



Economic Dimensions  
of a Two State  
Agreement Between  
Israel and Palestine

The Aix Group

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# An Outline of the Economic Issues of a Final Status Agreement in Jerusalem

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# Executive Summary

## 1. General

The main goal of this document is to offer ideas for economic agreements and arrangements that should accompany a future final status agreement between Israel and Palestine on Jerusalem. Due to the uncertainty about many aspects of the final agreement, especially on Jerusalem, we address a range of possible solutions and offer economic solutions for each possible scenario.

## 2. Main Assumptions on the Final Status Agreement

We assume that an agreement will divide Jerusalem politically between West Jerusalem / Yerushalayim, the capital of Israel, and East Jerusalem / Al Quds, the capital of Palestine. The exact location of the border between the two cities will be specified in the agreement. The two main uncertainties are the possible regime in the city and the location of the border.

There are three main possible regimes. The first is a *Divided City*, where the political border between the two cities will also be a physical border. The second is an *Open City*, with free movement of people and goods between the two cities. The third possible regime is a *Semi-Open City*, with a smaller open area such as the Old City in the city.

As for the location of the border, we identify three main possibilities. The first is a political border along the pre-1967 border, with all Jerusalem Settlements / Neighborhoods evacuated, except for the Jewish Quarter in the Old City. The second is a border that reflects the geographical divide between Jews and Arabs. The third is a border between these two possibilities that leaves some Jerusalem Settlements / Neighborhoods within Israeli sovereignty, while others are evacuated.

### 3. Institutions for Economic Negotiations

We recommend a special two-part negotiation mechanism to reach agreement on the economic arrangements in Jerusalem. One part is the “Jerusalem Economic Negotiation Teams” (JENT), made up of an Israeli team and a Palestinian team. The second part is the “Jerusalem Economic Arbitrator” (JEA), who will decide on economic matters on which the negotiating teams are unable to reach an agreement before the time of implementation of the agreement.

### 4. International Trade

The general trade arrangement recommended by the AIX Project is that of a Free Trade Area. This arrangement can be applied to Jerusalem, but not in the case of an Open City. In that case, tariffs and taxes in Jerusalem on goods from third countries must be uniform, with lower (or equal) rates than the minimum in the two countries. An Open City model also means that transportation from the city to the rest of the two states must be subject to restrictions at the city’s outside borders. In the Semi-Open City option, application of this special trade zone can be easier.

Such a trade arrangement can be quite expensive due to smuggling and loss of state revenues. For Israel such losses are estimated at 1% of GDP, or 2.5% of total tax revenues. For Palestine these costs might be higher. These potential costs cast doubt on the desirability of the Open City option.

### 5. Labor Arrangements

To the general recommendation of the AIX group that labor should be able to move freely between the two states, subject to regulation, we add one main recommendation on Jerusalem. Palestinians from East Jerusalem who have been working in Israel prior to the agreement will be able to keep their jobs for at least ten years, or until retirement.

### 6. Infrastructure

Infrastructure projects have significant network externalities, and hence should not be divided. But sharing infrastructure between two cities and two states might lead to inequality in services for political reasons, as each

project is run mainly by one side. We therefore recommend division of infrastructures between the two cities, but only after a transition period, as such a division requires large investments. Of course, the two sides will be able to continue to share an infrastructure beyond the transitional period, if they agree to do so.

## 7. Costs of Setting a Border

The future of the Jerusalem Settlements / Neighborhoods in East Jerusalem is one of the main issues in the agreement. An agreement might require evacuation of all, some, or none of these areas; also, less evacuation would require more infrastructure adjustment (tunnels and bridges) to increase contiguity to both sides. The economic agreements on these issues will be reached by the JENT and the JEA (if the JENT fail to agree).

We recommend that each required infrastructure project should be planned and built by the party who uses it, but has to be agreed to by the other party as well, hence negotiated. The financing of such projects should be borne by Israel.

With respect to an evacuation of a Jerusalem Settlement / Neighborhood, we strongly recommend that these neighborhoods not be destroyed. We also suggest that a special Palestinian administrative body handle the transfer of assets to Palestine and these assets' distribution. The two sides will negotiate whether and how many funds will be tendered for all assets, mobile and immobile, left by Israel in the area.

## 8. Social Security and Health

We recommend that all Palestinians in East Jerusalem who are entitled to social security benefits from the NII (National Insurance Institute) due to past contributions continue to receive the benefits that are due to them until death. Their new contributions, however, will be paid to the Palestinian Social Security Institution.

To smooth transition of health insurance from Israeli to Palestinian providers, we suggest a special transition period during which Palestinians from East Jerusalem will continue to pay health tax to Israel and receive health services from Israeli providers.

## 9. The Current Situation and the Final Status Agreement

Two current main obstacles to a final status agreement are the separation wall / barrier in Jerusalem, and expansion of settlements in and around Jerusalem. We focus here on their economic implications only. Both the wall / barrier and the expansion of settlements contribute to separating the north of the West Bank from its south. This split of the West Bank into two seriously derails economic development in Palestine, due to loss of returns to scale.

We strongly believe that economic development in Palestine is crucial to a peace agreement. A successful economy provides incentives to keep agreements and preserve peaceful relations, while economic hardship is a recipe for potential hostility and conflict. Hence, such obstacles to development are very detrimental to reaching an agreement.

## 10. Summary

This document is partly optimistic and partly pessimistic. We show that it is possible to outline economic arrangements of a final status agreement, and this is optimistic; but we also show how current developments in Jerusalem put obstacles on the road to peace. Our analysis therefore highlights the urgency of beginning negotiations on the final status agreement. Time is not in favor of reaching such an agreement.

## I . Introduction

This document discusses the economic aspects of a future final status agreement between Israel and Palestine on the issue of Jerusalem. Its main goal is to offer ideas for the economic agreements and arrangements that should accompany a future final status agreement on Jerusalem. In addition, the paper discusses current economic issues that might affect the path to a final status agreement, and the economic requirements for reaching and sustaining such an agreement.

We bear in mind that an economic agreement will be part of a broader Israeli-Palestinian final status agreement, which, as we all know, will be very difficult to reach. Since we are so far away from an agreement, it is hard to imagine how it will look. Where will the border pass? What arrangements will be made for the transitional period, and how will implementation of the agreement be safeguarded? The difficulties in forecasting an agreement are even more complicated in Jerusalem, where the current positions of the two sides are much farther apart than on most other issues of the conflict, and so the shape of a future agreement is even more uncertain. Thus it is clear that our ideas and recommendations for economic arrangements should not address a single possible solution, but rather a `range of possible solutions. Hence, our analysis will first examine the range of possible final status scenarios, followed by suggested economic solutions for each possible scenario.

In addition to analysis of the final status agreement, our paper includes an analysis of some economic aspects of the road to such an agreement. We focus mainly on the current possibility for economic development in Palestine in general and in East Jerusalem specifically. Although the prospects for future economic development for Palestine are not likely to be part of a final status agreement as such, they will have a significant impact both on the process of negotiation and on how the agreement will be implemented. A successful economy provides incentives to keep



agreements and develop peaceful relations. Conversely, economic hardship is a recipe for continued hostility and potential conflict. We therefore believe that future economic prosperity for Palestine and the means of achieving such prosperity, starting at the present time, are vital to the success of any final status process.

In order to lay down the factual basis of our analysis, we begin with some background and with a description of the current economic situation of East Jerusalem. We then describe possible scenarios for an agreement on Jerusalem, and suggest economic arrangements in the areas of trade, labor, infrastructure, social security and more. Finally, we look at some current developments in Jerusalem and examine their adverse effects on the economic development of Palestine and, as a result, on the ability to reach a final status agreement in the future.

## 2. Background

Jerusalem is a complex city due to its ethnic, religious and cultural heterogeneity. It is also special due to its importance to the three monotheistic religions and its national-historical significance to both Israelis and Palestinians. It was the capital of the country under the British Mandate and in many previous historical periods.

The attached map<sup>2</sup> illustrates the shifts in Jerusalem's boundaries since the end of the British Mandate. In the years 1948 – 1967, the city was divided between Israel and the kingdom of Jordan, which ruled the West Bank and East Jerusalem in the aftermath of the 1948 war. The division line, shown on the map to the right, which was a cease fire line, is now called the pre -1967 border or the Green Line. Before 1967 Arab East Jerusalem encompassed only 6.5 sq km. Immediately after the 1967 War and occupation, the Israeli Government decided to annex East Jerusalem, plus an additional 70 sq km which included 28 surrounding West Bank villages. Israel added all this area to West Jerusalem and the annexed territory became part of the greater municipal Jerusalem, which has expanded westward as well. The Palestinians in the annexed areas became residents of Israel, but not citizens. This unilateral annexation has never been recognized by any state other than Israel.

After the annexation in 1967, Israel began massive construction in the area of East Jerusalem. This construction included residential areas for Israelis, as well as infrastructure. As a result, the pre -1967 border lost much of its role as a dividing line between the two populations. This massive construction, which is still going on today, has changed the landscape of the city and has affected its demography, economy and many other aspects of life. It also makes reaching an agreement on Jerusalem much more difficult.

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2 The Palestinian Academic Society for the Study of International Affairs (PASSIA) Website.  
[http://www.passia.org/palestine\\_facts/MAPS/images/jer\\_maps/Jlem1947-2000.html](http://www.passia.org/palestine_facts/MAPS/images/jer_maps/Jlem1947-2000.html)

In 1982, the Israeli Government passed special legislation that further formalized the annexation of East Jerusalem by defining Jerusalem as a unified city within the municipal borders set by Israel. These municipal borders created a formal seam line between East Jerusalem and the West Bank and thus began to separate the Palestinians in the two areas. Palestinian residents of East Jerusalem were issued blue “Israeli” ID cards and residents of the West Bank were issued orange ID cards. The differences did not end with color, but extended to other aspects of life. Palestinians in East Jerusalem were eligible to participate in most Social Security programs in Israel through the National Insurance Institute (NII). They were also able to enter Israel and work, unlike Palestinians from the West Bank, who were subject to increasingly severe permit restrictions from the early 1990s on.

The separating line between East Jerusalem and the West Bank became more pronounced over the years, as physical barriers began to be erected in the 1990’s. These barriers began as checkpoints at the main entrances to Jerusalem, and gradually became more permanent. Access restrictions on West Bank ID-holders intensified following the start of the Al-Aqsa Intifada in 2000. Recently the separation became almost a hermetic seal with the building of the separation barrier / wall, which began in 2002 and which is almost complete in the Jerusalem area. The physical separation of East Jerusalem from the West Bank, and with it the reduced territorial contiguity and mobility between the north and south of the West Bank, significantly affects the economic conditions in Palestine.

Further intensifying the separation of north and south in the West Bank is the ongoing expansion of Ma’aleh Adumim, a settlement east of Jerusalem founded in 1975, and its satellite settlements. If Ma’aleh Adumim is linked to East Jerusalem by the planned “E-1” corridor, this will effectively close the eastern gate of Jerusalem, and completely sever the West Bank in two. Such a development will have severe consequences for the economy of East Jerusalem, as it will remain without area for future growth and development. It will also have dire consequences for the development of Palestine in general. Mobility through Jerusalem will become impossible and territorial contiguity and movement between the two parts of the West Bank will be very seriously impaired.

Before we begin a detailed analysis, we need to clarify some terms used in this paper, since terminology is a loaded issue for both sides. The first term we use is “Jerusalem.” This is a factual term that describes the current municipal area of Jerusalem, without any implied recognition of these municipal borders. Second, we call the cease fire line that prevailed before June 4, 1967 (the Green Line), the pre-1967 border. Next, we call the part of this area that is west of this line “West Jerusalem” or “Yerushalayim” and the part of this area that is east of it “East Jerusalem” or “Al Quds.”<sup>3</sup> The residential areas built by Israel in East Jerusalem are viewed as Jerusalem neighborhoods by Israel and as illegal settlements by the Palestinians and the international community. In this paper we will call these neighborhoods “Jerusalem Settlements / Neighborhoods,” again without any implied recognition of the legal implications of the term.

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3 To avoid too many definitions, in the rest of the paper we continue to call the future parts of Jerusalem after a final status agreement West and East Jerusalem, but the reader can think of the two capitals as Yerushalayim and Al Quds. The future border between the two cities might not be the pre-67 border; however, but another border that will be agreed upon by the two sides.



## 3. The Economic Situation of the Palestinians in East Jerusalem

This chapter contains a brief description of the economic situation of the Palestinian community in East Jerusalem. This description serves as a background to our analysis of policy recommendations in this document. It does not include some specific issues like social security and infrastructure, which are discussed in separate chapters.

### 3.1. Population

In 2005 the total population of Palestinians in East Jerusalem was estimated to be 251,000. This was 6.5% of the total Palestinian population in the occupied territories and 33% of the population of Jerusalem. Of this Palestinian population, 42% were under the age of 15 and 3.3% over the age of 65. The average household size was 5.3 members. Therefore it can be estimated that there were approximately 47,358 Palestinian households in East Jerusalem in 2005.

### 3.2. Living Conditions

In 2004, the average monthly consumption per Palestinian household in East Jerusalem was 6,043 NIS. This was over 3 times higher than the equivalent number in the rest of the occupied territories. The Palestinian definition sets the poverty line at US\$2 a day per person, which means that the percentage of Palestinians living in poverty in East Jerusalem was just 3.6% in 2003. According to the Israeli definition, which uses a relative measure of half the median income per capita adjusted for size of family, the poverty rate among Palestinians in East Jerusalem was much higher and reached about 42% in 1999. Since then the Palestinian economic situation has further deteriorated.

### 3.3. East Jerusalem and the Municipality

Another indicator of the poverty in East Jerusalem is the low level of property tax (*armona*) paid to the municipality. The data shows that East Jerusalem Palestinians contribute about 11% to the municipal revenues. More specifically, they contribute 10% to the residential *armona* and 12% to the commercial *armona*. In East Jerusalem, there is a considerable default rate on *armona* payments; approximately 35% of charges are corrected for exemptions. In West Jerusalem the default rate is about 11%.

Palestinians in East Jerusalem are also heavily discriminated against in the budget they receive from the municipality. In an analysis of municipal expenditures in East Jerusalem in 2003 by Meir Margalit (a former council member), he finds that East Jerusalem receives only 12% of the municipal expenditures.<sup>4</sup> This number is staggering for a number of reasons: Palestinians in East Jerusalem account for 33% of city residents; their poverty rate is more than double that of the Jewish population; and they have a higher percentage of children in their overall population (42%) than the residents of West Jerusalem (32%). In spite of these facts, Palestinians receive just about 12% of the city's welfare budget and only around 15% of the education budget. Furthermore, East Jerusalem receives only 8% of the engineering services, and a mere 1.2% of the culture and art budgets. Taking into consideration the differences in population alone, these figures mean that there is a significant disparity in favor of the city's Israelis by a factor of 3.6.

The bias against East Jerusalem and the Palestinian population is evident not only in past expenditures but also in future projects and in plans to maintain favorable Jewish demographic balance. The new light rail almost completely bypasses Palestinian neighborhoods. The plan for the city's future, *Jerusalem 2000*, was strongly criticized in a special report by the architectural organization "Bimkom" as heavily biased against Palestinians in East Jerusalem.<sup>5</sup>

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4 **Ir Amim Website.** [http://www.ir-amim.org.il/\\_Uploads/dbsAttachedFiles/BudgetMeirMargalit\(1\).doc](http://www.ir-amim.org.il/_Uploads/dbsAttachedFiles/BudgetMeirMargalit(1).doc)

5 **Bimkom Website** <http://www.bimkom.org/dynContent/articles/Jerusalem%20Master%20Plan%202000.pdf>

### 3.4. Other Social Indicators<sup>6</sup>

Despite their low economic indicators, East Jerusalem Palestinians enjoy access to good health services and thus score well with respect to basic indicators such as life expectancy at birth, which is equal to 76 years. This figure is higher than in the occupied territories, where life expectancy is equal to 71 years, but it is lower than in Israel, where life expectancy is nearly 78 years. Infant mortality in East Jerusalem is low at 7.2 deaths per 1,000 live births in 2001. This is much lower than in the occupied territories, where the rate is 17 deaths per 1,000 live births. However, it is higher than for Jerusalem as a whole, with a rate of 4.2 deaths per 1,000 live births.

Most of the Palestinian population in East Jerusalem has access to the Israeli social welfare system, which covers basic health costs and provides social security benefits, though access to these services may be difficult at times.

### 3.5. The Labor Market

In 2005, the labor force in Arab East Jerusalem consisted of 53,000 people, indicating a very low labor participation rate of 37.2% (66% of men and just 8.2% of women). By comparison, the Israeli labor participation rate (which is in itself low by international standards) is approximately 55%. The unemployment rate in Arab East Jerusalem is 20% of the active labor force. Therefore, only 45,000 residents are working on a regular basis.

Of these 45,000 workers, 50% work in West Jerusalem and in the rest of Israel. The distribution of the East Jerusalem Palestinian labor force by sectors exhibits a clear orientation to the service economy. This is because there is neither a real agricultural nor an industrial base in East Jerusalem, which leaves housing and services, especially tourism, as the main sectors in the East Jerusalem economy. Note that the service sector is the leading sector in West Jerusalem as well.

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6 Multi Sector Review (MSR) Project Website. <http://www.multi-sector.org/>



### 3.6. East Jerusalem's Economic Sub-sectors

The main economic sectors in Arab East Jerusalem are: housing and construction; tourism and transportation; small to medium size manufacturing; and retail and commerce. Finance and agriculture play only a minor part. Finance is currently limited to one development bank and several money changers, while total agricultural income per year amounts to only US\$2 million.

The total number of Palestinian economic establishments in East Jerusalem in 2005 was 5921 (compared with 5135 establishments in 2001). The sector breakdown for 2005 is as follows:

1. 706 are industrial establishments that employ 3486 workers.<sup>7</sup> The total production of these enterprises was US\$236 million and the value added from this production was US\$118 million.
2. The number of establishments engaged in internal trade and commerce activities was 3350. They employed 7579 workers and their total output was US\$99.1 million.
3. The number of establishments engaged in transportation was 110. This sector employs 784 workers and produced an output of US\$16.8 million in 2004.
4. The number of establishments engaged in the service sector was 1155. Those establishments employed 3643 workers in 2004. The product of this sector was US\$62.4 million and the value added was US\$45.8 million.

### 3.6. Tourism

Tourism is considered to be the main service sub-sector of Palestinian East Jerusalem's economy, and is the major source of foreign currency. Tourism generated more than 3,500 direct jobs in 2000, but this number dropped to less than 1,800 in 2005. During the Al-Aqsa Intifada and after the September 11 attacks, tourism to Israel and especially to East Jerusalem dropped dramatically. Although both sides of the city are usually

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<sup>7</sup> Chart and statistics from the Palestinian Central Bureau of Statistics (PCBS) Website.  
<http://www.pcbs.gov.ps/>

affected when it comes to tourism and political factors, to some extent the impact is different. In West Jerusalem, the number of bed nights in hotels dropped by 52% (from 2.85 million in 2000 to 1.36 million in 2001); in East Jerusalem, this figure dropped by 82% (from 600,000 in 2000 to 104,500 in 2001).

### 3.7. The Private Sector

The Palestinian economy in East Jerusalem is dominated by the private sector, which has had a substantial role in the development process, especially during the last two decades. The wages from the private sector are the main source of Palestinian household income in East Jerusalem. In addition to manufacturing, trade and services, many public service activities in the areas of health, education and social services are run by the private sector.

The number of Palestinian private sector enterprises in East Jerusalem declined in the 1990s: from close to 3,000 establishments in 1994, the number dropped to 2,245 in 2000. These numbers reflect the fact that much Palestinian economic activity has moved from East Jerusalem to other areas of the West Bank. Prior to the second Intifada, this process had been mainly driven by economic forces, including a less stringent regulatory environment, lower taxes, lower land and rent costs, and relative improvement in economic conditions in the West Bank between 1994 and 2001.

After 2001, Israeli security measures, namely the separation barrier and the frequent closures of the West Bank, set severe obstacles in the way of normal Palestinian economic activity in East Jerusalem. This caused a further shift of capital and of private enterprises to the West Bank.

Table 1: Number of registered private sector establishments and employment in East Jerusalem by sector, in the year 2000

<b>Firms</b>	<b>Firms: &lt;5</b>	<b>Firms: &gt;5&lt;10</b>	<b>Firms: 10+workers</b>	<b>Total firms</b>	<b>Total Employment</b>
Industry	153	24	16	193	1,424
Repair	74	14	8	96	314
Trade	1,155	46	14	1,215	2,332
Restaurants	127	11	31	169	1,214
Transport	19	17	35	71	862
Business services	161	20	12	193	626
Social services	220	32	56	308	3,968
<b>Total</b>	<b>1,909</b>	<b>164</b>	<b>172</b>	<b>2,245</b>	<b>10,740</b>

Source: PCBS Website. <http://www.pcbs.gov.ps/>

## 4. Potential Outlines of the Final Status Agreement

Any attempt to draw possible guidelines for the economic arrangements of the final status agreement must make some assumptions about the possible political characteristics of the final status agreement itself. In this section, we describe our working assumptions and classify the main possible scenarios for a final status agreement. We then fit each scenario with the economic arrangements that suit it best.

What is true for a final status agreement in general is especially true for any agreement on Jerusalem: it will be hard to achieve and could be quite complicated. Hence, trying to outline the main characteristics of such an agreement is a very important but also very difficult task. There are some elements of such an agreement that can be predicted with certainty, while other elements are uncertain. For those uncertain elements, we describe a number of options. The uncertainties include both the type of the future regime in the city, and the location of the border. What is certain, however, is that the regime and the location of the border are strongly related.

Before we examine these two uncertainties in more detail, we present what we view as the certainties of any future agreement on Jerusalem. Namely, we list a number of working assumptions which we believe will apply to any possible future solution. These assumptions reflect the basic requirements of any future final status agreement. In our view, if any of these elements is missing, a final status agreement cannot be reached or will not be viable or stable. These working assumptions are:

1. There will be two states, Israel and Palestine, living side by side, with an agreed-upon border between them.
2. Jerusalem will be divided into two cities. East Jerusalem / Al Quds, will be the capital of the state of Palestine under Palestinian sovereignty, and West Jerusalem / Yerushalayim, will be the capital of the State of

Israel under Israeli sovereignty.<sup>8</sup>

3. The precise location of the border between the two cities will be specified in the agreement. In general, the working assumption of the AIX Group is that the overall border between the state of Israel and the state of Palestine will be based on the June 4th 1967 Green Line with minor, reciprocal and equitable modifications agreed to by the two parties. Since many of these modifications might be in Jerusalem, they could be more substantial, relative to the size of the city, than in other border areas. Hence, this document considers below a number of options for the location of border.
4. Whether or not the two cities will be divided physically, they will have separate municipalities: a Palestinian one east of the border and an Israeli one west of the border. This is important for ending the conflicts over construction, settlement and quality of services once an agreement is reached. The two municipalities will cooperate on various issues that require cooperation.
5. Complete, free and unhindered access to the holy places in both cities will be granted to all.
6. The implementation of the agreement after it is signed will take some time, the length of which will be specified in the agreement. Our estimate is that the implementation can be as short as one year for some issues, but not longer than 5 years for any possible issue.

Note that these assumptions do not include any internationalization of the city of Jerusalem. It is our assumption that since at least one side will not agree to internationalization of its own capital, the agreement will not include internationalization of Jerusalem, as in the original UN partition decision of 1947. There might be some international local arrangements, mainly for the holy places in Jerusalem, but they will be partial, isolated, and will not affect the main regime options for the two cities.

#### 4.1. The Possible Regimes in Jerusalem

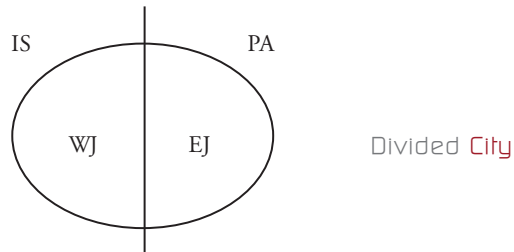
The many possible regimes in Jerusalem can be classified into three main

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<sup>8</sup> See footnote 3 above.

types. We are aware, of course, that innovative negotiators can always come up with additional ideas, but we nonetheless believe that these three types are the main candidates for an agreement as envisaged today.

#### 4.1. A. Divided City



One possible regime is a divided city, wherein the political border between the two cities is also a physical border that can be crossed only by use of passports or some other type of permit. Operationally this means a physical border separating the Palestinian sovereign areas from Israeli sovereign areas, with gates that enable limited passage of people and goods.<sup>9</sup> Special arrangements might be considered for tourists. Note that the divided city regime does not necessarily imply a hermetically closed border, as there can be free movement of some type (like trains or buses) between the two sides of the border. The divided city regime is described in the following diagram, where a solid line stands for a physical border, while a dashed line stands for a non-physical border, either between states or a municipal border.

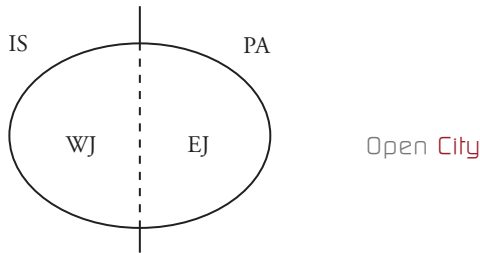
#### 4.1.B. Open City

The second possibility is an open city, in which there is free movement of people and goods between the two cities, despite the political border between them. In this case Jerusalem would become an enclave, separated physically both from the rest of Israel and from the rest of Palestine, with gates in each separation line. This solution is desirable primarily with

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<sup>9</sup> Note that a physical border need not be a fence or a wall, but can be monitored by some electronic devices that are now available through modern technology.

regard to the future development of tourism in the city.<sup>10</sup> Operationally, the Open City model means that there will be free and unimpeded movement of goods and people between the two cities, any limits to mobility will be between Jerusalem and the rest of the two states, not between the two cities. These limits will be required both for goods, through customs, and for people, through passport and security controls.<sup>11</sup> Such a regime is described in the following diagram:



#### 4.1.C. Semi-Open City

The third type envisages a smaller open area within the city (for example, all or part of the Old City) while the rest of the two cities are divided physically. This regime implies that there would be limitations on movement between the open area and the rest of the two cities.

#### 4.2. Possible Locations of the Border

The decision about the type of regime depends heavily on another decision: the exact location of the political border within Jerusalem. To show this, note that there are three main possibilities for the location of the border:

1. The first is a political border that runs along the pre-1967 border (Green Line), with evacuation of all Jerusalem Settlements / Neighborhoods except for the Jewish Quarter in the Old City. In this case, the Open City scenario becomes quite impossible. Such a massive evacuation

<sup>10</sup> Having an open city will require cooperation between the two municipalities, mainly in the area of law and order, but that is not the main focus of this document.

<sup>11</sup> Our study focuses only on the need for custom controls.

will create tensions and hostility between the two populations in the city, making life in an open city very dangerous and possibly even jeopardizing the implementation of the agreement. Hence, in this case the Divided City model seems to be the only realistic option.

2. The second possibility is that the border will not go along the pre-1967 border (Green Line), but will reflect the current geographical divide between Jews and Arabs.<sup>12</sup> This case raises serious questions of continuity both within the Palestinian city, and between the city and the rest of Palestine. If this is the agreed-upon border, then any of the Open and Divided City models are possible. Clearly, though, the Open City option becomes more plausible and even desirable, as it can significantly enhance mobility between the various Palestinian parts of the city.
3. The third possibility is a compromise between the strict pre-1967 border Green Line of the first case and the line between the Jewish and Arab areas in the second case. Namely, the border will leave some Jerusalem Settlements / Neighborhoods within Israeli sovereignty, but will lead to the evacuation of others, mostly to enable greater “contiguity” within the Palestinian city. Examples of settlements that could be evacuated are Atarot, Har Homa, Neve Ya’acov, or Pisgat Ze’ev. In this case we can use reasoning similar to that above and conclude that if the evacuated areas are rather small, then an open city can still be considered; but if the evacuation is extensive, the Open City option becomes quite impossible, leading again to a Divided City model.<sup>13</sup>

We should add here that we have considered a fourth option: withdrawal to the pre-67 border that leaves the Jerusalem Settlements / Neighborhoods in place and enables the Israelis who live there to become residents in Palestine. Despite the clear benefits of such a proposal it suffers from severe drawbacks that make it non applicable. First, such an arrangement might lead to repeated claims over the land of these neighborhoods by

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12 A similar idea was in the Clinton Proposals. It is important to note that this solution should not apply to isolated settlement houses, like Kidmat Zion and Shimon HaTzadik.

13 All three options relate mainly to the extent of territory transferred to Israel beyond the Green Line. This is because this is the relevant issue for our specific discussion. It should be mentioned though that these various options can also include a transfer of some territory from Israel to Palestine within Jerusalem, such as the Wallaje area.



Palestinian land owners. Some of these claims might even lead to violence. Second, the Israelis left in East Jerusalem will suffer a significant decline in the public services they receive. They will therefore refuse to stay there and demand alternative housing in West Jerusalem. For these reasons we have decided to rule out this option.

From the above discussion, we can conclude that any future decision with regard to the regime in Jerusalem will be significantly affected by the location of the future political border within the city. Specifically, the location of the border will, to a large extent, determine the nature and degree of openness of the city. The closer the border is to the pre - 1967 border Green Line, the more likely the Divided City option becomes. If, on the contrary, the border is close to the current geographical divide between Jews and Arabs, then both the Divided City and Open City options are possible.

#### 4.3. Other Considerations

There are other considerations to take into account when discussing the question of regime in Jerusalem. We focus next on one economic consideration. The current large gap in income and earning between the two parts of the city might make the open city regime less favorable to Palestinians. It might lead, for example, to specialization by East Jerusalem in low-skill services, while West Jerusalem specializes in high-skill services. This could significantly hamper economic development in East Jerusalem. Such considerations should affect the agreement on the future regime in the city.

## 5. Institutions for Economic Negotiations

Issues relating to Jerusalem require special arrangements in many areas, both political and economic. For example, special economic arrangements are required in areas such as trade, infrastructure, and Jerusalem Settlements / Neighborhoods. As a result, we recommend the creation of a special negotiation mechanism that is dedicated to the economic arrangements in Jerusalem, and that will work in conjunction with the political negotiators. Our suggestions are as follows:

### 5.1. Jerusalem Economic Negotiation Team

We suggest the creation of two special negotiating teams, one Israeli and one Palestinian, focused specifically on the economic aspects of an agreement on Jerusalem. These “Jerusalem Economic Negotiation Teams” (JENT) would operate in conjunction with the political negotiating teams to reach detailed agreements on trade arrangements, labor permits, financial aspects of evacuations of Jerusalem Settlements / Neighborhoods, and issues of infrastructure. Negotiations between the JENT will begin after the signing of the political agreement, or even earlier if possible, and end before the full implementation of the agreement. The teams will work together to decide the precise details of the implementation of the agreement in Jerusalem.

In principle, the JENT can be part of the Israeli and Palestinian economic negotiating teams, and the JENT should definitely be coordinated by these teams. But because of the large amount of economic agreements required in Jerusalem and their specific characteristics, which require a significant amount of specialization, there is a strong case for creating separate negotiating teams for the issues relating to Jerusalem.

## 5.2. Jerusalem Economic Arbitration

In the event that the two economic negotiating teams are unable to reach an agreement that leaves enough time before the implementation time, the matter will be brought to a mutually acceptable “Jerusalem Economic Arbitrator” (JEA). Since all issues dealt with by the JENT must be settled before the final implementation of the agreement, there is a clear need for such an arbitration mechanism. Note that the arbitrator will not decide on major issues like the location of borders, but rather on financial and economic issues related to the agreement.

## 6. Trade Arrangements

### 6.1. Trade Regimes

The general trade arrangement recommended by the AIX Project for Israel and Palestine is a Free Trade Area: a bilateral free trade agreement between Israel and Palestine with respect to goods produced in each country, while goods from third countries will be traded with tax and tariff adjustments. In this section we examine whether Jerusalem should have the same trade regime. As we demonstrate below, the main parameter that should determine the specific trade regime in Jerusalem is whether the city is open or divided.

1. If the city is divided, the economic regime in the city can and should be the same Free Trade Area arrangement that is recommended for Israel and Palestine.
2. If the city is open, a uniform system of tariffs and taxes is necessary in the two parts of the city for goods from the two states as well as from third countries. This follows from the simple fact that an open city means a free transport of goods between its two parts.
3. For each specific good, therefore, the rate of tariff and tax should be equal in both parts of Jerusalem, and it should be set at any rate between zero and the minimum rate in the two states. For example, if Israelis outside of Jerusalem pay a tax and tariff of 15% on DVD players while Palestinians outside of Jerusalem pay 20%, the rate in both parts of Jerusalem should be equal, and should be set anywhere between 0-15%. A rate higher than 15% would send Israeli shoppers from Jerusalem to a mall in Mevaseret Zion. As a result, if there is an open city in Jerusalem, it must be a special trade zone for goods from third countries relative to the rest of the two states, with lower rates for many goods.

4. In order to restrict the special trade area to Jerusalem, some restrictions must be placed on transportation at the outside borders between the two cities and the rest of the two states (the blue lines in the two diagrams above). We suggest that these restrictions should apply only to commercial transactions (trucks or trains) and not to households (private vehicles). One example of such an arrangement is the limitation on Eilat within Israel as a VAT-free city.
5. It is important to note that in the Semi-Open City option, the open area is relatively small. If trade in this area is restricted to certain classes of goods, like food, textile and tourism, that will make the special trade arrangements in this area less costly and less problematic than in the whole city.
6. One possibility of a special trade zone in the case of an open city is a full Free Trade Area with no tariffs and taxes on goods, including those from third countries, either as a permanent or as a temporary arrangement. Such an arrangement could give a significant economic boost to both parts of Jerusalem, but it also has some negative aspects, such as the potential to create resentment by favoring East Jerusalem over the rest of Palestine.

## 6.2. Economic Implications

A special trade arrangement for Jerusalem is a necessary by-product of the Open City option. Although the economic consequences of a special trade zone cannot be fully evaluated at the present time, the potential costs of such an arrangement should be taken into consideration when discussing the future model of the city. Current tariffs and excise tax rates on goods from third countries are quite similar in Israel and in the Palestinian Authority. Israel has relatively low tariffs: only 11% of Israeli imports pay tariffs (exceptions are cars, gasoline and some electric appliances). Purchase taxes are also low in Israel; only cars, cigarettes and alcohol are taxed at a high rate. If these rates continue to be coordinated and harmonized between the two states, the special trade zone in Jerusalem will not be costly. But once independent, Palestine might decide to impose higher or lower tariffs and taxes on various goods, reflecting either a need to finance its expenses, or its intentions to protect infant local industries.

Future potential discrepancies in tariffs and tax rates between Israel and Palestine might lead to massive smuggling through Jerusalem, which could be quite costly for both sides.

The following tax and tariff figures give some estimates of the potential smuggling costs to Israel from a free trade zone in an open city. In 2005 the income from purchase tax on cars and car parts in Israel was 6,849 million NIS, or 1.1% of GDP. The income from purchase tax on cigarettes was 3,342 million NIS in 2005, or 0.6% of GDP. Revenues from purchase tax on gasoline were 393 million NIS. The rest of the revenues from purchase taxes were 1,493 million NIS. If we omit cars from the total because they are hard to smuggle due to the need to register them, the rest of the goods created an income of 5,233 million NIS, or 0.9% of GDP. The income from tariffs to Israel reached 1,764 million NIS in 2005. Most of these tariffs were on goods that cannot be moved easily, like cars or inputs to industry. The value of tariffs on leather, textile and clothing, which are easier to move across the border, was 470 million NIS, which is less than 0.1% of GDP.

Hence, the potential income losses to the Israeli government from smuggling do not exceed 1% of GDP. This figure is not very high, but neither is it negligible: it is approximately 2.5% of the total government tax revenue. It is hard to draw conclusions from these figures with respect to losses of income to the Palestinian government, but we can say that in general, these losses can be expected to be even higher, since income from purchase tax and tariffs might well be larger relative to income in Palestine.

These potential costs make the Open City option much more complicated and costly than it initially appears. Hence these potential costs cast doubt on the desirability of the Open City option. Although it might benefit tourism, it could be costly for public revenues. Furthermore, there are additional, non-pecuniary social and moral costs to making Jerusalem a main channel for smuggling between the two states. A full consideration of these costs makes the Open City option much less attractive. We could even say that the above analysis puts a dilemma before the negotiators on Jerusalem: if they prefer an open city, it almost inevitably requires a policy of tax and tariff harmonization between the two states. If Palestine insists on tax and tariff independence, it means that the option of an open city

in Jerusalem has to be given up.

## 7. Labor Arrangements

The general recommendation of the AIX group for labor arrangements between Israel and Palestine is that labor will flow freely between the two states, but will be subject to regulation through taxes and/or permits. As detailed below, we adopt this recommendation for Jerusalem as well, though with one additional adjustment.

First note that unlike trade arrangements, labor arrangements do not depend much on the possible regime in the city. The main reason is that unlike trade in goods, which is to a large extent small-scale and anonymous, labor contracts are usually long-term, and drawn between well-known parties. Thus in the case of a divided city, it is possible to allow labor to flow across the border through designated passages; at the same time, it is also possible to regulate labor flows even if the city is open.

The labor arrangements in Jerusalem could therefore be similar to the overall labor arrangements between the two states, but with one important difference. We must acknowledge the fact that Palestinians from East Jerusalem have been working for Israeli employers for many years. We therefore suggest that in addition to the general labor agreement between the two states, there should be a provision for Jerusalem specifying that those Palestinians from East Jerusalem who have been working in West Jerusalem prior to the agreement will be able to keep their jobs for a minimum of ten years, or until retirement.

The team discussed the possibility of giving all Palestinians from East Jerusalem, not just those who already work in Israel, preferential treatment with regard to labor. The views on the issue were mixed. Such preferential treatment would help workers in East Jerusalem, but it might also create excess Palestinian immigration to East Jerusalem and hamper its economic development as a Palestinian capital. It might also create social tensions



within the Palestinian society. We therefore decided not to include it as a recommendation by the team.

## 8. Infrastructure

The division of infrastructure between the two cities poses a serious economic question. Many infrastructure projects, such as water, sewage, trains, electricity, and wired telecommunications, have by their nature significant network externalities, and thus large returns to scale. Hence, from a pure economic point of view, in an ideal world such infrastructure networks should not be divided between the two cities. But in the real world, where politics play a significant role, sharing the same infrastructure between two cities that belong to two different states involves serious difficulties. Mainly, such an infrastructure is usually run by one side, and it therefore has a tendency to neglect and under-serve the other side. Hence, our basic recommendation is to divide the infrastructures between the two cities, but to do it gradually. The gradual transition is required by the large investment involved in building infrastructure networks. We begin this chapter with a brief survey of infrastructure in the two sides of Jerusalem, and then offer detailed recommendations.

### 8.1. Description

There is a wide gap in infrastructure and provision of basic services between East and West Jerusalem. Table 2 provides evidence for this gap with respect to roads and streets, sewage system, garbage collection holders and public playgrounds.

Table 2: Basic Services in East and West Jerusalem<sup>14</sup>

Section	East Jerusalem	West Jerusalem, including Jerusalem Settlements
Roads and streets	87km	680km
Street side walks	73km	700km
Sewage system	76km	650km
Street garbage collection holders	149	1849
Public playgrounds	29	1079

### 8.1.A. Electricity

Electricity in East Jerusalem is supplied by the Jerusalem Electric Company (JEC), which was established in 1914 through a special concession from the Ottoman government. The concession was revised by the British government in 1928, providing the JEC with unique, exclusive market rights in a 50km radius around the Church of the Holy Sepulcher for a period of 44 years. In 1948 the company had to give up its concession over West Jerusalem to the Israeli Electric Corporation (IEC). Since 1948, the two companies, one Israeli (IEC) and the other Palestinian (JEC), have provided electricity to Jerusalem.

Presently, the JEC is still the main electricity provider for East Jerusalem and for 25% of the West Bank. More than 90% of its electric power is bought from the Israeli Electric Company, and the Israeli government sets the prices and the connection fees. The total number of the JEC's power customers is around 130,000, of which 64,000 are in Jerusalem, 40,000 in Ramallah, 22,000 in Bethlehem and 4,000 in Jericho. The company is the largest employer of Palestinians in East Jerusalem, with 538 workers and staff. In 2004, the number of subscribers to the JEC's electric service

<sup>14</sup> MSR Project based on Haaretz, 25 March 1999.

in Jerusalem was 72,459 and they consumed 337.6 million K.W.H.<sup>15</sup>

### 8.1.B. Atarot-Qalandia Airport:

This domestic-only airport is located along the road to Ramallah, in the most northern area of Jerusalem. Its official name is Jerusalem International Airport; it is called 'Qalandia' by Palestinians and 'Atarot' by Israelis. Until 1967 it was an international civilian airport run by Jordanian authorities and used by Palestinians. The airport has not been operational since the start of the Al-Aqsa Intifada in 2000.

### 8.1.C. Light Rail

The municipality of Jerusalem is currently building the first line of an above-ground light rail. The line will connect Pisgat-Ze'ev and other Jerusalem Settlements to West Jerusalem. The Palestinians strongly oppose this plan, for both legal and political reasons. The economic implications of the light rail and its relation to Israeli-Palestinian negotiations are discussed in more detail in Section 11 of this paper. In this chapter, we focus on the light rail as part of the city's infrastructure. It seems that any partition of the city, whether into a divided city or an open one, will require some partition of the rail lines that cross Palestinian territory. It would be helpful to consider this issue in advance, in order to economize on future costs.

## 8.2. Recommendations

Our main recommendations with respect to infrastructure are as follows:

1. The infrastructure networks should remain intact when the city is divided into two separate cities and municipalities. Citizens of each city will continue to use the other city and state's network services for a transitional period of 5, 10 or 15 years, as agreed to by both sides.
2. During the transitional period, citizens will pay their own state's providers for the infrastructure services, and the provider will settle

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<sup>15</sup> See Palestinian Central Bureau of Statistics Website. <http://www.pcbs.gov.ps/>

accounts with the other side's provider. Thus, residents of an Israeli neighborhood that gets electricity from the Jerusalem Electric Company will pay the Israel Electric company, which will settle accounts with the Jerusalem Electric Company. The rates will be negotiated and agreed upon by the Jerusalem Economic Negotiating Teams (JENT) and will be part of the economic agreement on Jerusalem.

3. During the transitional period, each municipality and each state will complete the building of its own infrastructure, so that by the end of this period the networks can be separated. It is reasonable to assume that much of the infrastructure network that will be built in East Jerusalem will be part of the general infrastructure build-up in Palestine. This investment is critical for the economic development of Palestine and it should start today. In Section 11 we discuss the current obstacles to such development. It is important to remember that development of Palestinian infrastructure is especially crucial in Jerusalem, where the two infrastructures are tangent and even intertwined.
4. It is also possible for the two sides to continue to share infrastructure beyond the transitional period, if both sides wish it. This should be discussed by the two sides during the transitional period.

## 9. Costs of Setting a Border

### 9.1. Background

In the 40 years since 1967, the physical, demographic and ethnic landscape of Jerusalem has changed significantly. The change that is a principal concern for a future agreement between Israel and Palestine is the construction of the Jerusalem Settlements / Neighborhoods in East Jerusalem. Approximately 180,000 Israelis currently live in the following twelve Jerusalem Settlements: East Talpiot, Gilo, Givah Tsarfatit (French Hill), Giv'at Ha-Matos, Har Homa, the Jewish Quarter of the Old City, Ma'alot Dafna (East), Neve Ya'acov, Pisgat Ze'ev, Ramot Allon, Ramat Shlomo and Ramat Eshkol. To this we should add Atarot, which is mainly an industrial and commercial center. The basic positions of the two sides with respect to the future of the Jerusalem Settlements / Neighborhoods are quite opposed. While Israel views them as legitimate neighborhoods that should remain in Israel, the Palestinians view them as illegal settlements that should be evacuated. Still, it seems that any future agreement on Jerusalem might leave some Jerusalem Settlements / Neighborhoods under Israeli sovereignty, within the framework of a land swap, and would evacuate some in order to enable better contiguity and future development space for East Jerusalem. Hence, our working assumption is that a future agreement on Jerusalem will determine which Jerusalem Settlements / Neighborhoods will be evacuated and which will become part of Israel, and that the agreement will deal with all relevant legal and citizenship issues.

This section deals with the economic issues that such an agreement raises. While we cannot fully predict the exact location of the future border, we can foresee two types of economic-geographical issues that such a border will create: one is how to conduct an evacuation of a Jerusalem

Settlement / Neighborhood once it is decided that it will be in Palestinian territory; the second is how to adjust the infrastructure (such as tunnels and bridges) for contiguity, and how such investments in infrastructure should be built and financed.

It is important to note that for many payments from one side to the other, one of the ultimate sources of financing will probably be the international community or donor countries, paying through an international fund, which will contribute their share to facilitate the agreements. We acknowledge this possibility but discuss the various payments as bi-lateral in order to clarify responsibilities and mechanisms. Another important note is that the results of the various mechanisms, also involving various other payments, should be added together and the actual payments should be the net ones only. Hence, in reality many of the payments described below might be written off.

## 9.2. Evacuation of a Jerusalem Settlement / Neighborhood

Of the many economic issues involved in an evacuation of a settlement / neighborhood, we focus here on one narrow issue: how to transfer it to the jurisdiction of Palestine.<sup>16</sup> The specific economic agreement over each evacuated Jerusalem Settlement / Neighborhood will be conducted by the JENT and will follow these guidelines:

1. The structures in the Jerusalem Settlements / Neighborhoods are apartment buildings and are therefore suitable as residences for Jerusalem Palestinians.<sup>17</sup> Hence, it is strongly recommended that such a settlement / neighborhood will not be destroyed, as was the case in previous Israeli evacuations, but rather be transferred as is. Destroying the structures and then building others similar to them would be economically extremely inefficient and wasteful.
2. An administrative body would be created by the Palestinian state that would be mandated to handle the transfer of settlements / neighborhoods

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<sup>16</sup> We ignore here the important issue of how Israel should compensate the evacuated households and what incentive should be implemented to facilitate quick evacuation.

<sup>17</sup> This is not necessarily the case with many West Bank Settlements.

from Israel to Palestine, their management, and the allocation and distribution of their assets, with a priority of returning lands to their original owners. This administrative body will cooperate with the JENT.

3. The JENT will negotiate whether funds will be tendered, and if so how much, for all tangible assets, mobile and immobile, which are left by Israel in an evacuated Jerusalem Settlement / Neighborhood. In case an agreement is not reached in due time, the matter will be brought to the JEA for decision.

In addition to the specific agreements on the evacuated Jerusalem Settlements, the JENT will negotiate an agreement on some form of compensation for the past use of land of all Jerusalem Settlements from 1967 to the time of the agreement. Such an agreement will also include settlements that will remain under Israeli control, since these settlements will become legally Israeli only after the agreement is signed.

The details of all these agreements will be negotiated by the JENT. In the case that an agreement cannot be reached by the JENT, the issue will be taken to the Jerusalem Economic Arbitrator (JEA).

We firmly believe that the principles described above should be part of the main final status agreement, as they are political as well as economic.

### 9.3. Infrastructure Adjustments

After an agreement is reached, infrastructure projects will need to be undertaken in both cities in order to enable free and easy mobility between Jerusalem neighborhoods, or above or below neighborhoods of the other city through bridges or tunnels. Our recommendations address the construction and financing of such infrastructure.

1. The construction should be negotiated and agreed to by both sides, through the JENT. Although the party whose needs will be served by the construction should be both the planner and the builder of the infrastructure, the other party has to agree to the plans as well, in order to minimize potential harm from the project at both the construction and the operational stages.

2. The financing of such projects should be borne by Israel, since the construction of the Jerusalem Settlements / Neighborhoods created the



need for such investments. Hence, an additional reason to negotiate all infrastructure projects through the JENT is to avoid a problem of agency, wherein a construction project is decided upon by Palestine and paid for by Israel. In the case of disagreements the final decision will be delegated to the JEA.

## 10. Social Security

### 10.1. The Current Situation

All Palestinians who currently have Israeli residency status are compulsorily insured by the National Insurance Institute (NII). Israel has a Beveridge-style<sup>18</sup> social security system that provides comprehensive social coverage, including old age pensions, survivors' benefits, child allowances, maternity benefits, disability benefits, unemployment insurance, and minimum income support. The share of the National Insurance allowances in GDP is approximately 9%. According to the 1999 income surveys of the Israel Central Bureau of Statistics (ICBS), East Jerusalem Palestinians received substantial amounts of their net income from the NII. This survey estimated the gross monthly household income of Palestinians in East Jerusalem to be 5,629 NIS, compared to 12,511 NIS for residents of West Jerusalem. The net monthly household income was estimated at 4,970 NIS and 9,469 NIS respectively.<sup>19</sup> Households in East Jerusalem received NII benefits amounting to 983 NIS, which was not much higher in absolute values than in West Jerusalem, but was much higher relative to net income – 19.7% compared to 9% in West Jerusalem. The reasons for the discrepancy are that residents of East Jerusalem have lower income, higher unemployment, and more children per household.

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18 Named after William Henry Beveridge, the initiator of the modern social security system in Britain.

19 In a recent survey (2004) the gross and net incomes of West Jerusalemites were 11,470 NIS and 9,167 NIS respectively.

Table 3: Income and NII benefits of Jerusalem households (1999)

	East Jerusalem	West Jerusalem
<b>Gross monthly income</b>	5,629	12,511
Taxes paid	660	3,042
Income tax	262	2,191
national insurance payments	156	409
health insurance	242	442
<b>Net monthly income</b>	<b>4,970</b>	<b>9,469</b>
Net monthly income tax	896	2,262
Gross monthly income from work	4,553	10,514
Other income	1,102	1,929
Capital income	34	240
Pension	23	407
<b>NII benefit payments</b>	<b>983</b>	<b>854</b>
Transfers	58	152
% NII benefit from net income	19.78%	9.02%

Source: MSR Project, Israel Central Bureau of Statistics Income survey, 1999.

Another important social security issue is the health insurance of Palestinians in East Jerusalem. Currently, the State of Israel provides health insurance through a Health Tax that is also collected by the NII. This tax entitles East Jerusalem residents to receive health services from Israeli HMOs and from Israeli hospitals.

## 10.2. Recommendations

We have four basic recommendations in this area:

1. All Palestinians in East Jerusalem who are entitled to social security benefits from the NII due to past contributions will continue to receive the benefits that are due to them until death.
2. The Jerusalem Economic Arbitrator (JEA) will set up a body to monitor these benefit payments and to ensure that the rights of the recipients are respected.
3. After the agreement is enacted, the social security contributions of Palestinians in East Jerusalem will be paid to the Palestinian Social Security Institution. They will accumulate separate benefits from then on.
4. In order to smooth the transition of health insurance and services from Israeli providers to Palestinian providers, we suggest a special temporary (e.g. 5 year) arrangement. During this transition period, Palestinians from East Jerusalem will be able to continue to pay health tax to Israel and to receive health services from Israeli providers. The tax payment could be made through the Palestinian state or through an international body set up by the JEA.



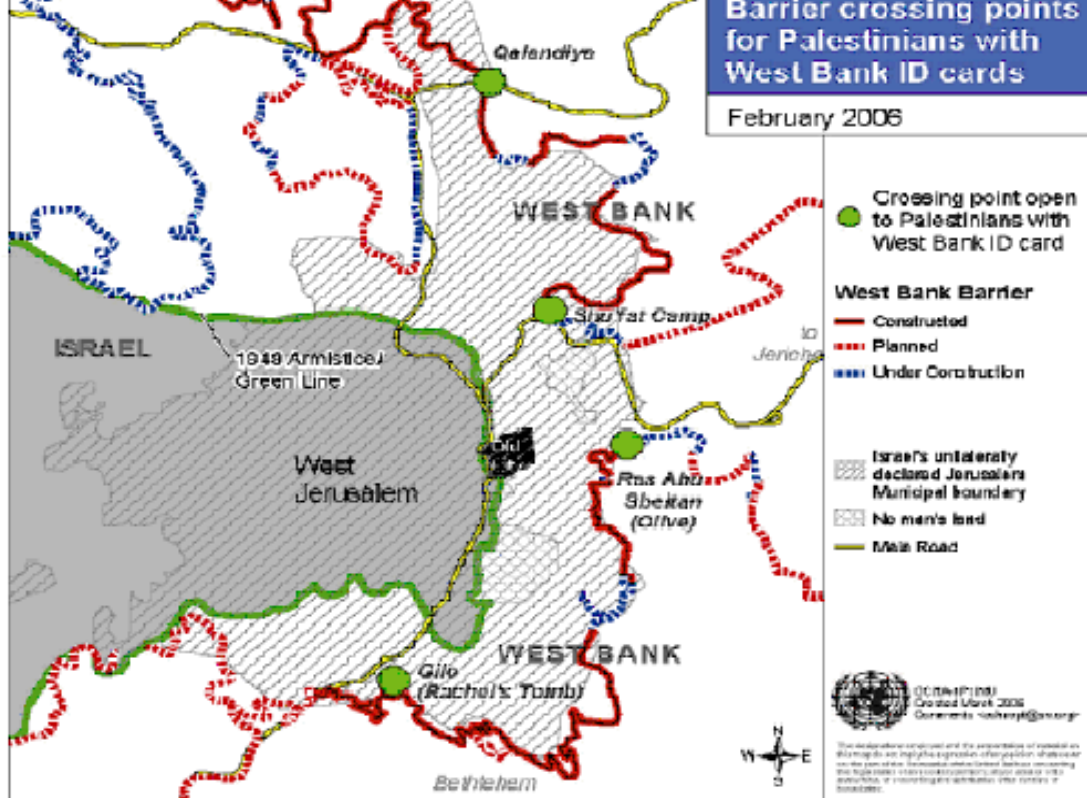
# 11. The Current Situation and the Final Status Agreement

Any future agreement will have to deal with the facts that have been created “on the ground” in the recent decades of occupation and conflict. For example, a settlement can affect an agreement whether it is annexed to Israel or evacuated. If annexed, the settlement will affect borders, space and mobility in the Palestinian territory; if evacuated, the high costs of relocation will have to be dealt with. As a result of issues such as these, it is often said that the settlements have a negative effect on the chances to reach an agreement. However, settlements and other “facts on the ground” have another, less obvious but critical economic effect which has a significant impact on the ability to reach a final status agreement: they adversely affect economic development in East Jerusalem and in Palestine as a whole. In this section, we discuss the three developments that are primarily responsible for this negative effect: the wall; the continued expansion of settlements; and the Jerusalem light rail project.<sup>20</sup> These developments have both political and an economic consequences for the possibility of reaching a final status agreement.

We strongly believe that economic development in Palestine is crucial to reaching and sustaining an agreement. People who live in a growing economy and who work hard to improve their physical and social standards of living are less willing to indulge in fighting, hatred and hostility. This is true for Israelis and it is even truer for the Palestinians, who bear many

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20 There are additional measures that exacerbate these three main developments, like excavations in and around the Old City of Jerusalem, the Ministry of Interior's policies of not granting ID's for Palestinians from East Jerusalem, various local policies of the Jerusalem municipality, etc. This document focuses only on the main developments.



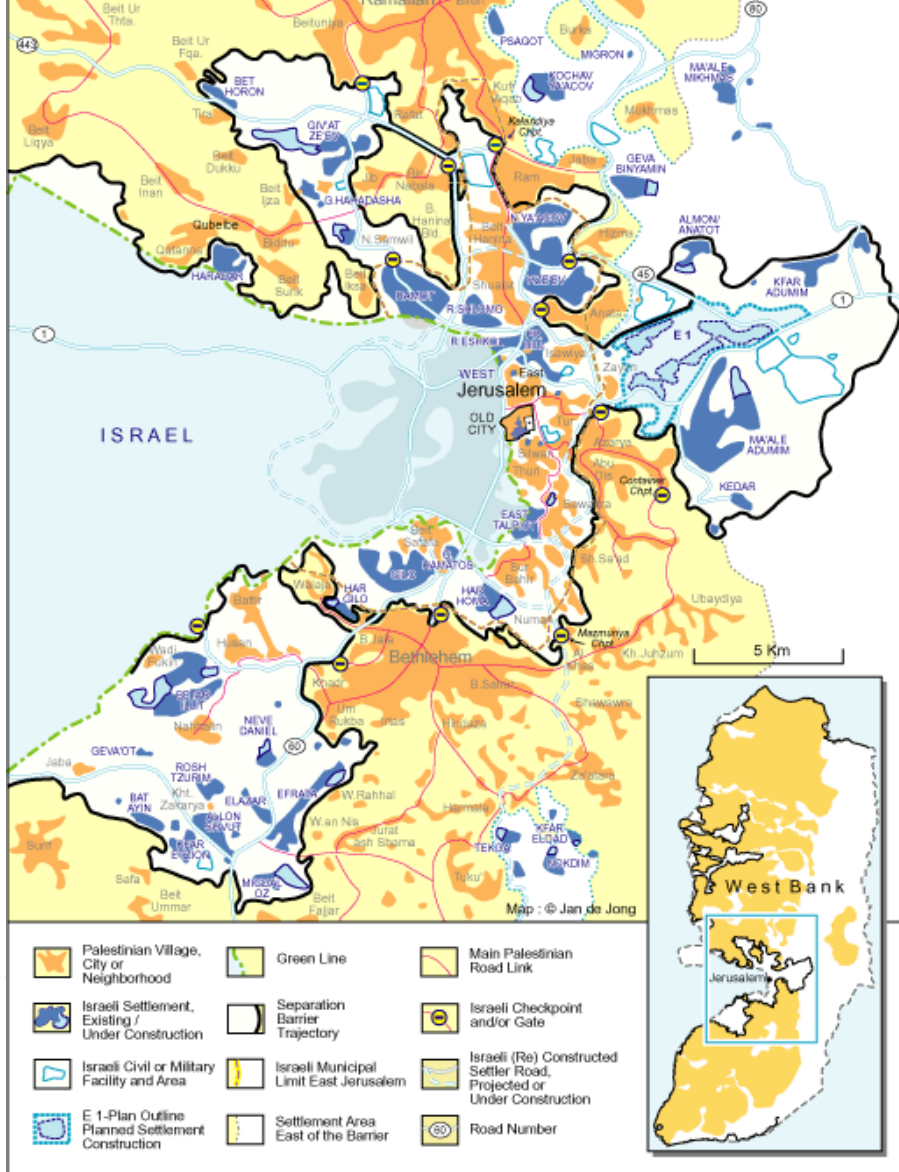
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This separation wall / barrier will lead to further deterioration of economic contacts between East Jerusalem and other parts of the West Bank and will significantly reduce the position of East Jerusalem as the center of Palestinian political and economic activity. Should this situation continue for an extended period of time, it will become extremely difficult to restore the economic role of East Jerusalem as the Palestinian capital. Hence, current developments should be considered in light of their effect on the present situation, but also with regard to their impact on a future final status agreement.

Even if the separation wall / barrier itself is removed once a final status agreement is reached, it will be very difficult to rebuild East Jerusalem as the economic hub of Palestine. But the segment that severs East Jerusalem from the other Palestinian areas has a much more profound economic effect on all of Palestine. East Jerusalem is not only the economic capital of the West Bank; it is also the main link between its northern and southern

21 For the political aspects of current developments, see Appendix B, which contains the Fast-Track document on the political effects that these activities have on reaching a final status agreement.

22 United Nations Office for the Coordination of Humanitarian Affairs (UN-OCHA)



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As previously discussed, this will have dire economic consequences not only for East Jerusalem, but for the West Bank and for Palestine as a whole. This settlement activity further blocks the territorial contiguity and physical mobility between the north and the south of the West Bank, hurting not only the current economic status of Palestinians, but also blocking to a large extent their ability to begin large scale development projects and to begin to experience economic growth.

23 The United Nations Office for the Coordination of Humanitarian Affairs Website. ReliefWeb Map Centre. <<http://www.reliefweb.int/rw/rwb.nsf/db900sid/JBRN-72EBNY?OpenDocument>>



### 11.3. The Light Rail

The separation barrier / wall and the settlement activity in and around Jerusalem are physical blocks to Palestinian territorial contiguity and mobility between the northern and southern West Bank, and between Jerusalem and the West Bank. These physical restrictions are further reinforced by the Israeli Municipality in Jerusalem in the construction of the light rail in Jerusalem. Although most of the first line of the rail runs within West Jerusalem (from Mt. Herzl to Jaffa Street), the line is scheduled to directly connect Jerusalem Settlements (French Hill and Pisgat Ze'ev) to West Jerusalem. This will create greater mobility to the Jerusalem Settlements in northern Jerusalem and will increase their population. It could also lead to the expansion of these areas eastward, even beyond the current municipal borders, a process that has already begun. This would result in further encroachment on Palestinian neighborhoods, as well as in even greater restrictions on Palestinian mobility in and out of the city and between the northern and southern West Bank. Furthermore, Pisgat Ze'ev is an important point on the route between Jerusalem and the settlements to the east and north of the city (though not to Ma'aleh Adumim). Hence, the building of the light rail will make these settlements -- especially those that are very close to the city -- more attractive to move to, strengthening Israeli settlements linkages with Israel proper and the light rail will make it harder to divide Jerusalem as part of a negotiated final status solution for the city. The crippling effect of such a situation on Palestinian economic development has been described above.

## 12. Summary

This paper has two elements. The first, more optimistic element is the attempt to outline economic arrangements that might accompany a final status agreement. The other element is more pessimistic, and illustrates how current developments in and around Jerusalem are creating obstacles on the road to a peace agreement between Israel and Palestine -- obstacles that are not only political but economic as well.

On the optimistic side, this document attempts to show that economic arrangements for a final status agreement on Jerusalem are attainable. Despite the difficulty of reaching such an agreement, we are able to outline various economic arrangements for almost all scenarios of an agreement. We suggest possible trade arrangements, labor arrangements, and arrangements for issues of infrastructure, social security and more. We believe that what we describe is feasible, simple and realistic, once an agreement is reached.

One issue which we can especially imagine creating problems in the future is the economic cost of setting the border. Drawing a border line is not only a difficult political act, but it entails significant economic costs as well. In this case the economic cost is a result of the vast Israeli construction activity in East Jerusalem and in the settlements around it. This construction could lead to significant expenses when the time comes to set a border, whether the expenses are those of evacuating settlements / neighborhoods or of building new infrastructure in the event that some settlements / neighborhoods are annexed by Israel as part of a future land-swap. These costs are substantial and are growing with time as a result of ongoing settlement activity. This document does not deal directly with the political price of reaching an agreement under such conditions, but it is clear that this price is made even greater by the economic costs, and might even prevent an agreement altogether. One possible conclusion of this analysis is that imposing a settlement freeze in the West Bank

in general and in East Jerusalem in particular is both a political and an economic necessity.

Another effect of this construction activity is the obstacles it creates for Palestinian economic development. The obstacles are primarily physical, blocking Palestinian mobility to and from Jerusalem and between the northern and southern parts of the West Bank. This curtailed mobility diminishes chances for Palestinian economic re-integration, derails developments of networks, reduces returns to scale, and prevents construction of large-scale development projects. This effect is further exacerbated by the physical closure of East Jerusalem to the West Bank, since Jerusalem has been the social, economic and political center of Palestinian society for many years. Placing further obstacles on the road to economic development is not only causing human suffering, it is also hindering the possibility of reaching and sustaining a permanent peace agreement. Poverty never helped peace.

Thus our summary is somewhat mixed. We believe that we have identified ways to solve some of the main economic problems facing a future agreement, once it is reached. But we are afraid that current developments place enormous obstacles in the way of reaching such an agreement to begin with. These obstacles are both political and economic, though our document focuses mainly on the economic aspects. Interestingly, these obstacles to reaching an agreement are concentrated in the Jerusalem area, since the city is an essential link between the two parts of the West Bank and is thus a key to Palestinian economic development. Our analysis therefore highlights the urgency of beginning negotiations on the final status agreement. Time is not working in favor of reaching such an agreement.

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