the Palestinian National Authority, and a clearance bill is issued containing the commission and profit of the Israeli trader in accordance with the agreements between both parties at the clearance session. However, as a result, the statistics and value of external trade are not accurate, and the price of the good to the Palestinian consumer is higher because of the additional commission collected by the Israeli trader.

Regardless of the manner in which it takes place, indirect imports cause fiscal leakage and much wider economic losses. Depriving the Palestinian National Authority of revenues due to it from this type of importing increases its financial difficulties and limits the scope of fiscal and trade policies at the disposal of decision-makers. The loss of such resources is a loss for the economy as a whole because they could have been injected into the Palestinian economy to stimulate aggregate demand, investment, employment and income.

1. *Why Palestinian traders resort to indirect importing:*

- *Lack of control over resources and weak productive base, and infrastructure.* With the onset of occupation in 1967, Palestinian economic performance has been shaped largely by the objectives and policies of the occupying power. The terms of the economic agreement were not fully observed in the period following the Oslo Accords. Therefore, the nature of the economic relation was not conducive to Palestinian development; the level of economic subordination to Israel remained high, and Palestinian domestic production capacity remained weak and vulnerable. To this day, the establishment of factories and farms still requires Israeli authorization. Low production capacity and the high transaction costs of moving Palestinian imports from countries other than Israel created a high dependence on imports in a situation where it is often easier for Palestinian traders to bring goods via a telephone call to the Israeli market, whether or not the goods are of Israeli origin.
- *The relationship between Palestinian and Israeli traders.* This relationship is the result of long years of Israeli policies that created certain mutual commercial interests. These relations include informal contracts. For example, several Palestinian factory and workshop owners work as subcontractors for Israeli producers. Such workshops and factories make goods that meet Israeli specifications and are treated as if they were made in Israel. This multi-layered trade relationship cannot be dissolved overnight, especially given the lack of alternative Palestinian economic and trade policies to change such entrenched relations and reduce the need for the importation of inputs and raw materials for this type of work. For example, over 50 sewing workshops in the Jenin area make clothes for Israeli companies. Several shoe factories in Hebron work in the same manner: Israeli companies provide the raw materials – fabric, leather and rubber – which are mostly imported from a third country (Ministry of Finance, Customs and Excise Department, Central Clearance Directorate, 2011).
- *Customs restrictions set by Israel.* Because of the high customs tariff, Palestinian traders import directly from the Israeli market to avoid paying customs duties and reduce shipping, clearance, and transportation and storage costs.
- *Restrictions and obstacles affecting direct importing.* These restrictions are numerous and variable. There are restrictions relating to security, health, specifications, standards and quantities. Imports of certain agricultural and health products and pesticides are prohibited, and Israeli ports discriminate against goods destined for the Palestinian market in terms of searches, delays and inspection, as opposed to goods destined for Israel. Moreover, Israel does not recognize Palestinian customs clearance agents, limiting their role to subcontracting for Israeli clearance agents. Further, Palestinian importers, clearance agents and customs officials are not allowed to enter Israeli ports. As a result, import and shipping information has become the exclusive domain of Israeli importers – it is not available to Palestinians.
- *Signed economic agreements.* All agreements identify the types of goods that can be imported through specific lists of goods, in addition to identifying the countries from which importing is allowed. These agreements have not given Palestinian traders complete freedom to import from the international market because the goods listed do not cover all the needs of the Palestinian market.

This has had negative effects on Palestinian trade, pushing it towards indirect importing and deepening its dependence on the Israeli market as a source of imports. The whole trading system has made it much easier and cheaper for Palestinian traders to import all kinds of goods from the Israeli market without any complications regardless of whether the imports are produced in Israel.

- *Administrative obstacles.* These are the importing procedures that Palestinian traders face to obtain permission and licences to import – and such licences must be renewed regularly. Sometimes Palestinian traders have to wait several weeks to obtain an import authorization from the Israeli authorities and must cope with obstacles related to opening times and working hours at crossing points, especially for goods coming from or through Jordan. In addition, customs procedures related to the value and valuation of Palestinian goods go through several administrative and procedural hurdles, such as amending the customs declaration and paying customs fees and fines, as well as paying the difference for the revaluation and the delays in applying and implementing such decisions. This all leads Palestinian traders to favour importing from the Israeli market.

Chapter V – Fiscal leakage and its Economic Repercussions

In this chapter, the fiscal leakage resulting from direct and indirect importing and smuggling will be estimated in the framework of the current trade and economic system. The repercussions of this leakage on the economy of the Occupied Palestinian Territory and Palestinian labour force will also be assessed. The methodology of the estimation utilizes the statistically recorded values of exports and imports between Palestine and Israel. The estimation also considers the fiscal leakage resulting from the evasion of custom duties on goods flowing illegally into the Occupied Palestinian Territory.

A. Fiscal leakage from recorded imports from the Israeli market

Official PCBS statistics were used to estimate this part of the fiscal leakage. All Palestinian imports from Israel were classified in eight digits based on the Harmonized System for the years 2010 and 2011. Following the conditions stipulated by the Paris Protocol, Israeli tariff tables were used to identify the customs duties. Furthermore, purchase tax rates were applied separately to each good imported from Israel. All imported goods not subject to customs duties and purchase tax were excluded from the calculation, as was VAT on these goods, since it is applied only when clearance bills are filed.

As explained previously, local and imported goods alike are subject to the purchase tax, which means that all goods produced in Israel should be subject to the purchase tax based on the Israeli tariff. Therefore, the methodology for calculating Palestinian revenues from the purchase tax was not based on the origin of the imported good, but only on whether the type or classification of the good was subject to the tax, and whether the intended final destination was the Palestinian market. Only when these two conditions are met, the purchase tax is considered revenues that should be transferred to or collected by the Palestinian treasury.

The methodology adopted the 2010 estimates of the Bank of Israel to calculate the tax revenues from indirect imports that are produced by a third party but enter the Palestinian market as if they were of Israeli origin. After excluding petroleum, gas and energy, which Israel exports to the Palestinian public sector because they are subject to tax in the monthly clearance session, those estimates show that 39 per cent of total Israeli exports to the Palestinian market come through the Israeli commercial sector. Accordingly, the estimate assumes that at least 39 per cent of Palestinian imports that are recorded as imports from Israel are actually indirect imports produced in a third country. In line with the Paris Protocol, the import tax and customs on these imports are supposed to be transferred to the Palestinian National Authority. The VAT applied to customs duties and the purchase tax was also included in the calculation. However VAT applied to the original value of these goods was not calculated, because it is applied when the clearance bills are filed.

B. Fiscal leakage from “statistically unrecorded” imports – evasion of customs duties

This type of fiscal leakage includes all taxes, customs revenues and purchase taxes on goods smuggled from Israel to the Palestinian market, regardless of the origin of the goods. Since these goods are smuggled, no revenue is collected, and they enter the Occupied Palestinian Territory without any official documentation. The estimation

methodology in this case depends on identifying the proportion of customs duties evasion by referring to the statistics of the Palestinian Customs and Excise Police, as well as the assessment of the Palestinian Ministry of Finance officials: the General Director of Customs, Excise and Value Added Tax; the President of the Revenue Council; and the Chief of Customs and Excise Police Force.

Officials at the Ministry of Finance contend that the percentage of customs duties evasion is between 25–35 per cent of the total imports from Israel due to the lack of control over the borders between the West Bank and Israel, the geopolitical division of the Occupied Palestinian Territory into areas A, B and C, as well as the Palestinian National Authority's inability to combat smuggling effectively in areas B and C. An official of the Customs and Excise Police Force stated that combating smuggling through area C adjacent to areas under Palestinian National Authority jurisdiction is done covertly because Palestinian officials are prevented from entering these Palestinian territories, which are controlled by Israel. The official estimated that the customs efficiency of the Palestinian National Authority in combating smuggling covers 80 per cent of all smuggling in area A, 70 per cent in area B and less than 50 per cent in area C.

Official records of the Customs and Excise Police Force show that smuggling is common, with 11,967 cases officially recorded between 2009 and 2011 throughout the Occupied Palestinian Territory. This is a clear indicator of the magnitude of this phenomenon. The value of smuggled goods that were intercepted in 2010 and 2011 was \$240 million. Around \$6 million in fines were imposed on the importers of these goods; the fines varied between 1–5 per cent of the value of the confiscated goods, bearing in mind that these statistics do not include confiscated and destroyed goods or the cases reported by the regional customs, excise and value added tax offices. There are no data on the amount of VAT collected from these goods; however, police reports at the Customs and Excise Police Force show that more than 3,000 tons and over 500,000 items were intercepted in 2010 and 2011 (Palestinian Customs and Excise Police Force – Collected Smuggled Goods Report, 2010 and 2011).

C. Results of fiscal leakage estimates

1. Data and methodology

Tables 5 and 6 show the main indicators and statistics used in estimating recorded fiscal leakage by identifying the following factors:

- The value and amount of goods imported from the Israeli market through clearance bills, whether direct or indirect imports, which averaged \$2,906 million and 1,560 types of goods in 2010 and 2011;
- The value and amount of goods subject to customs and purchase tax based on the Israeli customs tariff, which averaged \$511 million and 453 goods in 2010 and 2011;
- The value of goods imported by the Palestinian public sector (petroleum, natural gas, tobacco and cigarettes), which averaged \$791 million in 2010 and 2011;
- The value of imports by the private sector minus public sector imports, which averaged around \$2,115 million in 2010 and 2011.

Table 5. Number and type of imports from Israel subject to import and purchase taxes

<i>Item</i>	<i>2010</i>	<i>2011</i>	<i>Average of the two years</i>
Gross domestic product (million dollars)	8 331	8 769	8 550
Value of goods imported from Israel (million dollars)	2 873	2 938	2 906
Number of goods imported from Israel (type)	1 439	1 682	1 560
Value of total imported goods except for those imported by the public sector (million dollars)	2 117	2 114	2 115
Value of public sector imports (million dollars)	757	825	791
Value of goods imported from Israel subject to import taxes (million dollars)	506	516	511
Number of goods subject to import taxes (type)	428	478	453

Source: PCBS

Notes: Public sector imports are goods imported only by the Palestinian National Authority; not traded by the private sectors before imported; include mainly petroleum, natural gas, tobacco and cigarettes.

Value and number of goods subject to import taxes are goods subject to customs duties or purchase tax, or both. Customs duties are applied according to the Israeli customs tariff table. The Harmonized System is used to identify the number of goods.

To estimate the fiscal leakage and apply the customs equations on goods subject to customs, purchase tax and VAT, 2010–2011 statistics were used to calculate the average percentage of importing taxes, based on the following assumptions:

- Imports from Israel are not exempted from import taxes (see table 6);
- About 17.6 per cent of all goods imported from Israel can be subject to import taxes (customs fees and purchase tax) except for VAT, which applies to all goods;
- The average rate of import taxes on goods imported from Israel, where customs fees, purchase taxes and VAT could be applied, reaches 37 per cent of the total value of these goods. This is the result of dividing the average import tax revenues in 2010–2011 (\$195 million), calculated from the Israeli tariff table for the goods exported to the Palestinian market by the value of these goods (\$511 million). In other words, if these goods had been imported from another country, import tax revenues would have been 37 per cent of their value;
- The average effective rate of import taxes (not including VAT) reaches 8 per cent. This rate was derived by dividing the calculated value of customs and purchase tax on imported goods by the import value (except for public sector imports). This rate is useful for calculating import taxes on smuggled goods;
- At least 39 per cent of goods exported to the Palestinian market from Israel are of non-Israeli origin (indirect imports, based on the aforementioned Bank of Israel data).

Table 6. Effective tax rates on imports, 2010–2011

<i>Item</i>	<i>2010</i>	<i>2011</i>	<i>Average of the two years</i>
Value of imported goods from Israel subject to import taxes (million dollars)	506	516	511
Value of import taxes on goods imported from Israel (million dollars)	110	126	116
Goods subject to import taxes as a percentage of total	17.6	17.6	17.6
Percentage of import taxes on goods subject to import taxes*	35.4	37.8	36.6
Import taxes as a percentage of total imports	6.2	6.6	6.4
Percentage of import taxes on total imported goods except for public sector imports	8.5	9.2	8.8

Source: These percentages were calculated based on PCBS data and Israeli tariff tables.

* The tax rate is a weighted average calculated by using all import taxes based on the Israeli customs tariff table applied to Palestinian imports. It is applied to all taxable goods imported from Israel.

2. Fiscal leakage from statistically recorded trade

Table 7 shows the fiscal leakage resulting from statistically recorded direct and indirect imports from Israel. To calculate purchase tax leakage, origin of import was not considered, because the tax is imposed according to the type of goods, not origin. Fiscal leakage resulting from importing from the Israeli market (this does not include smuggling) reached an annual average of \$115 in 2010 and 2011, including the foregone VAT, customs duties and purchase tax. Average leakage from indirect imports is valued at about \$46 million; leakage as a result of the Palestinian National Authority not receiving all its dues from collected purchase taxes and VAT was about \$70 million.

3. Statistically unrecorded fiscal leakage from smuggling

To estimate the fiscal leakage stemming from smuggled goods from the Israeli market, the analysis assumed that the evasion of customs duties is at the lower estimate of 25 per cent of the value of imported goods from Israel. The effective rate of import taxes was assumed to be around 8.8 per cent (see table 6) on smuggled goods, plus the 16 per cent VAT of the value of smuggled goods, in addition to the purchase tax that should be collected from smuggled goods. Table 7 shows that the average annual fiscal leakage resulting from smuggling in 2010 and 2011 (goods smuggled from the Israeli market regardless of its origin) can be estimated at around \$190 million. One third of this fiscal leakage is due to loss of revenues from import taxes, and the other two thirds are the result of losing revenues of the VAT that could have been collected from these goods.

4. Total fiscal leakage

Table 7 shows that total annual average fiscal leakage resulting from customs duties evasion and direct and indirect importing for the years 2010–2011 is estimated to be around \$306 million. This represents around 3.6 per cent of GDP and more than 17 per cent of the tax revenues collected by the Palestinian National Authority in one year. As will be shown in the following section, if these resources were available for public spending, they will have positive effects not only on the Palestinian fiscal crisis, but also on labour and economic growth.

Table 7. Fiscal leakage resulting from direct and indirect imports and smuggling from the Israeli market
(Million dollars)

<i>Item</i>	<i>2010</i>	<i>2011</i>	<i>Average for the two years</i>
1. Total value of goods imported from Israel	2 873.3	2 938.5	2905.9
2. Value of goods imported from Israel and subject to import taxes	506.0	516.1	511.0
Fiscal leakage (can be statistically recorded) from direct and indirect importing from Israel^a			
3. Amount of customs fees on goods imported from Israel subject to customs duties	112.7	122.5	117.6
4. Amount of customs fees on indirect imports from Israel (39 per cent of row 3)	43.9	47.8	45.9
5. Amount of purchase tax on imported goods subject to purchase tax	42.9	47.1	45.0
6. Amount of value added tax on importing taxes	23.3	25.4	24.4
7. Amount of fiscal leakage resulting from importing from Israel (rows 4 + 5 + 6)	110.2	120.3	115.3
Fiscal leakage (statistically unrecorded) from smuggling from the Israeli market			
8. Value of smuggled goods (25 per cent of row 1)	718.3	734.6	726.5
9. Value of importing taxes on smuggled goods (8.8 per cent of row 8) ^b	63.2	64.6	63.9
10. Amount of leakage resulting from value added tax (16 per cent of rows 8 + 9)	125.0	127.9	126.5
11. Amount of fiscal leakage from evasion of customs duties (rows 9 + 10)	188.3	192.5	190.4
Total amount of fiscal leakage resulting from importing and smuggling from Israel (rows 7 + 11)	298.5	312.9	305.7
Percentage of fiscal leakage to gross domestic product	3.6	3.6	3.6
Percentage of fiscal leakage to total tax revenues	17.8	16.4	17.1

^a The value of all types of leaked taxes was calculated separately according to the customs fees, purchase tax and VAT for each good based on the relevant rate from the customs tariff table. It was calculated by multiplying the tariff rate by the value of the imported good using PCBS import data. The number of goods imported from Israel subject to import taxes in 2011 was 478, valued at \$516 million. The figure 39 per cent was used to estimate the value of customs revenue from indirect imports from Israel.

^b The value of taxes on imported goods was calculated on the basis of an effective tax rate of 8.8 per cent (average of 2010 and 2011; see table 6).

Economic effects of fiscal leakage: Gross domestic product and unemployment

The cost of financial resource leakage exceeds the nominal value of lost revenues. There are additional outputs and employment costs that the economy would have been able to generate had the lost financial resources been available to expand the fiscal space. To evaluate the costs of the fiscal leakage estimated in the previous sections, the macroeconometric model developed by UNCTAD of the Palestinian economy was simulated to assess economic performance under alternative scenarios that assume that the leakage did not occur and the leaked resources were instead available to the Palestinian National Authority to finance, for example, either transfer payments to the poorest or an export promotion programme.

Three alternative scenarios were simulated:

- The baseline scenario reflects economic performance under the present conditions using actual historical data, including fiscal leakage;
- The transfer payment scenario also uses historical data, but assumes no fiscal leakage and hence an increase in tax revenue (17 per cent) equivalent to the estimated leakage, which is used to increase expenditure on transfer payments;
- The export promotion scenario is similar to the second scenario, but assumes that the increase in revenue is allocated to promote Palestinian exports.

The result in table 8 shows that capturing the leaked revenue would expand the fiscal policy space available to Palestinian policymakers and facilitate fiscal stimulus. While the transfer scenario would increase real GDP in 2004 dollars by about \$205 million (3 per cent) above the baseline in 2012, the export promotion scenario would increase GDP by \$280 million (4 per cent). As for the impact on employment, the transfer and export promotion scenarios would increase employment over the baseline scenario by 3,300 and 9,200 jobs respectively.

The estimated costs to the Occupied Palestinian Territory of the \$300 million leaked annually to Israel is equivalent to 17 per cent of total tax revenue, in addition to 4 per cent in lost GDP and about 10,000 jobs per year. The analysis also shows that these costs are compounded over time as the economy grows. Therefore, there is a need for measures to stem the fiscal leakage and remedy the information asymmetry between both parties, as well as measures to expand the operations and control of Palestinian National Authority customs. It would also be necessary to reconsider the revenue clearance arrangement in place.

However, several points should be noted. First, the estimated fiscal leakage in this study is modest and conservative, given that the research did not take into account total accumulating economic losses resulting from many other channels of fiscal leakage that are not covered by this study. Second, it would be necessary to carry out additional studies covering all sources of Palestinian fiscal leakage. Third, the economic cost of the estimated fiscal leakage in this study is modest, considering the structural deformity of the Palestinian economy and its limited capacity to create highly productive job opportunities because of restrictive policies under prolonged

occupation and the forced erosion of the Palestinian productive base. As a result, the economy is forced to increase imports when new fiscal and/or economic resources are available.

Table 8. Estimated economic and employment costs of Palestinian fiscal leakage

	2010	2011	2012
<i>Tax revenue and fiscal leakage (million dollars)</i>			
Total tax revenue	1 690.0	1 905.0	1 940.0
Fiscal leakage	289.5	312.8	319.7
Leakage/tax revenue – percentage	17.8	16.4	16.5
<i>Impact on real gross domestic product (millions of 2004 dollars)</i>			
Baseline scenario	5 754.4	6 423.1	6 763.4
Transfer payment scenario	5 856.4	6 570.5	6 968.9
Impact – million dollars	102.0	147.4	205.4
Impact – percentage	1.8	2.3	3.0
Export promotion scenario	5 903.4	6 640.0	7 041.9
Impact – million dollars	148.9	216.9	278.5
Impact – percentage	2.6	3.4	4.1
<i>Impact on employment (thousand jobs per year)</i>			
Baseline scenario	685.8	787.0	809.5
Transfer payment scenario	687.5	789.3	812.7
Impact – thousand jobs	1.6	2.3	3.3
Impact – percentage	0.2	0.3	0.4
Export promotion scenario	690.9	794.4	818.7
Impact – thousand jobs	5.1	7.4	9.2
Impact – percentage	0.7	0.9	1.1

Chapter VI – Conclusions and Recommendations

The bilateral trade agreements between Palestine and other countries created a new state of optimism about the Palestinian economy. This optimism was fuelled by the signing of the Oslo Accords. However, the expected convergence and benefits from closer ties with Israel failed to materialize. The main bilateral agreement limited the positive effects of the other bilateral agreements, as the Paris Protocol closely tied the Palestinian National Authority to the Israeli economy in a semi-customs union, which resulted in a lack of proper trade rules that could support the growth of the Palestinian economy. Indirect importing of goods of non-Israeli origin from the Israeli market is one of its most enduring and costly weaknesses, leading to the loss of a significant part of customs and tax revenues for the Palestinian treasury. In addition to the increased evasion of customs duties due to the lack of Palestinian control at the borders and having occupied territories out of Palestinian control, it became even more difficult to collect revenues. Further, the Palestinian treasury had to forego a large portion of those revenues, and the Palestinian National Authority was no longer able to design developmental fiscal, taxation and trade policies. This in turn resulted in a chronically confused and fragile Palestinian budget situation and a recurrent fiscal crisis, on top of difficulty in financial planning due to uncertainty and unguaranteed regular and complete collection of public revenues.

Fiscal policy is one of the most important economic instruments used by governments to influence total demand and supply by aligning tax policies with national economic conditions and objectives. Revenue collection and public expenditure policies based on the general budget lines influence the distribution of income and seek to allocate resources to serve economic objectives. Governments use this economic tool by changing the level of spending and revenues with a focus on stimulating economic growth and increasing employment and in turn renewing the economic growth cycle.

The main source of funding for the treasury of the Palestinian National Authority is foreign aid and indirect taxes. This tool, however, is not used in its natural dimensions because of the restrictive framework of the Paris Protocol, the lack of sovereignty and control over revenues, as well as the limited ability to obtain credit from local and international banks owing to the lack of a Palestinian currency. Fiscal policy from the demand side is used to affect total demand and how it is managed and directed by following a stimulus policy of lowering taxes and increasing government spending or an austerity policy of increasing taxes and lowering government spending. Such policies are used to absorb shocks faced by the economy by increasing or decreasing total demand as a response to economic problems such as inflation, recession, high unemployment and low growth rates. The Palestinian National Authority is virtually helpless in influencing this demand because it does not control fiscal policy instruments, despite the assumption that it can control expenditure policies. However, expenditure policies are dependent on foreign aid, the nature and level of tax revenues, and the need for expenditure on social services, health and education. This dependence impedes the formulation and implementation of coherent fiscal and development policies.

Accordingly, a government's ability to use fiscal policies mainly depends on the available scope and flexibility to move smoothly from one instrument to another, and on the stability and sustainability of the fiscal system under economic instability. An increase in revenues makes it possible to find a larger space to use fiscal policy in the area of government spending and motivate supply and demand (Heller, 2005). However, the

Palestinian National Authority has suffered mainly from policies of the occupation over the past four decades, which has restricted the possibility of using such policy instruments. It has also suffered from fiscal leakage responsible for large losses to treasury resources. The Palestinian National Authority was therefore unable to implement any financial policy to respond effectively to the needs of the Palestinian economy.

There is an urgent need to make fundamental changes in the structure of the Palestinian trade system under the Paris Protocol. This system, which has endured for two decades, has not allowed the Palestinian economy to achieve tangible or sustainable development; it has actually prevented such development. This is mainly due to Israel's lack of commitment in applying the terms of the Protocol, as well as the shortcomings of some provisions relating to trade, taxation and monetary policies.

Further, there is an urgent need to agree on new trade arrangements that include border crossings, to find customs areas and warehouses in the Occupied Palestinian Territory and to allow Palestinian customs teams to be present at international and internal crossings. Freedom of movement of goods and persons must be provided – without restrictions or obstacles, internally and with neighbouring countries such as Jordan and Egypt. It is necessary to facilitate the process at the Al-Karamah crossing with Jordan, while activating trade passages and facilitations for goods imported through Israeli channels.

Fiscal leakage is the result of many gaps in the structure of the Paris Protocol on the one hand, and the lack of Israeli commitment to applying the provisions of this agreement on the other, especially in terms of indirect taxes, clearance mechanisms and exchange of information. There is fiscal leakage resulting from failure to submit clearance bills to the Palestinian tax offices; other leakage results from the manipulation and falsification of these bills, the evasion of customs duties and the indirect imports of goods of non-Israeli origin entering the Palestinian market. This led to fiscal leakage resulting from the evasion of customs duties and direct and indirect importing from the Israeli market that exceeded \$310 million in 2011: 3.6 per cent of GDP and over 17 per cent of the total customs revenues of the Palestinian National Authority. To prevent fiscal leakage, trade relations and taxation policies need to be revised with a view to:

- Ensuring negotiations between the Palestinian National Authority and the Government of Israel to develop a mechanism for calculating and transferring Palestinian revenues leaked to the Israeli treasury since the establishment of the Palestinian National Authority;
- Exchanging on a regular basis information on clearance bills between the Government of Israel and the Palestinian National Authority;
- Removing the maximum time frame for clearance bills identified in the Paris Protocol so as not to lose the right to claim them after expiry;
- Providing the Palestinian National Authority with lists of goods and Israeli companies that are subject to purchase tax and making sure that the Government of Israel honours its commitments regarding clearance of the purchase tax as stipulated in the Wye River Memorandum;

- Removing non-customs restrictions and obstacles to the movement of imported Palestinian goods from third parties to reduce indirect imports through Israeli intermediaries;
 - Allowing Palestinian traders and clearance agents to enter Israeli ports, clear their goods and follow up on customs procedures as set out in the Paris Protocol;
 - Allowing Palestinian customs officials to be present at Israeli crossings to follow up on customs work relating to Palestinian goods;
 - Drawing up a Palestinian tariff table for goods imported from third parties in line with the structure of the Palestinian economy and guaranteeing the application of these tariffs within the framework of customs arrangements, such as the establishment of special customs zones and the use of the transit system for goods imported through Israel;
 - Designing comprehensive awareness-raising campaigns on tax that stress the importance of direct importing to the Palestinian economy while diversifying sources of imports.
 - Developing motivational trade and taxation policies for importers of raw materials and intermediate goods aimed at re-building the productive base of the Palestinian economy, which will help Palestinian manufacturers to produce, compete with and replace imported goods with local ones;
 - Developing Palestinian customs monitoring systems to serve as advanced monitoring tools capable of dealing with all aspects of existing and evolving trade and customs situations by using the most recent international standard systems in information technology for customs purposes;
 - Devising a strategy to develop the capacity of the Palestinian customs staff and their technical systems and enhancing skills and training of staff. This is essential for the preparation and building the required capacity for a sovereign Palestinian State, since customs is a system that embodies the principle of sovereignty. It is furthermore strategically and politically important, playing a key role in a State's economy, finances, society and national security.
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