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Legal and Structural Hurdles to Achieving Political Stability and Economic Development in the Palestinian Territories

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Abstract

As the institutions of Palestinian self-government have evolved, it has become increasingly apparent that the principal challenge for Palestinian decision-makers will be to establish structural and legal bases for the emergence of a civil society and a dynamic economy. The hurdles that confront Palestinian decision-makers in this regard are considerable, and may be divided into two groups. First, Palestinian leaders must recognize and resolve the “structural” challenges reflected in the political and economic realities imposed by current events. These include the peace process with Israel, the creation of the Palestinian National Authority (“PNA”), and the more recent creation of the Palestinian Council. The second group of hurdles facing Palestinian authorities are legal. These challenges embody the legal fallout of the region’s tumultuous recent history, which has resulted in an awkward amalgam of laws derived from legislation enacted under the auspices of various rulers who have controlled the West Bank and Gaza (collectively, “Palestinian Territories”) at different periods during this century. This Essay addresses both groups of hurdles, structural and legal, in turn.

LEGAL AND STRUCTURAL HURDLES TO ACHIEVING POLITICAL STABILITY AND ECONOMIC DEVELOPMENT IN THE PALESTINIAN TERRITORIES

*Keith C. Molkner**

FORWARD

The following Essay was written in an attempt to condense into a few pages various observations and impressions resulting from nearly thirty months of continuous involvement in economic and legal aspects of the Middle East peace process. Ninety-five percent of it was written immediately before the renewal in February 1996 of terrorist bombings in Israeli cities and the subsequent prolonged closure of the Palestinian Territories. Following these events, certain changes were added to the text in an attempt to address the tragic loss of life and the current precariousness of the peace process.

The Essay was originally composed in a spirit of cautious optimism, recognizing the seriousness of the hurdles before the Israeli and Palestinian peoples, but believing in their dedication to putting decades of tragic conflict and suffering firmly behind them. The later additions, however, were written during a period of sadness and anxiety. As this book goes to print, none can tell how deeply the peace process has been damaged. The decision to publish the Essay in spite of the present difficulties was therefore not easy. Nonetheless, irrespective of the fluid political situation, the basic underlying realities and interests remain the same. Hopefully, the discussion in this Essay of specific hurdles to stability and development will be of some use to those who, sooner or later, will have to find solutions to these problems.

I. PARAMETERS OF THE PROBLEM

The current Middle East peace process is built, in large part, on two sea changes in the psychology of conflict that has plagued the region for decades: Israeli recognition of Palestin-

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ian aspirations to self-determination and Palestinian recognition of the legitimacy of the Israeli State. In recent years, bilateral and multilateral negotiations between Israel and the surrounding Arab states have introduced important additional elements, such as: full peace with Jordan; active ties with Morocco, Oman, and Qatar; lower intensity but important ties with several other Arab states in North Africa and the Gulf; and ongoing peace talks with Lebanon and Syria. These other developments, however, were made politically possible by means of mutual recognition on the part of Israel and the Palestinian Liberation Organization ("PLO"). Furthermore, continued improvement in Arab-Israeli relations will remain dependent on future progress in Israeli-Palestinian *rapprochement*. Thus, successful implementation of the agreements on Palestinian self-rule is critical to a comprehensive and durable Middle East peace.

The successful implementation of Palestinian self-rule, in turn, relies on two major criteria: the establishment of stable and effective governance, and real economic growth that is rapid, profound, and sustained. Leaders both within and without the region have repeated that if it is to succeed, the peace process must deliver real and visible improvements in the lives of ordinary people. In the case of the Palestinians, this primarily means that disorder, violence, and wide-scale poverty must cease.

As the institutions of Palestinian self-government have evolved, it has become increasingly apparent that the principal challenge for Palestinian decision-makers will be to establish structural and legal bases for the emergence of a civil society and a dynamic economy. Only by creating a new environment that protects individual liberties and encourages entrepreneurial activity will the current process enable the Palestinian people to reap the benefits of peace. The hurdles that confront Palestinian decision-makers in this regard are considerable, and may be divided into two groups. First, Palestinian leaders must recognize and resolve the "structural" challenges reflected in the political and economic realities imposed by current events. These include the peace process with Israel, the creation of the Palestinian National Authority ("PNA"),¹ and the more recent crea-

1. The Palestinian National Authority refers to the interim self-rule authority created upon Israeli withdrawal from Gaza and Jericho in the summer of 1994. See

tion of the Palestinian Council.² The second group of hurdles facing Palestinian authorities are legal. These challenges embody the legal fallout of the region's tumultuous recent history, which has resulted in an awkward amalgam of laws derived from legislation enacted under the auspices of various rulers who have controlled the West Bank and Gaza (collectively, "Palestinian Territories") at different periods during this century. This Essay addresses both groups of hurdles, structural and legal, in turn.

II. STRUCTURAL HURDLES

The structural hurdles to development have unfolded in lockstep with the establishment of Palestinian self-government. The optimism among Palestinians during late 1993, when Israel and the PLO signed the Declaration of Principles on Interim Self-Government Arrangements,³ cooled as it became apparent that Palestinian aspirations for full independence, democratic government, and economic prosperity would not occur immediately. Contrary to popular expectations, the end of Israeli military rule over Gaza, Jericho,⁴ and, later, other West Bank cities⁵ did not automatically lead to an improvement in economic life or the establishment of a genuine rule of law. In fact, the changes led to new economic, political, and administrative problems.

A. Economic Problems

The most dramatic of the structural problems facing Palestinian decision-makers is the painful economic transition currently underway. Unemployment has risen sharply since the

Michael Kelly, *In Gaza, Peace Meets Pathology*, N.Y. TIMES, Nov. 27, 1994, § 6 (Magazine), at 56 (discussing formation of PNA).

2. The Palestinian Council, or *Al-Majlis Falistini*, in Arabic, is the legislative body elected by Palestinian voters on January 20, 1996.

3. Declaration of Principles on Interim Self-Government Arrangements, Sept. 13, 1993, Isr.-PLO, 32 I.L.M. 1525 [hereinafter Declaration].

4. The end of military rule in these areas took place following the withdrawal of Israeli troops from Gaza and Jericho under the Agreement on the Gaza Strip and the Jericho Area. Israel-PLO Agreement on the Gaza Strip and Jericho Area, May 4, 1994, Isr.-PLO, 33 I.L.M. 622 [hereinafter Cairo Agreement].

5. The end of Israeli military rule took place following the redeployment of Israeli troops outside West Bank cities under the Israeli-Palestinian Interim Agreement on the West Bank and the Gaza Strip. Israeli-Palestinian Interim Agreement on the West Bank and the Gaza Strip, Sept. 28, 1995, Isr.-PLO [hereinafter Interim Agreement] (on file with the *Fordham International Law Journal*).

early months of the peace process, approaching sixty percent in Gaza alone. Over 100,000 Palestinians who formerly worked in Israel found themselves jobless as the Israeli Government implemented its policy of "separation" between the two peoples.⁶ The results for the Palestinian economy have been devastating.

Initially, Palestinian leaders hoped that new enterprises would be initiated in the areas under Palestinian self-rule, providing alternative sources of employment. The shortage of capital in the Palestinian economy, however, made it imperative that Palestinian leaders attract substantial investment by *diaspora* Palestinians⁷ and other foreign investors. Unfortunately, such foreign investment has yet to materialize. Thus, while many new companies have been registered, comparatively few factories and other job-creating enterprises have been established.

In addition to unemployment, the Palestinian economy suffers from restrictions on the movement of Palestinian goods into Israel. While Israel and the PLO signed a customs union agreement nearly two years ago providing for free movement of industrial goods and most agricultural produce,⁸ the Israeli security closures constitute a formidable barrier to the entry of Palestinian goods. Not only has this non-tariff barrier resulted in largely one-way Israeli-Palestinian trade, it has also interfered with Palestinian exports to third markets and hampered commerce between Gaza and the West Bank.

Finally, the financial and banking sectors of the Palestinian economy are only now emerging from twenty-seven years of mar-

6. Separation, or *hafrada*, in Hebrew, was first put forward as the response of the Government of Prime Minister Yitzhak Rabin to the terrorist attacks by Palestinian extremists attempting to torpedo the peace process by conducting suicide bombings in Israeli cities. The practical effect of this policy was the initiation of "security closures" during which Palestinians were not allowed to pass the checkpoints into Israel. It was resurrected by the Government of Prime Minister Shimon Peres in response to the even worse suicide bombings of early 1996.

7. See Joel Brinkley, *Comment by Baker Angers Shamir*, N.Y. TIMES, Mar. 3, 1990, at A5 (discussing Palestinian diaspora).

8. Cairo Agreement, *supra* note 4, annex IV, 33 I.L.M. at 696; Interim Agreement, *supra* note 5, annex V. The Protocol on Economic Relations Between the Government of the State of Israel and the PLO Representing the Palestinian People was signed as a separate agreement in Paris, but was subsequently attached to the Gaza/Jericho Agreement as Annex IV. A revised form of the Economic Protocol was later included in the Interim Agreement as Annex V. For purposes of this Essay, "Economic Protocol" refers to the original Agreement as signed in Paris. References to the newer version cite to the Interim Agreement.

ginal existence. Arab and foreign banks existing in the West Bank and Gaza prior to the 1967 Arab-Israeli War were closed by Israeli Military Order shortly after the entry of Israeli forces. Direct financial links to the Arab world were severed and Palestinians came to rely on gray market providers of financial services, such as money changers and money lenders.⁹

Following the signing of the Declaration of Principles, several Jordanian and Palestinian banks quickly moved to open or reopen branches in the West Bank and Gaza. Presently, about twelve banks operate over fifty branches in the Palestinian Territories, roughly a 500% increase in institutional coverage since September 1993.¹⁰ Furthermore, total deposits increased tenfold from 1993 to 1995.¹¹ Despite this dramatic expansion, the Palestinian banking sector continues to be characterized by poor regulation and insufficient service. Lending remains heavily constricted and conventional wisdom attributes this, in part, to bank-facilitated capital flight. Moreover, the lack of a central check clearance facility and the prevalence of dishonored checks seriously impede the development of an efficient system of payments. The larger effect of such problems is an insufficient harnessing of domestic financial resources for the development of the Palestinian economy.

B. *Political Problems*

While the economic problems described above exert the strongest direct effect on the majority of Palestinian individuals and families, the problems that attract the greatest attention of foreign governments, international media, and the Palestinian leaders themselves, are essentially political. These problems implicate the central question of the peace process: Will the Palestinian leadership be able to provide political stability and maintain its internal legitimacy while simultaneously fulfilling its obligations to Israel and concluding further Israeli-Palestinian

9. Two Arab banks, the Bank of Palestine and the Cairo Amman Bank, were licensed to reopen in the 1980's, but the services they provided remained inadequate. Indeed, it was common for no interest to be paid on savings deposits and lending was woefully scarce. By 1993, these two banks operated only thirteen branches for the entire West Bank and Gaza Strip.

10. PALESTINIAN ECONOMIC POLICY RESEARCH INSTITUTE, PALESTINIAN BANKING SECTOR STATISTICAL REVIEW xii-xiv (1995) [hereinafter PEPRI].

11. *Id.*

negotiations? For the peace process to succeed, the answer must be affirmative.

The Palestinian leadership has been walking a political tightrope ever since the negotiations known as the "secret Oslo channel"¹² became publicly disclosed. Historically, the PLO strove to be a broad-based national organization that, although dominated by *Fatah*,¹³ was willing to accommodate all movements dedicated to the "liberation" of Palestine. Since the *Fatah* leadership undertook, on behalf of the PLO, to recognize Israel and to forswear the use of violence, however, a rift has opened in Palestinian society between "moderates" who support working towards Palestinian statehood within the framework of transitional autonomy, and "extremists" who reject any negotiated solution that concedes maximalist Palestinian claims. The Palestinian leadership thus finds itself under pressure both from Israel and the West, particularly the United States, to crack down on extremists and from a substantial portion of its own constituency to renounce the new partnership with Israel and the United States.

The conflicting political pressures that Palestinian leaders face are well-illustrated by the issue of the Palestinian Covenant.¹⁴ The Covenant, essentially the PLO's charter, calls for the destruction of Israel and implicitly rejects a peaceful solution to the conflict. Israeli Prime Minister Yitzhak Rabin made the renunciation of these provisions a precondition to Israeli recognition of the PLO and the signing of the Declaration of Principles.¹⁵ Accordingly, on September 9, 1993, PLO Chairman Yasser Arafat wrote a letter to Prime Minister Rabin declaring these articles inoperative and undertaking to make the necessary changes in the Covenant. Despite repeated demands by Israel and the United States that the changes be made, however, and

12. See Serge Schmemmann, *Killing of Bomb 'Engineer' Unites Palestinian Factions*, N.Y. TIMES, Jan. 10, 1996, at A3. The "secret Oslo channel" refers to Israeli-Palestinian talks that were held quietly in Norway and resulted in the Declaration of Principles. *Id.* The channel's existence became public knowledge in early September 1993. *Id.*

13. *Fatah*, or "victory," is the dominant faction headed by PLO Chairman Yasser Arafat.

14. The Palestinian National Charter, reprinted in THE ISRAEL-ARAB READER 366, 366-71 (Walter Laquer & Barry Rubin eds., 4th ed. 1984).

15. See Steven Greenhouse, *Mideast Accord: In Washington; Twist to Shuttle Diplomacy: U.S. Aide Mediated by Phone*, N.Y. TIMES, Sept. 25, 1995, at A1 (discussing inception of Declaration of Principles).

despite repeated promises by Chairman Arafat to do so, the Covenant remains unchanged.¹⁶

Failure to amend the Covenant revealed the precarious position of the PNA, at least prior to the elections of January 20, 1996.¹⁷ Political reality dictated that the PNA satisfy minimum Israeli expectations, particularly with regard to the prevention of violence against Israelis, while preserving a demeanor of dialogue and national unity that included, rather than excluded, the Islamicists and other members of the emergent opposition. When a series of bus bombings in Israeli cities in late 1994 and early 1995 nearly brought the peace process to a standstill,¹⁸ however, it became increasingly problematic for Palestinian leaders to speak in English of peace and coexistence while continuing to speak in Arabic of *jihad*.¹⁹

Following the repeated spectacle of Palestinian police arresting large numbers of suspects after each terror strike against Israel and then releasing them a few days later,²⁰ the PNA acted to assert its authority. Various tactics were used to put an end to instability and violence. Attempts were made to coopt, marginalize, intimidate, or incarcerate opponents of the regime. Special closed courts were established to try "security offenders" under military procedures without providing proper defense counsel.²¹ Journalists, newspaper editors, and human rights activists who spoke out found themselves unemployed or, in some cases, jailed.²² In one case, *Al-Nahar*, a major Palestinian newspaper with an "errant" editorial policy, was closed for an extended period.

The Palestinian elections were optimistically expected to presage the arrival of a new period of democratization and political calm. Generally, the populace deemed the elections a suc-

16. See Tzachi Hanegbi, *A One-Sided Peace*, N.Y. TIMES, Mar. 6, 1996, at A21 (discussing Covenant and Arafat's refusal to amend it).

17. See *Arafat Sets Jan. 20 as the Date for First Palestinian Elections* (AP), Dec. 14, 1995, at A12 (discussing elections and role of PNA and Palestinian Council).

18. See Serge Schmemmann, *Bus Bombing Kills Five in Jerusalem; 100 Are Wounded*, N.Y. TIMES, Aug. 22, 1995, at A1 (discussing impact of bombings on elections).

19. *Jihad* is the Islamic term for holy war.

20. See Steven Emerson, *High Noon for Arafat*, N.Y. TIMES, Oct. 20, 1994, at A27 (reporting on release of Hamas operatives one day after their arrest).

21. See Clyde Haberman, *Arafat's Police in Gaza Widen Crackdown on Muslim Radicals*, N.Y. TIMES, Apr. 12, 1995, at A1 (discussing closed courts).

22. *Id.*

cess. The voting, which was monitored by large numbers of local and international observers, was by most reports orderly and fair.²³ Yet, the fact that *Hamas*²⁴ and other opposition movements boycotted the election, and that heavy-handed tactics were used to promote favorable press coverage of *Fatah* candidates and suppress opponents,²⁵ revealed the limits on stability and genuine democracy in the nascent Palestinian political system. Despite such concerns, however, in the immediate aftermath of the elections, it was generally thought that the new Council would enjoy greater popular legitimacy than the unelected authority which preceded it. Well-wishers hoped that this expanded legitimacy would lead to greater freedom of action regarding relations with Israel, increased internal stability, and heightened respect for the rule of law.

Tragically, the Palestinian political system and the peace process itself were subjected to a devastating shock before the Council had ever convened. The recent bombings of Israeli buses and a street corner by *Hamas* terrorists in late February and early March, 1996,²⁶ resulted in an indefinite cessation of Israeli-Palestinian talks and a protracted closure of the Palestinian Territories.²⁷ Support for the peace process has fallen dramatically among both Israelis, concerned for their security, and Palestinians, suffering from the effects of the closure.²⁸ It remains to be seen whether the Palestinian political leadership will be able both to recapture Palestinian popular support for the peace process and convince Israel that it is doing all it can to break the terrorist infrastructure and contain extremism. It also remains to be seen whether the Palestinian leadership will continue to

23. See Serge Schmemmann, *Arafat Backed in First Voting by Palestinians*, N.Y. TIMES, Jan. 21, 1996, at A1 (declaring overall success of elections) [hereinafter *Arafat Backed in First Voting*].

24. *Hamas* refers to the largest and most active Palestinian extremist group. In Arabic, *Hamas* is an acronym for "Islamic Resistance Movement."

25. See *Arafat Backed in First Voting*, *supra* note 23, at A1 (discussing boycott); Joel Greenberg, *Palestinians Trying Out Elections, Warts and All*, N.Y. TIMES, Jan. 18, 1996, at A10 (discussing tactics used to suppress opponents).

26. See Serge Schmemmann, *Bombings in Israel: The Overview; 2 Suicide Bombings in Israel Kill 25 and Hurt 77, Highest Such Toll*, N.Y. TIMES, Feb. 26, 1996, at A1 (reporting on aftermath of bombings).

27. *Id.*

28. See Serge Schmemmann, *Bombing in Israel; Israeli Rage Rises as Bomb Kills 19, Imperiling Peace*, N.Y. TIMES, Mar. 4, 1996, at A1 (reporting on effect of bombings on Israelis and Palestinians).

have Israeli partners in peacemaking following the Israeli general elections in May, 1996. Support among the Israeli public for the peace process has fallen dramatically, as have the chances for reelection of Prime Minister Shimon Peres.²⁹ Chairman Arafat and the Palestinian leadership have come under tremendous pressure to dissolve the infrastructure of terrorist groups inside the Palestinian Territories. Meanwhile, the Israeli Government has declared that if Arafat fails to do so, Israel will. In the wake of the bombings, Chairman Arafat banned all armed groups inside Palestinian-controlled territory and committed his regime to confiscating their weapons and arresting their hardcore members. Action by the Palestinian security forces to fully implement these commitments will probably result in serious armed resistance. Failure to take meaningful action, however, will, in all likelihood, permanently doom the peace process.

C. *Administrative Problems*

In addition to the economic and political problems discussed above, Palestinian development also faces hurdles engendered by administrative problems. These structural problems affect the quality of daily administration by Palestinian officials of the territories under their jurisdiction. As a result of these problems, Palestinian governance is less efficient and effective than it would otherwise be.

One source of inefficiency stems directly from the interim structure of the peace process. This structure is based on a gradual transfer of power and responsibility from the Israel Defense Forces ("IDF") to a Palestinian Interim Self-Government Authority over a five-year transitional period, followed by the negotiation of a final settlement.³⁰ While the history of mutual mistrust may have made this formula a tactical necessity designed to gradually build confidence on both sides, it is nonetheless extraordinarily difficult for Palestinian decision-makers to embark upon long-term planning in the absence of a final status agreement. In particular, Palestinian leaders and officials are presently in the awkward position of administering the powers and territories

29. See Serge Schmemmann, *The Trials of a Peace Seeker — A Special Report; Terrorism Forces Peres from Brink of Triumph*, N.Y. TIMES, Mar. 10, 1996, at A1 (analyzing effect of violence on peace process and Peres Government).

30. The Declaration of Principles articulates the transfer of power, while the Cairo and Interim Agreements implements it.

under their jurisdiction without assurance concerning what the final extent of these powers and territories will be. Thus, they are uncertain whether Palestinian self-rule will ultimately take the form of an independent state, a confederation with Jordan, or some other, as yet undisclosed, arrangement.

Additional administrative problems derive from the geographic division of the territories under Palestinian self-government into two major territorial units: the West Bank and the Gaza Strip. Prior to the implementation of Palestinian self-rule, the West Bank and the Gaza Strip had functioned as two distinct administrative units since the 1948 Arab-Israeli War.³¹ This long separation continues to have important consequences for the administration of the territories under Palestinian self-government. For example, the court systems of the West Bank and the Gaza Strip remain separate and distinct, each governed by its own rules and procedures. While the PNA took some steps to harmonize the two judicial systems under the administrative framework of its Ministry of Justice, it remains unclear how or whether the two systems will ultimately be unified.

Still more important, as will be discussed below, two separate legal systems exist in the Palestinian Territories. Whereas the legal system of Gaza derives from English common law, the legal system of the West Bank is based on the legal tradition of Jordan, which is heavily derived from civil law. That Palestinian officials must currently administer two different legal systems further contributes to the administrative complexity of Palestinian self-governance.

Administrative difficulties such as these are considerably heightened by the non-contiguous geography of the West Bank and Gaza. It is often difficult or impossible for Palestinians, including public officials, to get permission to cross Israeli territory in order to move between the two territories. Various plans have been discussed regarding creation of a safe passage through Israel for travelers moving between Gaza and the West Bank. None of them, however, have yet been put into action. Furthermore, those parts of the West Bank that are currently under vari-

31. The West Bank was occupied by Jordan in 1948 and annexed in 1951, whereas the Gaza Strip came under Egyptian occupation in 1948 but was not annexed. Israel occupied both territories in 1967 but preserved their administrative separation by appointing one military commander for the West Bank and another for the Gaza Strip.

ous forms of Palestinian self-rule, commonly referred to as Areas "A" and "B," are themselves non-contiguous. Thus, passage between them, while not as difficult as passage between the West Bank and Gaza, still involves travel through the Israeli-controlled portions of the West Bank, known as Area "C."³² Lastly, an additional impediment to efficient and effective administration is the fact that while the Palestinian Council has jurisdiction over civil affairs in both Areas "A" and "B" in the West Bank, PNA police can operate only in Area "A."³³

A final set of administrative problems stems from corrupt practices within the PNA. Stories abound concerning individuals who have exploited their positions within the PNA for personal gain. While these stories may well be exaggerated, it generally appears that the PNA has suffered from a certain level of corruption. Among other allegations, it has been credibly reported that certain Israeli companies have successfully employed improper financial inducements to gain monopoly positions with respect to the import of certain goods into the Palestinian market. One may hope that the newly-elected Palestinian Council will be able to disclose and reduce, or eliminate, such corrupt practices.

III. LEGAL HURDLES

The present legal structures in the Palestinian Territories also constitute a major hurdle to development. As noted above, the existence of two separate legal systems for Gaza and the West Bank constitutes a source of inefficiency that hampers economic development. Furthermore, not only are the legal systems of Gaza and the West Bank inconsistent with one another, they are also each internally disharmonious.

The internal disharmony of the Gaza and West Bank legal systems stems from the fact that each system is constructed from a confoundingly complicated body of diverse legal sources. The

32. Interim Agreement, *supra* note 5. Area "A" is comprised of the eight Arab cities of the West Bank: Bethlehem, Hebron (where only part of the city is under Palestinian self-rule), Jenin, Jericho, Kalkilya, Nablus, Ramallah, and Tulkarm. Area "B" is comprised of smaller towns and villages in which Palestinian jurisdiction encompasses civil affairs, but in which Israel is responsible for internal security. Area "C" consists of the Israeli-controlled remainder of the West Bank, including rural areas, military zones, and Israeli settlements.

33. Interim Agreement, *supra* note 5.

laws of Gaza are comprised of British Mandate ordinances, as amended and supplemented by Egyptian and Israeli military orders. The laws of the West Bank, in contrast, are comprised of Jordanian statutes, as amended and supplemented by a different set of Israeli military orders. In addition, the legal systems of the West Bank and Gaza both contain a residue of Ottoman law in certain legal fields, as well as new enactments by the PNA. Thus, inconsistency between the laws of the West Bank and Gaza is aggravated by the internal disharmony and complexity of the two legal systems.

Furthermore, the British and Jordanian ordinances and laws that comprise the statutory basis of the legal systems in Gaza and the West Bank, respectively, are also generally anachronistic. The British ordinances are entirely comprised of pre-1948 laws, while the Jordanian laws date from before June 1967. These laws often embody legal thinking and terminology that are outdated and unsuited for modern economies. Additionally, many of these laws have been amended by cumbersome Israeli military orders that are often insufficiently hospitable to commercial and other economic activity.

While thousands of military orders were promulgated by the Israeli military authorities in the West Bank and Gaza beginning in 1967, they have never been fully compiled and consolidated. Furthermore, a significant number of military orders and policy directives have not even been made available outside the IDF and the Civil Administration.³⁴ Thus, a certain level of legal uncertainty exists in the West Bank and Gaza regarding the laws in force. Finally, because the amendments by military order were generally drafted to serve the needs of Israeli security rather than Palestinian development, several of the military orders amend laws in a manner that renders them overly burdensome and restrictive.

The disharmony, uncertainty, and confusion associated with the legal systems in the West Bank and Gaza have resulted in various concerns on the part of international investors and business interests regarding the legal vacuum in the Palestinian Ter-

34. The Civil Administration was the administrative and civil affairs apparatus of the Israeli military government in the West Bank and Gaza. It was dissolved in Gaza upon the withdrawal of Israeli forces and its jurisdiction in the West Bank is now limited to Area "C" territories.

ritories. Despite such problems, however, the legal system functions surprisingly well on a day-to-day basis. Business is conducted successfully and routinely in the West Bank and Gaza. Palestinian courts operate under well-established procedures and adjudicate a wide variety of commercial cases. In addition, alternative mechanisms for resolving disputes are frequently employed and carry the force of cultural tradition behind them. These mechanisms include meditation, conventional arbitration, and traditional practices of conciliation known as *Sulha*.³⁵

The primary legislative challenge presently before the newly elected Palestinian Council is to review the body of laws in the West Bank and Gaza and to identify priority areas for legal reform. Such reforms should be built on the existing legal structures to which Palestinians are accustomed, but should eliminate harmful anachronism, incongruity, and irrationality. By thus modernizing and harmonizing commercial legislation in an organized and well-considered fashion, the Palestinian Council will be able to systematically eliminate the existing legal hurdles to economic development.

The remainder of this Essay briefly surveys three legal fields that the Palestinian Council is likely to address in the near future: investment law, banking law, and tax law. Each of these fields currently presents various hurdles to economic development.

A. *Investment Law*

As mentioned above, local and foreign investment in the Palestinian economy is one of the foremost requirements of Palestinian economic growth. This was recognized early on in the peace process, as evidenced in an annex to the Declaration of Principles, which calls for Israeli-Palestinian cooperation in the creation of a "Financial Development and Action Program" to encourage international investment in the region.³⁶ While such a cooperative program has yet to be established, the PNA placed

35. *Sulha* is a traditional method of conflict resolution embedded in centuries of Arab tradition. According to this method, a dispute is brought before one or more respected community leaders or elders who mediate the dispute and reconcile the parties. The decisions are generally treated with respect and compliance.

36. Declaration, *supra* note 3, annex III, 32 I.L.M. at 1537-40.

considerable emphasis, almost from the date of its inception, on the creation of a new Palestinian investment law.

At the time of the Israeli withdrawal from Gaza and Jericho and the creation of the PNA, the legal structure in place for encouraging investment in the West Bank and Gaza was disharmonious, confusing, and inadequate. This legal structure consisted of a 1967 Jordanian law,³⁷ two Israeli military orders,³⁸ and a set of policy directives issued by the Israeli Civil Administration in the West Bank.³⁹ These laws, orders, and directives relied on discretionary decision-making and heavy administrative control while granting insufficient incentives and legal guarantees to investors. The PNA earmarked the replacement of this legal structure with a modern, unified investment law representing the first commercial law reform.

A drafting period of several months ensued during late 1994 and early 1995 that saw the preparation and circulation of a number of draft Palestinian investment laws. Ultimately, the final draft was submitted by the PNA Ministry of Economics, Trade, and Industry to Chairman Arafat and the PNA Council of Ministers. Following its approval of the draft, the PNA promulgated the Law on the Encouragement of Investment ("Investment Law") on April 29, 1995.⁴⁰

The Investment Law sets forth a new legal structure for the encouragement of investment and revokes all prior inconsistent legislation. For the time being, however, the Law has entered into force only in those areas of the West Bank and the Gaza Strip that fall within the legislative jurisdiction of the Palestinian Council,⁴¹ specifically, the Gaza Strip (excluding Israeli settlements and the IDF base) and Areas "A" and "B" of the West

37. Jordanian Temporary Law No. 1 for 1967: The Encouragement of Capital Investment Law.

38. The Encouragement of Capital Investment, Military Order 1055 of 17 June 1991 (Gaza District) (Isr.); The Encouragement of Capital Investment, Military Order 1342 of July 7, 1991 (Judea and Samaria) (Isr.).

39. The Encouragement of Investment Act (as amended 21 November 1991); Civil Administration of Judea & Samaria (Judea and Samaria); Unnumbered Directives on The Encouragement of Foreign Investment.

40. Law on the Encouragement of Investment, reprinted in David P. Fidler, *Foreign Investment in Palestine: An Analysis of the Law on the Encouragement of Investment in Palestine*, 19 *FORDHAM INT'L L.J.* 529, 603-10 (1995) [hereinafter *Investment Law*].

41. Interim Agreement, *supra* note 5, art. 18. Article 18 reads, "The Council has the power, within its jurisdiction as defined in Article 17 of the Agreement, to adopt legislation." *Id.*

Bank. According to the Law, the Council's jurisdiction is to be extended over eighteen months to the remaining Area "C" territories, except for those areas that are linked with issues to be negotiated in the "final status talks."⁴² Concurrently, the Israeli military orders and Civil Administration directives concerning investment will remain in force throughout the interim period in all areas not transferred to the jurisdiction of the Palestinian Council.

The Investment Law represents a major improvement over the earlier laws, military orders, and directives in force in the West Bank and Gaza. The law is marred, however, by several features that, in effect, constitute obstacles to the creation of a legal structure that will be genuinely attractive to investors. These legal hurdles fall into three basic categories: the Investment Law's guarantees and protections for investors, incentives, and the administrative framework.

1. Investor Guarantees

The Investment Law provides several guarantees of the rights of investors, including prohibition of expropriation, guaranteed national treatment of foreign investors, and free repatriation of profits and capital.⁴³ One problem with these guarantees, however, is that their terminology and language is not fully consistent with internationally accepted legal usage. By thus deviating from standard international language, the Investment Law engenders a lack of clarity regarding the interpretation of the guarantees. The Investment Law poses a second problem related to the guarantee of investor rights in its provision stating that Palestinian investors will be given a "priority" in the purchase of tax-exempt fixed assets from other investors.⁴⁴ While it is unclear from the Investment Law how this priority is to be implemented, it appears to compromise the guarantee of national treatment of foreign investors. A final problem is that while the Investment Law gives Palestinian Courts jurisdiction to

42. Interim Agreement, *supra* note 5, art. 17. The relevant final status issues are settlements, Jerusalem, and borders. Declaration, *supra* note 4, art. 5, 32 I.L.M. at 1526. Final status talks are slated to begin in the Spring of 1996 and to last no more than three years.

43. Investment Law, *supra* note 40, arts. 9, 18, at 606, 608.

44. *Id.* art. 16, at 608.

adjudicate investment disputes,⁴⁵ it fails to make reference to the option of using independent arbitration or various international dispute resolution mechanisms in appropriate cases. As foreign investors often have greater confidence in such mechanisms than in local courts, the Investment Law would be more encouraging to such investors if it included a statement recognizing the right of investors to make use of such mechanisms where agreed upon by the disputants or where called for under international agreements.

2. Incentives

The incentive structure created by the Investment Law consists of exemptions from income taxes and dues for a specified number of years.⁴⁶ The Investment Law provides for both "regular exemptions" (fixed term) and "exceptional exemptions" (discretionary term). The Investment Law also establishes the Higher Palestinian Agency for the Encouragement of Investment ("Agency"), which is responsible for administering the exemptions. Only investment projects which have been approved by the Board of Directors of the Agency ("Board") may receive exemptions.

The major shortcoming of this incentive structure is its reliance on excessive exercise of discretion by the Agency and the Board. Generally, under the Investment Law, investment incentives should "to the extent possible be automatically granted, directly linked to the type of activity to be encouraged and equally extended"⁴⁷ to foreign and local investors alike. Under the Investment Law, however, applications for exemptions are to be approved or rejected on what is essentially a discretionary basis. While the Investment Law provides that the Board must state reasons for its decision on an application,⁴⁸ it does not provide clear and binding criteria to be used in reaching the decision. Furthermore, the Investment Law fails to provide firm guarantees against arbitrary actions that alter the status of exemptions after they are granted. As a result of such reliance on open-

45. *Id.* art. 20, at 609.

46. *Id.* art. 1, at 603. "Dues" are defined as customs duties and purchase taxes on machinery, equipment, and raw materials. *Id.*

47. *Guidelines on the Treatment of Foreign Investment*, 7 ICSID REVIEW: FOREIGN INVESTMENT LAW JOURNAL 302 (1992).

48. Investment Law, *supra* note 40, art. 13, at 607-08.

ended discretionary decision making, the Investment Law fails to provide an incentive structure that is rational and predictable.

3. Administration

The framework for administering the Investment Law is centered on the Board of the Agency. The Board is comprised of fifteen members, each of whom serves a three-year term.⁴⁹ The primary functions of the Board include carrying out the business of the Agency, deciding on applications for exemptions, and suspending or revoking exemptions for violations of the law.⁵⁰

The major problem regarding this administrative framework is that the Board appears to be less a professional body of impartial civil servants than a collection of disparate, potentially competing political interests. Thirteen of the fifteen members of the Board are political appointees selected by the Chairman of the PNA. Furthermore, only one of the members is a full-time employee of the Agency. This highly politicized administrative structure creates the potential that political interests and institutional biases of members stemming from their activities outside the Agency will unduly influence the Board's decision-making. This potential could undermine investor confidence in the impartiality of the administration of the Investment Law.

A related criticism of the administrative framework created by the Investment Law concerns the fact that the general tone and emphasis of the Investment Law seem to be placed on administration as a tool of bureaucratic control rather than a means of efficient and liberal treatment of investment. This tone and emphasis is exemplified by, *inter alia*, the failure of the Investment Law to provide a mechanism for challenging a rejection of an application for benefits. Furthermore, while the Investment Law does provide a right of appeal in the case of investors whose exemptions are suspended or revoked by the Agency, the appeal must be made directly to the Chairman of the PNA.⁵¹ This type of mechanism for direct appeal of administrative disputes to the chief executive is highly irregular and further re-

49. *Id.* art. 3(2), at 604.

50. *Id.* arts. 5, 11-17, at 605, 606-08.

51. *Id.* art. 19, at 609. In Arabic, the term for chairman, *Raees*, is also often translated as President.

flects the Investment Law's tendency towards heavy administrative and political control.

While these legal hurdles represent genuine obstacles to the encouragement of investment in the Palestinian economy, the promulgation of a uniform Palestinian investment law represents a substantial step forward in the creation of a modern Palestinian legal infrastructure. It should also be remembered that the Investment Law represents the first achievement of Palestinian commercial law reform. Moreover, problematic features of the Investment Law can be corrected by enacting amendments as the commercial law reform process continues to develop. The inauguration of the newly elected Palestinian Council may create opportunities for specialized legislative review and, where necessary, amendment, of legal enactments promulgated by the PNA prior to the elections. If this is the case, the Investment Law would be an obvious candidate for such review.

B. *Banking Law*

The emergence of a strong banking sector in the Palestinian Territories is one of the primary prerequisites for economic development. The large-scale return of Palestinian and foreign, mostly Jordanian, banks to the West Bank and Gaza over the last two and one half years is a positive development that has already had a pronounced effect on savings patterns. Previously limited to using Israeli banks, money changers, or various informal financial institutions, Palestinians now have access to modern banks located in all the cities and major towns of the West Bank and Gaza. The expansion of the banking sector, however, has highlighted the inadequacy of the present banking laws and engendered several new problems.

The banking laws presently in force in the West Bank and Gaza are outdated and incomplete. The most important banking statute in effect in the West Bank is the Jordanian Banking Law of 1966.⁵² Its equivalent in Gaza is the British Mandate Palestine Banking Ordinance of 1941.⁵³ While numerous Israeli military orders have directly or indirectly amended the banking law in the Palestinian Territories, many of them were never

52. Jordanian Temporary Banking Law No. 94 of 1966.

53. Palestine Mandate Banking Ordinance No. 26 of 1941, *published in* The Palestine Gazette No. 1134, Supplement No. 1 (Oct. 9, 1941).

given effect or enforced.⁵⁴ In fact, the volume and disorganization of the military amendments has rendered it at times difficult to determine precisely what the current law requires. This complicated legal structure constitutes a serious hurdle for regulators, the banking sector, and the entire financial infrastructure of the Palestinian economy.

Efforts to reform the legal structure as it applies to the banking industry must address three major types of problems currently afflicting the banking sector. First, as the newly established Palestinian Monetary Authority⁵⁵ ("PMA") has not yet fully developed its licensing and supervisory capacities, banks are operating in the Palestinian Territories with a minimum of regulatory oversight. Second, despite the dramatic increase in the number of operating banks, the provision of essential banking facilities, such as lending and checking services, remain well below required levels. Third, and finally, Palestinian businessmen and economists have raised serious concerns that foreign banks are exporting Palestinian deposits to finance lending operations abroad, precisely at a time when the Palestinian economy is suffering from an acute shortage of capital.

These problems figure prominently in the effort currently underway to reform the banking laws and regulations in the West Bank and Gaza. It remains uncertain whether this effort will ultimately result in a total unification of the banking laws of the West Bank and Gaza, or whether the harmonization will be more limited and gradual. In any case, modernization of banking and related laws is a high priority of the PMA. Such reforms are particularly necessary with respect to four legal fields: licensing, supervision, system of payments, and lending.

1. Licensing

The Bank of Israel was responsible for licensing banks in the West Bank and Gaza from June 1967 until the May 1994 signing of the Economic Protocol. The Economic Protocol provided for the creation of the PMA as the licensing authority for bank-

54. The Bank of Israel often simply applied the Jordanian and British Mandate statutes in supervising Palestinian banks, despite the existence of superseding military legislation.

55. Cairo Agreement, *supra* note 4, annex IV, art. IV(1), 33 I.L.M. at 708; Interim Agreement, *supra* note 6, annex V, art. IV(1). The Palestinian Monetary Authority ("PMA") acts as the central financial institution within the PNA. *Id.*

ing activities in the Palestinian Territories. The PMA was formally constituted by an executive decree issued by Chairman Arafat in January 1995.

Once the Israeli-Palestinian peace process opened the way for Arab and foreign banks to return to the Palestinian Territories, Jordanian banks quickly moved to assume a dominant position in the region. Since the PMA did not come into being until 1995, and since Israel and Jordan had already concluded a Memorandum of Understanding on banking cooperation by December 1993, Jordanian banks applied to the Bank of Israel for licenses to open branches in the Palestinian Territories until the PMA was established. The PNA subsequently agreed with the Jordanian Government that the PMA would retroactively approve licenses issued to Jordanian banks by the Bank of Israel during this period. Most of the banks presently operating in the Palestinian territories are, therefore, operating under conditions set forth in the licenses issued by the Bank of Israel prior to the cancellation of its supervisory role in the Palestinian Territories.

The PMA is now in control of bank licensing in Gaza and Areas "A" and "B" of the West Bank. However, the PMA is not yet fully staffed and is operating in an atmosphere of a regulatory vacuum. The PMA is not yet in a position to properly evaluate the necessary qualifications of owners and managers of banks applying for licenses to operate in the Palestinian Territories. Nor has it established regulatory guidelines for evaluating applications in light of the economic needs of the Palestinian Territories. Further institutionalization of the PMA and development of legislation and regulations promulgated by the Palestinian Council and the PMA, respectively, are fundamental requirements if bank licensing procedures in the Palestinian Territories are to move beyond the present interim arrangements.

2. Supervision

The PMA recently established a banking supervision department responsible for monitoring the proper operation, stability, solvency, and liquidity of banks operating in the Palestinian Territories. The PMA has successfully enlisted a number of qualified supervisors with experience acquired in various Arab and Western countries. The level of professional competence of these supervisors is generally thought to be quite high. How-

ever, the supervision department is presently operating without an established regulatory structure.

The banking laws currently in force in Gaza and the West Bank fail to articulate the responsibilities and powers of a supervisory authority. The British Mandate and Jordanian statutes provide no basis for the imposition of prudential regulations and the carrying on of "on-site" inspections by a supervisory authority. Furthermore, the need for such regulation and inspection is particularly great, because the absence of a lender of last resort for Palestinian banks, as opposed to Jordanian or other foreign banks operating in the Palestinian Territories, has created considerable uncertainty regarding their stability, solvency, and liquidity.

Presently, Jordanian and other foreign banks operating in the Palestinian Territories continue to be supervised by their respective home supervisory authorities. These home authorities generally act as a lender of last resort for those banks falling under their supervisory responsibility. For example, Jordanian banks, which account for a large majority of deposits in the Palestinian Territories, are supervised by the Central Bank of Jordan, which not only monitors the banks but also protects them through its role as lender of last resort. Thus, Jordanian and foreign banks are, at least objectively, more secure than local Palestinian banks. This situation places Palestinian banks in a disadvantageous position that will continue until the PMA is more thoroughly established, both in terms of financial resources and regulatory authority.

3. System of Payments

Checks are written in the Palestinian Territories in Israeli sheqels, Jordanian dinars, and U.S. dollars. No central clearing house system exists for the Palestinian territories. Checks clear in different ways depending on the currency in which they are denominated. Inefficiencies in check clearance have impeded the more widespread dissemination of checks as a means of payment.

While sheqel-denominated checks can be efficiently cleared through the Israeli central clearance system in Tel Aviv, dinar-denominated checks are generally cleared bilaterally between local banks. This practice can be inefficient and burdensome,

since each local bank must credit and debit separate accounts with a growing number of other banks, and must separately assess the credit of each of these banks. Dollar-denominated checks are cleared on a collection basis, for instance, through an actual transfer of money rather than through the crediting and debiting of accounts, a procedure that is slow and relatively expensive. The establishment of a central clearing facility for dinar checks would improve efficiency. However, any such facility would have to be closely coordinated with the Central Bank of Jordan.

The presentation of checks without adequate backing funds on account ("bad checks") further compromises the acceptance of checks as a means of payment. The large volume of bad checks written in the Palestinian Territories constitutes a significant problem, and the original banking statutes in effect in the West Bank and Gaza fail to provide a mechanism to deter this practice. An Israeli military order provides for restrictions to be placed on a checking account in the event of repeated check-bouncing on any given account.⁵⁶ However, this order has been largely ignored by banks in the Palestinian Territories. Thus, an important priority of Palestinian banking law reform should be to create an effective legal mechanism to enforce coordinated restriction, or other penalties, against offenders.

4. Lending

The volume of financial lending by banks in the Palestinian Territories is well below the needs of the market and the resources of banks. Most banks operating in the West Bank and Gaza are over liquid, in some cases maintaining loan-to-deposit ratios of only twenty percent. Furthermore, the majority of lending carried out by banks in the Palestinian Territories is reputedly in the form of small-scale overdraft facilities, which account for eighty-six percent of all lending by Palestinian banks.⁵⁷ Worse still, it is widely believed that foreign banks are facilitating capital flight by transferring Palestinian deposits to more attractive markets in Jordan and elsewhere. Whether or not this is the case, the low level of lending in the Palestinian Territories con-

56. Israeli Military Order Regarding Checks Without Coverage, No. 1024 (Judea and Samaria) of 1982.

57. PEPRI, *supra* note 10, at xv.

stitutes a grave hurdle to development of the Palestinian economy.

The primary impediment to lending in the Palestinian Territories has been the inability of banks to enforce secured lending agreements through the court system. There is no collateral lending law in Gaza, and the Jordanian Collateral Lending Law of 1953, currently applicable in the West Bank, is outdated and in need of replacement. Furthermore, during the period of Israeli occupation, Palestinian courts refrained from issuing foreclosure judgments against defaulting debtors, as execution of the order would require cooperation with the IDF. Additionally, the strong Palestinian social taboo against evicting an owner from his land may continue to make foreclosure difficult or impossible in cases where real property is put up as collateral. Finally, the absence of a modern land registration system in the West Bank and Gaza poses further obstacles to the use of real property as security for collateral lending.

While Palestinian courts can now rely on the Palestinian police to enforce foreclosures, the procedures for doing so have not yet been tested. A modern Palestinian collateral lending law clarifying these procedures would substantially alleviate the concerns of banks regarding judicial enforcement of collateral loan agreements. Such legislation should harmonize the foreclosure procedures in Gaza and the West Bank, provide safeguards for defaulting debtors, such as a generous notice provision and a right of debtor redemption, and include language that can be incorporated into collateral lending contracts stating that the bank may exercise the foreclosure option if the debtor fails to redeem the loan within the notice period. Concurrently, a somewhat more interventionist approach could be used to directly address the problems of over liquidity and capital flight by issuing regulations requiring reasonable loan-to-deposit ratios.

C. *Tax Law*

The establishment of an efficient taxation system is a third prerequisite for Palestinian economic development. The present tax laws, derived from disharmonious, anachronistic statutes amended by a cumbersome body of military orders, pose serious hurdles for both Palestinian taxpayers and tax collectors. These hurdles include burdensome rules and procedures, a lack of

legal clarity, and excessive discretionary powers granted to the tax authorities. Furthermore, the exercise of tax powers by the Palestinian Council is far more restricted by agreements with Israel than those powers exercised with respect to investment law, banking law, and other commercial law fields. The rules governing Palestinian tax powers were first established in the Economic Protocol and were subsequently reconfirmed in a slightly modified form by the Interim Agreement. These rules and restrictions have engendered additional hurdles to Palestinian economic development.

Under the Interim Agreement, the tax powers exercised by the Palestinian Council are divided into two classes of taxes: indirect taxes and direct taxes. The Interim Agreement provides that the Palestinian and Israeli tax administrations will each levy and collect all indirect taxes in their respective areas of jurisdiction. Such indirect taxes include a value added tax ("VAT"), a purchase tax, and an import tax. At present, the areas under the responsibility of the Palestinian tax authority include Gaza (excluding Israeli settlements and the IDF base) and Areas "A" and "B" of the West Bank. Area "C" will continue to fall under the responsibility of the tax departments of the Israeli Civil Administration until such time as these areas are transferred to the Palestinian Council in accord with the Interim Agreement.

The Palestinian Council is similarly empowered to levy all direct taxes on economic activities in the areas under its administration, as well as on economic activity by residents living in areas under the responsibility of the Israeli tax administration. Direct taxes include an income tax on individuals and corporations, a property tax, a municipal tax, and fees. However, under the August 1994 Agreement on the Preparatory Transfer of Powers and Responsibilities,⁵⁸ the Palestinian tax authority is empowered to tax income earned by Palestinians and foreigners anywhere in the West Bank, except for settlements and IDF areas. Thus, while the Palestinian Council is responsible for levying direct taxes on all residents of Gaza (excluding Israeli settlements and the IDF Base) and Areas "A" and "B" of the West Bank, it may also levy income tax on all non-Israelis earning income in Area "C" (excluding Israeli settlements or IDF areas).

58. Agreement on Preparatory Transfer of Powers and Responsibilities, Aug. 29, 1994, Isr.-PLO, 34 I.L.M. 455 (1995) (done in Cairo, August 19, 1994).

The PNA established an income tax department and a VAT department shortly after it came to power in 1994. During the first year of Palestinian self-rule, inaccurate reporting by taxpayers was rampant and resulted in low revenue. These difficulties primarily arose as a result of a lack of trained personnel and poor coordination with the outgoing Israeli Civil Administration tax departments. For example, very few trained Palestinians were available to perform the tasks previously discharged by Israeli tax officers, particularly assessment and investigation. In addition, the Palestinian tax departments commenced their operations in Gaza and Jericho without any taxpayer files, despite the fact that the Civil Administration had maintained a sophisticated computerized taxpayer file system.

Following the transfer of tax powers in the West Bank, the Palestinian tax departments sought to avoid the problems they had experienced in Gaza and Jericho by initiating close cooperation with Israel regarding personnel training and computer services. Over two hundred Palestinian tax officers were hired and sent to participate in specialized training courses established through cooperation with the Israeli tax departments. Furthermore, the PNA contracted the services of SHAM, the Israeli company providing tax-related computer services to the Israeli Government. The efficiency and resources of the Palestinian tax departments have thus dramatically improved since the early days of self-rule.

Despite the improvements in the institutional capabilities of the Palestinian tax departments, the actual tax laws and policies continue to create serious hurdles for both revenue collection and economic development. Furthermore, other hurdles have arisen as a result of the implementation of various Israeli-Palestinian agreements regarding coordination of tax policy and cooperation in the area of tax administration. The most important hurdles are apparent in three spheres of taxation: income taxation, VAT and purchase taxation, and import taxation.

1. Income Tax

The current income tax laws in the Palestinian Territories are problematic for four reasons. First, as in other legal areas in the region, the tax laws in the West Bank and Gaza are not uniform. The disharmony between West Bank and Gaza tax law se-

riously complicates compliance and revenue collection for both taxpayers and tax administrators. Second, the income tax statutes are out of date. In Gaza, the relevant statute is the 1947 British Mandate Income Tax Ordinance,⁵⁹ while in the West Bank it is the 1964 Jordanian Income Tax Law.⁶⁰ Third, both the tax regime and tax enforcement are made dauntingly complex by the numerous amendments issued by the Israeli military Governments in both territories between 1967 and 1994, as well as by amendments issued by the Egyptian military Government in Gaza between 1948 and 1967. Many of these military orders are poorly drafted and ambiguously worded, creating a lack of legal clarity and inviting excessive interpretive discretion by the tax authorities. Fourth, in addition to these basic problems, the tax laws contain provisions that constitute specific hurdles to development.

The most crucial of the specific obstacles to development engendered by the tax laws have been the inordinately high income tax brackets and rates that the Israeli military government established prior to the transfer of tax powers to the Palestinian Authority. For example, the highest tax bracket in the Palestinian Territories during the period of Israeli military rule was 55%. By comparison, in Jordan the highest tax bracket is currently 45% and in Israel 48%. Moreover, during the period of Israeli military rule, West Bank and Gaza taxpayers faced the highest rate of taxation if their income exceeded the approximate equivalent of US\$16,000. By comparison, under current Israeli law, taxpayers do not reach the highest tax bracket until their annual income surpasses the approximate equivalent of US\$30,000.

Additional specific hurdles to Palestinian economic development are posed by the required prepayment of income tax. Under Israeli military orders, taxpayers must prepay estimated income taxes based on payments from previous years. This requirement constitutes a burden for taxpayers, generally, and for small businesses, in particular, as it presumes these individuals and entities enjoy a steady cash flow and ready access to credit when, in fact, they often do not. Consequently, many Palestin-

59. Income Tax Ordinance No. 13 of 1947 (British Mandate), *published in* The Palestine Gazette, No. 1568, Supplement No. 1, (Mar. 20, 1947).

60. Hashemite Kingdom of Jordan Income Tax Law, Law No. 25 (1964).

ian businesses operate in the informal sector, evading taxes and fostering inequities between firms that are capable of operating informally and those that are not.

The Palestinian tax authorities are well aware of the problems of the current tax laws. Certain regulatory changes have already been made to ease the most burdensome procedures and rules regarding tax brackets and rates. Furthermore, an effort is now underway to unify and modernize the income tax laws of the West Bank and Gaza. Palestinian authorities have relied on the assistance of international tax and legal experts to this end and a draft Palestinian income tax law may be prepared in the near future.

2. VAT and Purchase Tax Rates

VAT and purchase tax rates have been specially addressed in Israeli-Palestinian negotiations. The interdependence of the two economies, formally linked through the customs union agreement, argues for coordination of certain aspects of tax policy and administration. Thus, Palestinian-Israeli agreements have established special guidelines regarding VAT and purchase tax rates. As a practical matter, these guidelines restrict the freedom of the Palestinian Council to set VAT and purchase tax rates independently of Israel. While harmonization of VAT and purchase tax rates between the two economies provides certain theoretical macroeconomic benefits, the limits on independent PNA policy formulation exact a definite economic cost.

The Interim Agreement provides that the Palestinian and Israeli tax administrations will each levy and collect VAT and purchase taxes in their respective areas of responsibility. According to the agreement, the purchase tax rates in both jurisdictions will be identical for both locally produced and imported goods.⁶¹ The sole exception from this rule permits the Palestinians to determine their own purchase tax rate on motor vehicles.⁶² The Palestinian VAT rate, however, may be set one percent to two percent lower than the Israeli rate.⁶³ The Interim Agreement also establishes that businesses under the Palestinian tax authority's jurisdiction may not be exempt from VAT if their

61. Interim Agreement, *supra* note 5, annex V, art. 6.

62. *Id.* art. 3.

63. *Id.* art. 6. Currently, the Israeli value added tax ("VAT") rate is 17%.

annual revenue exceeds US\$12,000.⁶⁴ Finally, the Interim Agreement provides rules for the clearance of VAT revenues between the Israeli and Palestinian VAT departments.

The arrangements for VAT clearance have raised several problems for the Palestinian tax authority. By the terms of the Interim Agreement, the Palestinian VAT department is to receive the VAT paid by Palestinians purchasing goods or services in the Israeli economy. Similarly, the Israeli VAT department is to receive the VAT paid by Israelis in the Palestinian economy. In order to expedite clearance of Palestinian and Israeli VAT claims, it was agreed that a special unified invoice must accompany every transaction between Palestinian and Israeli businesses.⁶⁵ The VAT department of each side is to distribute the invoices to businesses that sell goods and services to clients from the other side. Upon receiving payment for the goods or services rendered, the seller must issue an invoice specifying the amount of VAT paid. The invoices must then be used to establish VAT clearance at monthly meetings between representatives of the two VAT administrations.⁶⁶ Clearance claims are to be settled within six days of each monthly meeting, through the issuance of a payment by the administration with the net balance of claims against it.⁶⁷

Given the per capita income of the Palestinian Territories, the minimum permissible VAT of fifteen percent is an unusually high rate. Purchase taxes are also probably higher than they would normally be, in the absence of a commitment to match Israeli purchase taxes. The PNA agreed to harmonize its VAT and purchase taxes with Israel as a necessary condition for free access to the Israeli market for Palestinian goods. However, non-implementation of free trade commitments as a result of the security closures has meant that Palestinians are, in effect, paying the price of the customs union without enjoying its benefits. In addition, the Palestinian VAT department has expressed concern that Israel has not acted to implement the VAT clearance arrangements. According to the Palestinians, many Israeli companies selling products to clients in the Palestinian Territories

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

are neither provided with invoices, nor even made aware of their existence. Furthermore, in the absence of sufficient logistical support, the Palestinian VAT department has been unable to monitor the movement of Israeli goods into the Palestinian territories. Thus, the Palestinian VAT department, which expects to be owed between US\$100 million and US\$150 million on annual VAT clearance with Israel, is presently in a weak position to enforce compliance with VAT rules and to secure its interests through VAT clearance procedures.

3. Import Tax

The essence of the customs union established between Israel and the PNA is a harmonized import and customs policy. With respect to external trade, Israel and the Palestinian Territories are treated as one economic entity. The goal of the customs union is to prevent leakage of low-tariff imported goods from the Palestinian Territories into Israel. Thus, according to the Interim Agreement, Palestinian import taxes must generally be set no lower than the Israeli import taxes on equivalent goods.⁶⁸ However, the Interim Agreement provides three lists of goods for which Palestinian import taxes may be set independently of the Israeli tax rates. Goods on the first two lists may be imported to the Palestinian Territories in quantities agreed upon by the two sides, according to the needs of domestic consumption in the Palestinian market.⁶⁹ Any such goods imported to the Palestinian Territories in excess of the agreed-upon quantities are subject to import taxes set no lower than the corresponding Israeli import taxes.⁷⁰ The third list comprises basic food items and other goods required by the Palestinian economic development program that may be imported in unrestricted quantities subject to independently established Palestinian import taxes.⁷¹ Finally, imported motor vehicles may also be taxed at a rate set independently of the Israeli customs rate.

The Interim Agreement also establishes a procedure for the clearance of revenues from all import taxes and levies between Israel and the PNA. The clearance of revenues is based on the

68. *Id.* art. 3.

69. *Id.*

70. *Id.*

71. *Id.*

place of final destination.⁷² Thus, import taxes collected on goods in Israel's territorial sea or in airports and destined for the Palestinian territories are to be credited to the Palestinian customs administration. Revenue clearance is to be effected within six working days from the date the import taxes are collected.⁷³

The first major problem with the scheme for import tax harmonization established by the Interim Agreement is that, as with VAT and purchase tax rates, the Palestinian customs rate is probably higher than it otherwise would be, in exchange for a non-implemented free trade relationship with Israel. The second, and more serious, problem is that the restrictions on the PNA's ability to independently determine their own import policy substantially weakens their capacity to negotiate favorable trade terms with third countries. Due to these restrictions, the PNA is not in a position to offer favorable access to their domestic market as a *quid pro quo* for reciprocal access to a given foreign market. Thus, the PNA is largely dependent on Israeli trade policy to open foreign markets to Palestinian products. This situation is particularly unfortunate because the foreign markets that most interest Palestinian exporters are often countries with which Israel has little or no trade.

The third, and final, problem concerns import tax revenue clearance. Because high-volume Israeli importers can generally obtain lower unit costs and shipping rates than Palestinian importers, Palestinian businesses often prefer to import through Israeli firms. Furthermore, Palestinian businesses often prefer to use Israeli importers in order to avoid costly delays resulting from security checks. Thus, a large quantity of goods destined for the Palestinian Territories arrive at Israeli sea and airports marked as imports to Israel. Import taxes collected on these goods by Israeli customs officials, therefore, accrue to the Israeli treasury rather than the Palestinian treasury. Palestinian tax officials estimate that tens of millions of dollars of revenue, if not more, is being lost annually on this basis.

The hurdles deriving from the income tax, VAT, purchase tax, and import tax systems in the Palestinian Territories are doubly significant. Not only do these hurdles place costly burdens on entrepreneurs and other taxpayers, they also result in

72. *Id.*

73. *Id.*

low public revenue with untold consequences for the stability of the current political system. Reform of tax laws and policies, including those deriving from agreements with Israel, is, therefore, essential to ensuring an environment that is favorable to economic development and political stability.

CONCLUSION

The Middle East peace process has moved mountains since the September 1993 signing of the Declaration of Principles. Most of the Palestinian inhabitants of Gaza and the West Bank are now living under the authority of a democratically elected Palestinian Council. The IDF has departed from almost all Palestinian cities. Several Arab and Muslim states have opened diplomatic relations with Israel or initiated diplomatic and economic contacts. Business leaders throughout the region are joining forces to engage in joint ventures, trade, and other forms of economic cooperation. However, for the Palestinians, the process of building a free, prosperous, and stable society is far from complete.

The structural and legal hurdles to achieving economic growth and political stability in the Palestinian Territories represent a tremendous challenge to the Palestinian people. These hurdles cannot be overcome easily or quickly. In surmounting them, the Palestinians will require considerable support from fellow Arabs, technical and financial assistance from the United States and Europe, good faith and cooperation from Israel, and, most importantly, resolve and determination from their own people to make peace and self-determination succeed. In solving the structural and legal hurdles to national development, the Palestinian leadership can be truly effective only if the Palestinian people organize the mechanisms of civil society, develop positions on contemporary issues, and voice their opinions at every level of public policy formulation.

The twentieth century has seen the emergence and development of a Palestinian national consciousness that arose in a context of protracted suffering and dispossession. With the implementation of self-government after so many decades of disenfranchisement, the Palestinian nation is now at a crossroads. It can choose the rule of law, democracy, and peace or poverty, anarchy, and conflict. The recent resumption of terrorist attacks

against Israel during late February and early March, 1996 is, therefore, of the gravest possible concern. Not only do such attacks result in the loss of numerous innocent lives and feed the vicious cycle of violence and retribution, they threaten the very foundations of the peace process by calling into question the ability and commitment of Palestinian society to contain its radical elements. It is thus of inestimable importance that Palestinian society and its political leaders make a strategic decision to identify the cessation of all violence and terrorism as a primary national interest, and move decisively to quell it.

The Palestinian future is not written in stone. In fact, the Palestinians probably now have more control over their collective fate than ever before in their history. Furthermore, the level of Palestinian control over the course of their national life is continuing to rise. The Palestinians are now in a position to make difficult choices concerning the direction of their national future. As they begin tackling the numerous hurdles to achieving political stability and economic growth, they carry a profound responsibility. Their choices will disproportionately affect the fortunes of larger nations and the entire region. It has long been said that the Palestinians are the key to peace in the Middle East. It is also often said that the Middle East is the lynchpin to ensuring the stability and peace of the World. Thus, the success of the Palestinians in surmounting the hurdles before them is a matter of truly global concern.