FOR AGENDA

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SM/94/95
Supplement 1

CONTAINS CONFIDENTIAL
INFORMATION

May 20, 1994

To: Members of the Executive Board

From: The Secretary

Subject: Israel - Staff Report for the 1994 Article IV Consultation

The attached supplement to the staff report for the 1994 Article IV consultation with Israel (SM/94/95, 4/14/94) provides a brief summary of the recently signed "Protocol on Economic Relations" between Israel and the Palestine Liberation Organization (PLO), that will govern the economic relations for the West Bank and Gaza Strip during the interim period.

Mr. Lachman (ext. 36223) or Mr. Maciejewski (ext. 37134) is available to answer technical or factual questions relating to this paper prior to the Board discussion which is tentatively scheduled for Wednesday, May 25, 1994.

Unless the Documents Preparation Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the GATT Secretariat, following its consideration by the Executive Board.

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ISRAEL

Staff Report for the 1994 Article IV Consultation - Supplement

Prepared by the European I and Middle Eastern Department

Approved by Michael Deppler and Mark Allen

May 19, 1994

On April 29, 1994, the Government of Israel and the Palestine Liberation Organization (PLO) signed in Paris a "Protocol on Economic Relations" (hereafter, the Protocol). The Protocol establishes the contractual agreement which will govern the economic relations between the two sides and covers the West Bank and the Gaza Strip during the interim period. 1/ The purpose of this supplement is to provide a brief summary of the main provisions of this agreement.

The provisions of the Protocol are broadly consistent with the understandings in principle that had been reached earlier between the Israeli Government and the PLO as reported in the Staff Report and the Selected Economic Issues Paper for the 1994 Article IV consultation with Israel (SM/94/95 and SM/94/112). In addition to providing detailed arrangements on trade and labor, taxation, and banking and finance, the Protocol also covers agriculture, industry, tourism, and insurance. However, a number of issues are not fully specified and various technical aspects remain outstanding. These issues are expected to be resolved by the Palestinian-Israeli Joint Economic Committee (JEC) established under the Protocol, which is to begin operation shortly.

1. Trade regime and external tariff

The agreement establishes a system under which most of the trade between Israel and the areas under the jurisdiction of the Palestinian Authority (PA) will be free from restrictions, and to which Israeli import policies and practices, in most cases, will apply. Thus, for all imports not subject to the exceptions detailed below: (i) the Israeli rates of customs duties, purchases taxes, levies, excises, and other charges will serve as the minimum basis from which PA can make upward changes; (ii) both sides shall apply the same import policy and regulations, including import

1/ The implementation will be according to the stages envisaged in the Declaration of Principles on Interim Self Government Arrangements signed in Washington, D.C. on September 13, 1993 and the Agreed Minutes thereto. It will therefore begin in the Gaza Strip and the Jericho Area and at a later stage will also apply to the rest of the West Bank.

licensing and standards, as those applied by Israel. The clearance of revenues from all import taxes and levies will be based on the "destination principle". At the same time, the Palestinians will have the right to export agricultural and industrial products to third markets without restrictions on the basis of certificates of origin issued by the PA.

There are, however, several important exceptions to the aforementioned arrangements that appear to have been designed to permit the PA: (i) to develop independent trade ties with third countries, especially Jordan and Egypt; and (ii) to import goods needed for the Palestinian economic development program. First, the agreement identifies two lists of goods: List A1 of goods locally produced in Jordan, Egypt, and other Arab countries, and List A2 consisting mostly of foodstuffs imported from Arab, Islamic, and other countries. With respect to these two lists, the PA will have full responsibility for import and customs policy and procedures, including the setting of customs rates, purchase tax, levies, and other charges. Palestinian residents may import the listed items in mutually agreed quantities up to the level of "Palestinian market needs", as estimated periodically by a joint subcommittee of experts under the JEC. Second, the PA will have responsibility for the rates of customs duties, purchase taxes, levies, excises, and other charges on a third list, List B, which consists mainly of capital equipment, pharmaceuticals and wood products that will be imported under the Palestinian economic development program. Third, the PA will determine its own rates of customs and purchase tax on motor vehicles to be registered with the PA. Fourth, the PA will be permitted to import petroleum products, subject to meeting certain quality standards, and will have the right to determine the prices of petroleum products for sale in the areas under its jurisdiction, except for gasoline. The difference between the final price of gasoline to consumers in Israel and to consumers in the areas under the PA's jurisdiction is not to exceed 15 percent of the official consumer fuel price prevailing in Israel.

The Protocol also provides for the free movement of industrial and agricultural products, free of customs duties and of import taxes, between the two sides, subject to certain exceptions and arrangements. In particular, quantitative restrictions will apply to exports from either side to the other of six agricultural products: poultry, eggs, potatoes, cucumbers, tomatoes, and melons. These quantitative restrictions are to be phased out according to an agreed schedule and eliminated by 1998.

2. Labor

Under the Protocol, each side will attempt to maintain normal labor movements between them, but will retain the right to determine the extent and conditions of such movements into its own area of jurisdiction. If either side temporarily suspends normal labor movements, it must give immediate notification to the other side, which may raise the matter in the JEC. The placement and employment of workers from one side in the other side will be through the other side's employment service and in accordance with the other side's legislation.

Israel will transfer on a monthly basis to the PA the "equalization deductions" as defined by Israeli legislation. 1/ These sums will be used for social benefits and health services for the Palestinians employed in Israel as decided by the PA. Israel will also transfer on a monthly basis the pension insurance proceeds that are withheld from Palestinian workers' earnings in Israel to a relevant pension insurance institution to be established by the PA. Israel will continue to deduct health insurance fees from Palestinian wages and will transfer the related proceeds to the PA for inclusion in the Palestinian health insurance system.

3. Taxation and other fiscal issues

With regard to direct taxation (including income taxes on individuals and corporations, property taxes, and municipal taxes and fees), Israel and the PA will each administer their own policy in their respective areas of jurisdiction. Each side will also have the right to impose additional taxes on residents (individuals or corporations) which conduct economic activities in the other side's area. Moreover, Israel will transfer to the PA: (i) 75 percent of the income taxes collected from Palestinians in the Gaza Strip and the Jericho Area who are employed in Israel; and (ii) the full amount of the income taxes collected from Palestinians from the Gaza Strip and the Jericho Area who are working in the settlements.

As regards indirect taxation, Israel and the PA will levy the value added tax (VAT) and purchase tax on local production, as well as any other indirect taxes, and collect the revenues therefrom, in their respective areas of jurisdiction. The Palestinian VAT rate will be 15-16 percent (versus 17 percent in Israel), and identical purchase tax rates will be applied to locally-produced goods and services and imports. There will be monthly clearance of VAT revenues between the two sides.

4. Monetary and banking issues and currency arrangements

The PA will establish a Palestinian Monetary Authority (PMA), which will serve as the PA's official economic and financial advisor; the sole financial agent for the PA and public sector entities, both locally and internationally; the manager of the public sector's foreign exchange and

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1/ These are taxes on the wages of non-Israeli workers in lieu of contributions to the Israeli social insurance system.

gold reserves; the responsible agency for licensing and supervising banks and foreign exchange dealers; and the lender of last resort for the banking system in the areas under the PMA's jurisdiction. 1/

The PMA will have a banking supervision department, which will be responsible for the proper functioning, stability, solvency, and liquidity of the banks operating in the areas under Palestinian jurisdiction. In particular, the PMA will determine the reserve requirements to be deposited at the PMA on all deposits in banks operating in the areas under its jurisdiction. 2/ The PMA will also regulate and administer a discount window system; supply temporary finance to banks operating in the area; and establish or license a clearing house to clear money orders between banks operating in the areas and with other clearing houses. Each side will allow correspondent banking relationships with the other side's banks.

Banking supervision will be based on international standards and principles, especially those of the "Basle Committee". The PMA will relicense each of the five branches of Israeli banks currently operating in the West Bank and Gaza Strip. Any other Israeli bank wishing to open a branch or subsidiary in the areas under the PMA's jurisdiction will apply to the PMA and will be treated equally with other foreign banks, provided that the same will apply to Palestinian banks wishing to open a branch or subsidiary in Israel. The PMA will also have the authority to regulate and supervise capital market activities in the areas under its jurisdiction, including the licensing of capital market institutions, finance companies, and investment funds. 3/

1/ While on the face of it the Protocol appears to be more far-reaching on monetary matters than earlier understandings, it is not clear at this stage how some of these functions, such as lender of last resort and discount window operations, can be carried out in practice under existing currency arrangements. There is also a question as to whether the provisions of the Protocol with respect to monetary and banking matters supersede those of the Memorandum of Understanding between Israel and Jordan and of the agreement on economic cooperation between the PLO and Jordan.

2/ The Protocol does not specify how and on what basis reserve requirements will be established. As regards deposits in new Israeli sheqalim (NIS), however, the Protocol indicates that the reserve requirement will not be less than 4 percent to 8 percent, according to the type of deposit.

3/ The Protocol does not elaborate on the transitional arrangements for prudential oversight over banks prior to the time when the PMA will be in a position to exercise banking supervisory functions effectively.

Regarding currency arrangements, the NIS will be one of the currencies circulating in the areas under the PMA's jurisdiction. 1/ Accordingly, the PA, related institutions, local authorities, and banks will accept the NIS, along with the other circulating currencies, as means of payment for any transaction. The Protocol states that the Israeli authorities and the PLO will continue to discuss "the possibility of introducing a mutually agreed Palestinian currency or temporary alternative currency arrangements for the PA".

The PMA will have the right to exchange excess NIS holdings due to balance of payments flows into foreign currency based on estimates of all Israeli "imports" of goods and services from the areas under its jurisdiction, which were paid for in NIS, less estimates of all Israeli "exports" of goods and services to the areas, which were paid for in NIS. 2/ The PMA and the Central Bank of Israel will meet annually to determine the annual amount of convertible NIS during the following calendar year, and semi-annually to adjust this amount based on data and estimates of the past trade flows and forecasts of future flows.

5. Other areas

The Protocol also includes agreements in the areas of agriculture, industry, tourism, and insurance. In addition to the trade-related aspects reviewed in Section 1 above, the Protocol deals extensively with understandings on veterinary and plant protection and transportation of livestock and animal products. As regards the industrial sector, the PA can promote development of Palestinian industry through various means, including the provision of grants, loans, direct tax benefits, and research and development assistance facilities. However, indirect tax rebates or benefits or other subsidies to sales will not be allowed in the trade between Israel and the areas under the PA's jurisdiction.

The PA will establish a Palestinian Tourism Authority, which will have authority to regulate, license, and supervise tourist services, sites, and industries; promote foreign and domestic tourism; develop Palestinian tourist resources and sites; and supervise the marketing, promotion, and information activities related to foreign and domestic tourism. Both Israel and the PA will allow passage of tourist transport licensed and authorized by the other side and will permit tourism entities licensed by one side to conduct tours in the other.

1/ Although the Protocol does not specify which are these other currencies, it is understood that the NIS will be in circulation along with the Jordanian dinar and the U.S. dollar.

2/ The Protocol does not specify how existing outstanding NIS balances, if any, as well as net NIS balances that may arise in the future as a result of capital inflows would be treated.

The PA will have responsibility for insurance, including the licensing and supervision of insurance companies and agents. The Protocol also requires the PA to maintain a compulsory, absolute liability system for road accident victims, and contains extensive provisions on the compensation of such victims.