

**The Economic Costs of the Israeli Occupation
for the Palestinian People:
Cumulative Fiscal Costs**



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In tables, two dots (..) indicate that the data are not available or are not separately reported

Any references to dollars (\$) are to United States dollars.

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Abbreviations

GDP	gross domestic product
IMF	International Monetary Fund
MAS	Palestine Economic Policy Research Institute
PCBS	Palestinian Central Bureau of Statistics
PNA	Palestinian National Authority
UNCTAD	United Nations Conference on Trade and Development
VAT	value added tax

Executive summary

Despite the temporary state of optimism that followed the signing of the Protocol on Economic Relations (Paris Protocol), today, a steady deterioration of the Palestinian economy can be seen in most economic and development indicators, the chronic fiscal and trade deficit, and the high level of dependence on the economy of Israel. The expected gains and outcomes from the Paris Protocol were counterproductive, given that the ensuing trade framework and economic policies of Israel do not serve the interests of the Palestinian economy. Add to that the closure policy of Israel and restrictions on the movement of people and goods, and a range of security and military measures imposed on the Occupied Palestinian Territory, which have led to accumulating economic losses to the Palestinian people. The fiscal part of these losses is the main focus of this study.

In the last decade, several UNCTAD studies and reports have addressed the Palestinian fiscal leakage to Israel. This has prompted other international organizations to bring this issue into question, which has helped in retroactively retrieving part of the fiscal resources of the Palestinian National Authority (PNA) from Israel.

This study takes stock of previous work, attempting to provide up-to-date data on the causes of losses to Palestinian public resources, whether in the narrow sense of the Palestinian treasury's fiscal leakage to the treasury of Israel, or in the broader sense of costs and losses to the Palestinian public wealth as a result of the continuing occupation.

As in previous reports, the study examines the Palestinian fiscal leakage to Israel in the context of the Paris Protocol framework, by estimating the value of the leakage in 2015 from the specific sources that can be identified. The study also sheds light on the concept of Palestinian fiscal losses or economic costs of the Israeli occupation and attempts to provide an estimate of some of its sources in 2015. The study also seeks to estimate the cumulative economic leakage and losses in the period 2000–2017 and investigate the repercussions these have had on the economy of and labour in the Occupied Palestinian Territory. Finally, the study concludes with a set of recommendations for reducing fiscal leakage and losses.

Based on the thorough investigation and mapping of the potential sources of losses in this study, the total monetary value of the Palestinian fiscal losses resulting from the occupation – or the economic costs of occupation – in 2015 is estimated at \$1,660.9 million, or 13.1 per cent of gross domestic product (GDP), \$473 million (3.7 per cent of GDP) of which resulted from fiscal leakage to Israel in total. The remaining \$1.2 billion (9.47 per cent of GDP) represents other Palestinian fiscal losses.

Based on these estimated figures, the cumulative total of monetary leakage and losses in the period 2000–2017 are estimated at around \$5.6 billion, equivalent to 39 per cent of the Palestinian GDP in 2017. Adding the cumulative interest on fiscal leakage for the same period (\$1 billion) raises the cumulative total to \$6.6 billion. The monetary value of the cumulative fiscal costs in the same period is estimated at \$19.5 billion, equivalent to 140 per cent of the Palestinian GDP in 2017, that is, more than the gross output of the Palestinian economy in one year. By adding compound interest Palestinians pay to offset the estimated annual losses, the monetary value of Palestinian fiscal losses identified in the period 2000–2017 is estimated at \$47.7 billion, almost triple the Palestinian GDP in 2017.

To gauge the economic and employment impact of fiscal leakage and losses, the study uses the UNCTAD model of the Palestinian economy to simulate the fiscal conditions under a scenario that assumes Palestinian fiscal sovereignty in the absence of occupation in the period 2000–2017. The study concludes that, under this scenario, the economic costs of occupation resulting from the loss of Palestinian fiscal resources can be estimated at \$36.4 billion (real 2015 prices); 2.7 times the size of the Palestinian GDP in 2017. The cost in terms of employment is estimated at 111,000 job opportunities every year. This could have reduced the unemployment rate by 9 per cent in the period of the analysis.

Based on these results, the study recommends that future negotiations should aim at a new rectified framework that deals with all outstanding issues and accumulated dues to Palestinians retroactively and by which Israel would be obliged to share with Palestinians all information related to these funds. The study also recommends upgrading the manual clearing system currently in use for settling trade transactions between the Palestinian market and the market of Israel to an interconnected automated system, allowing for the exchange of information in a quick, complete and accurate manner. It also recommends that a new arrangement should provide for the presence of the Palestinian customs police at border crossings for co-surveillance of the clearing of goods imported to the Occupied Palestinian Territory, or negotiate a mechanism for transporting and storing imported goods in Palestinian warehouses to ensure its clearance through Palestinian customs as well. Finally, the study recommends revising the handling fees, taking into consideration the proportion of Palestinian imports to total Palestinian and Israeli imports processed by the customs authority of Israel.

I. Rationale and background

A. Introduction

Since 1967, the Occupied Palestinian Territory has been subject to protracted Israeli occupation that has created a hostile environment affecting the Palestinian economy and all spheres of life. Following the signing of the Protocol on Economic Relations in 1994, which was expected to improve Palestinian economic conditions, the economic policies as well as the security and military measures of Israel imposed on the Occupied Palestinian Territory have rendered the outcomes of the Paris Protocol inimical to Palestinian development needs. The Palestinian economy is characterized by deteriorating economic indicators, along with a chronic fiscal and trade deficit and a high level of dependence on the economy of Israel. This has entailed over two decades of denying the Palestinian people and economy the right to benefit from the country's diverse natural and water resources and to make optimal use of fiscal, financial and other resources. The issue of the costs of the Israeli occupation and Palestinian fiscal losses and revenue leakage to Israel resulting from flawed application of the Paris Protocol are therefore garnering increased attention. In this context, since 2014, different studies have addressed Palestinian fiscal leakage and losses resulting from the current trading framework with Israel, the first of which was published by UNCTAD in 2014.

Building on these earlier research efforts, the present study examines Palestinian fiscal leakage resulting from the trade policies and practices of Israel and provides up-to-date data and estimates of each source of leakage. Yet the study's contribution goes beyond that. By providing up-to-date estimates of the evasion of customs duties and taxes and the leakage of tax revenues from indirect imports, relying on recent data and a more comprehensive methodology, the study identifies more channels of Palestinian fiscal leakage. The research presented here sheds light on the other fiscal losses that are components of the fiscal costs of the Israeli occupation, even if not leaked to Israel. This concept is wider than the Palestinian fiscal leakage to Israel. In this context, the Palestinian fiscal costs of occupation, which forms part of the overall economic costs of occupation, consists of two components, namely, the leakage of fiscal resources to Israel and other fiscal losses as a result of the Israeli occupation. Following the estimation of the fiscal costs of occupation, the study attempts to assess the impact of these costs on the Palestinian economy and its employment and development. The study concludes with a set of recommendations for feasible interventions for stemming the fiscal leakage and losses.

B. Significance and objectives of the study

The study's significance derives from the following:

- Provision of a detailed estimation of the Palestinian fiscal costs of occupation caused by public revenue leakage to Israel and by fiscal losses caused by the occupation, identifying each channel and source of leakage.
- Review of previous research on this topic, and exploration of new dimensions not before investigated.

- Analysis of the nature and causes of the evasion of customs duties in the Occupied Palestinian Territory.
- Compilation of a record of Palestinian trade losses resulting from the flawed and unilateral application of the Paris Protocol and its requirements, which limit Palestinian trade options.

Based on this, the study aims to achieve the following objectives:

- Map channels of fiscal leakage not identified in previous research studies, such as leakage from direct taxes, tax evasion via underinvoicing or the undervaluation of imported goods (from Israel and the rest of the world) and losses resulting from the withholding of Palestinian clearance revenues.
- Provide more accurate and reliable estimations of fiscal leakage to Israel and document sources of leakage, with calculations based on a systematic methodology.
- Review different international studies and trade agreements, which may inform future trade and financial negotiations.
- Update UNCTAD (2014a) and re-assess previous estimates of fiscal leakage to Israel in light of more recent data.
- Differentiate between Palestinian fiscal leakage to Israel and other fiscal losses caused by the measures imposed by the occupation but not leaked to Israel; these two components comprise the Palestinian fiscal costs of occupation.
- Estimate other Palestinian fiscal losses and document their sources to provide, along with the estimates of fiscal leakage to Israel, an estimate of the Palestinian fiscal costs of occupation.
- Estimate the accumulated fiscal costs of occupation in the period 2000–2017 and assess its impact on the Palestinian economy and employment.
- Detect gaps and weaknesses in the trade and financial relations of PNA, to contribute to the establishment of new foundations for trade relations with Israel and the rest of the world.

C. Methodology

The following methodology has been used to achieve the study's objectives:

- Review of previous research, re-estimations and recalculations based on recent data and information.
- Conduct of meetings and interviews with experts and officials from the public and private sectors.
- Use of official statistics published by the Palestinian Central Bureau of Statistics (PCBS) and the Israel Central Bureau of Statistics.

- Adopt a detailed approach in analysing import data at the Harmonized Commodity Description and Coding Systems 8-digit level instead of using average tariff and tax rates.
- Apply the estimation and calculation mechanism for fiscal leakage and losses to each type of loss based on available data related to each source.
- Follow a conservative estimation approach by adopting minimum values to ensure cautious estimates.

D. Limitations of the study

This study focuses on one particular component of the economic costs of occupation, namely, the Palestinian fiscal costs of occupation that consists of fiscal leakage to the treasury of Israel within the current economic policy framework established by the Paris Protocol and other fiscal losses that do not find their way to the Palestinian treasury due to measures imposed by the occupying Power. However, it should be emphasized that there are other causes and sources of Palestinian fiscal leakage and losses that need to be further investigated. The following topics are not analysed in this study, but should be considered as areas for future research:

- Fiscal leakage and losses resulting from the flow of service imports from Israel.
- Fiscal losses resulting from the lack of sovereignty over natural resources.
- Fiscal losses resulting from the unilateral annexation of East Jerusalem and the forced separation of its economy from the rest of the economy of the Occupied Palestinian Territory.
- Fiscal losses resulting from the delay in transferring the wages and compensations of Palestinians working in Israel and its settlements.
- Indirect fiscal losses resulting from denying the Palestinian people the right to adopt economic, trade and industrial policies that respond to the needs and interests of the Palestinian economy.
- Fiscal losses resulting from restrictions in Area C and the resulting loss of potential investment and foregone exploitation of natural resources in the area.
- Other losses caused by the occupation as a result of various practices, such as military operations, sieges, closures, the demolition of buildings and the uprooting of trees.

E. Definitions and concepts

The following terms and concepts are used in this study.

Clearance invoice: Official trade document needed to import directly from or export to Israel, which specifies details and descriptions and must accompany goods transported between the markets, as specified in the Paris Protocol. The invoice is used for processing the clearance of revenues between the parties.

Clearance revenues: All tax and customs revenues collected by Israel on behalf of PNA, then transferred every month to the Palestinian Ministry of Finance, as specified in the Paris Protocol.

Customs declaration: Official document accompanying goods imported from third countries.

Customs fees: Duties imposed at various percentages on goods imported from third countries, depending on the tariff structure of Israel.

Direct importing: The Palestinian private sector imports goods (excluding cars) directly from third countries through the customs borders of Israel. Israel levies all applicable taxes on these imports on behalf of PNA, then transfers these revenues to PNA, after deducting handling or administrative fees of 3 per cent.

Evasion of customs duties and taxes: Undervaluation and/or underinvoicing in a declaration or misdeclaration of the actual value of goods that enter the Palestinian market. Also refers to goods that have a clearance invoice but are not presented to the relevant tax authorities.

Fiscal costs of the Israeli occupation: Refers to all Palestinian public revenue losses resulting from protracted occupation, including the sources of fiscal leakage and other losses detailed under *Palestinian fiscal leakage* and *Other fiscal losses caused by the Israeli occupation*. In other words, there are direct and indirect fiscal losses resulting from the control of the occupying Power of Palestinian resources and revenues, military operations and actions, the siege imposed on the Gaza Strip, closure in the West Bank, the demolition of buildings and uprooting of trees, among other measures. These fiscal costs reflect the difference between the current position of the Palestinian public finances under occupation, with the narrow policy space it allows, and the position of the Palestinian public finances under a hypothetical scenario of fiscal sovereignty.

Import taxes: Taxes levied on goods imported from third countries as described in the customs declaration, including value added tax (VAT); purchase taxes; customs duties; and protection (uplift) taxes.

Indirect importing: Refers to the importing of goods that are recorded and treated as being of Israeli origin, although they originate from a third-party source. They include goods for which the proportion of Israeli value added is less than 40 per cent and should therefore be classified as originating in a third country other than Israel, in accordance with the rules of origin under the World Trade Organization. However, in practice, Israel deals with these goods as being of Israeli origin and retains the related taxes and customs tariff revenues rather than transferring them to the Palestinian treasury.

Indirect taxes: Taxes levied on goods imported from Israel or a third country or on domestic economic activities. They include VAT, purchase taxes, customs duties, excise taxes and other taxes levied under the tariff book of Israel in operation on both sides.

Other fiscal losses caused by the Israeli occupation: Represents the lost fiscal resources that were not leaked to the treasury of Israel but that, without the occupation, would have been realized and flowed to the Palestinian treasury.

Palestinian fiscal leakage: One component of the Palestinian fiscal costs caused by the occupation. This type of loss is associated with the leakage to Israel of part of the revenues due to the Palestinian treasury under the Paris Protocol and the constraints this imposes on the Palestinian economy. The Protocol enables control by Israel of the flow of Palestinian trade, leaving PNA minimum policy space, coupled with a selective and unilateral application of the

Paris Protocol by Israel. This study is concerned with investigating this type of fiscal loss, which is due, but not transferred, to the Palestinian government in accordance with the Paris Protocol.

Purchase taxes: Indirect taxes imposed by Israel on certain goods. The rate depends on the nature of the goods (e.g. luxury goods) and does not distinguish between those that are imported and those that are domestically produced.

Smuggling: Goods that enter the Palestinian market without official documentation, such as a clearance invoice if the goods are imported from Israel or a customs declaration if they are imported from a third country.

Taxation system: Refers to a coherent and consistent matrix of rules and regulations that comprise the official taxation policy of a government, created with the aim of regulating different activities in a way that responds to economic and social interests at specific times and places, while taking into consideration varying economic, social, cultural and ideological variables in the local, regional and international arenas. The tax structure consists of quantity or ad valorem taxes imposed on the economic activities of the various sectors and professions or imported and exported goods. Each type of tax is goal-driven and has a base and collection method, regardless of the nature of the economic activity, whether productive or pertaining to consumption, acquisitive or reciprocal. Each type of tax has a socioeconomic impact on the different segments of society.

VAT: Indirect tax imposed on all commercial transactions, at a rate of 16 per cent. For imported goods, the tax is imposed on the total cost of the goods, which includes customs duties and purchase taxes, in addition to the cost of the imported goods at the port of arrival, including transport, insurance and freight.

II. The interdependence between the Paris Protocol trade regime and structure and sources of revenue

The Palestinian trade and taxation policy framework was established in accordance with the Paris Protocol, as the West Bank and Gaza Strip came under the jurisdiction of PNA for a transitional period that was stipulated to last for only five years. The Protocol shapes the main policy framework for the management of economic affairs by PNA, not only in terms of external trade relations, but also in terms of financial, monetary and other economic relations with Israel, including policies related to importing, taxation, banking, insurance, water and energy. As mentioned earlier, this study is not concerned with assessing the deteriorating economic conditions associated with the Protocol, which has been elaborated in numerous other studies. Instead, this study is mainly concerned with investigating the fiscal and tax revenue aspects of the Protocol, in relation to the trade and taxation policies of Israel, identified in article III of the Protocol (for more information, see UNCTAD, 2014a).

The Paris Protocol provided PNA with autonomous authority and a space that the Palestinian people had not enjoyed since 1948. It specifies certain limited powers and responsibilities to manage their economic, trade and taxation affairs. The Protocol constituted a precedent that could be built upon in the future, as it recognized and legitimized Palestinian economic rights that had previously been unacknowledged, such as the right to impose direct taxes and to reinstitute direct Palestinian trade relations with Arab countries for the first time since 1967. For this specific purpose, new provisions were included in the Protocol to allow the importation of some goods (cement, iron and petroleum) from Arab markets based on Palestinian trade policy. The Protocol also included the classification of three lists of goods within the Palestinian trade framework and allowed the establishment of an autonomous Palestinian Monetary Authority to carry out some limited functions of a central bank during the interim period, except for issuing a national currency.

However, the inadequate implementation of the Oslo Accords (the key political reference framework between Palestinians and Israel) continues to cast a shadow over the economic part of the agreement. As a result, the Paris Protocol has outlived the five-year transitional phase for which it was designed and Israel has frequently violated ignored, limited or selectively interpreted many of the Palestinian rights under the Protocol (International Monetary Fund (IMF), 2016; El-Ja'fari and Al-Ardah, 2002; Misyef, 2004; UNCTAD, 2014a; UNCTAD, 2014b; UNCTAD, 2015; UNCTAD, 2016; World Bank, 2016a).

According to previous studies, the Paris Protocol entailed a customs union whose framework and terms were based on the trade system of Israel, which is designed to serve its own interests (Al-Jawhari, 1995; Al-Naqib, 1996; El-Ja'fari and Al-Ardah, 2002; IMF, 2012; IMF, 2013; Misyef, 2004; UNCTAD, 2010; UNCTAD, 2011; UNCTAD, 2012; UNCTAD, 2013; UNCTAD, 2014b, UNCTAD, 2015; UNCTAD, 2016; World Bank, 2002; World Bank, 2009). Furthermore, Israel controls borders and crossing points. This has led to severe stunting of the Palestinian economy from 2000 to the present, as seen in the shrinking of the Palestinian productive capacity and base, interrelated economic distortions, high and rising unemployment rates, financial unsustainability, a chronic trade deficit and a high level of dependence on international aid to finance a large and persistent budget deficit.

Impact of the Paris Protocol on Palestinian imports and taxation systems

This section provides an overview of the Palestinian taxation system, describes how it was put in place and its components, as well as the approach followed for levying tariff rates and purchase taxes on imported goods. This clarifies the specificities of the arrangements under the Paris Protocol, the economic and trade relations and the mechanisms of identifying and distributing sources of revenues. This section serves as an introduction to identifying the different aspects of Palestinian fiscal leakage and losses.

1. Structure of the Palestinian taxation and customs system

The Palestinian taxation and customs system is a newly introduced system. The indirect taxes imposed by Israel and officially put into force by PNA following the signing of the Paris Protocol are of importance to this study. The provisions of the Protocol acknowledge the right of PNA to adopt an independent taxation policy with regard to income, property and individual and corporate taxes. However, different articles of the Protocol stipulate that indirect taxes should be set in accordance with the taxation structure of Israel and customs policies applied in Israel, except for a limited number of commodities identified in lists A1 and A2.

As such, the trade and taxation system has two main components, namely, direct taxes and indirect taxes. The former taxes include income and property taxes, which are imposed on the tax base according to the income of an individual or a corporation or in terms of real estate ownership, such as ownership of buildings or land. The latter taxes are those imposed on different types of economic activities, whether related to goods or services, and include VAT and purchase taxes, as well as excise taxes on fuel and cigarettes, customs duties and other compulsory payments on agricultural and other products.

The contribution of each type of tax to total revenues is an indicator of a country's level of economic advancement. Advanced countries depend mainly on direct taxes to fund their treasuries. In contrast, developing countries depend largely on indirect taxes. In the State of Palestine, indirect taxes constitute 87 per cent of total tax revenues. This high level is attributed to the structure of the potential tax and revenue sources, which is inherently related to the clearance system established under the Paris Protocol (UNCTAD, 2014a).¹

2. The taxation system and flow of imported and smuggled goods, and their impact on revenue

Clearance revenues include taxes on imports from third countries and taxes on imports from Israel. Importing goods from Israel depends on the issuance of a clearance bill, which should be submitted to the Palestinian Ministry of Finance. When seizing smuggled goods, Israel does not acknowledge the transaction, even if the smuggler is a merchant from Israel, and also does not acknowledge the transaction if the clearance bill is over six months old. In these two cases, PNA

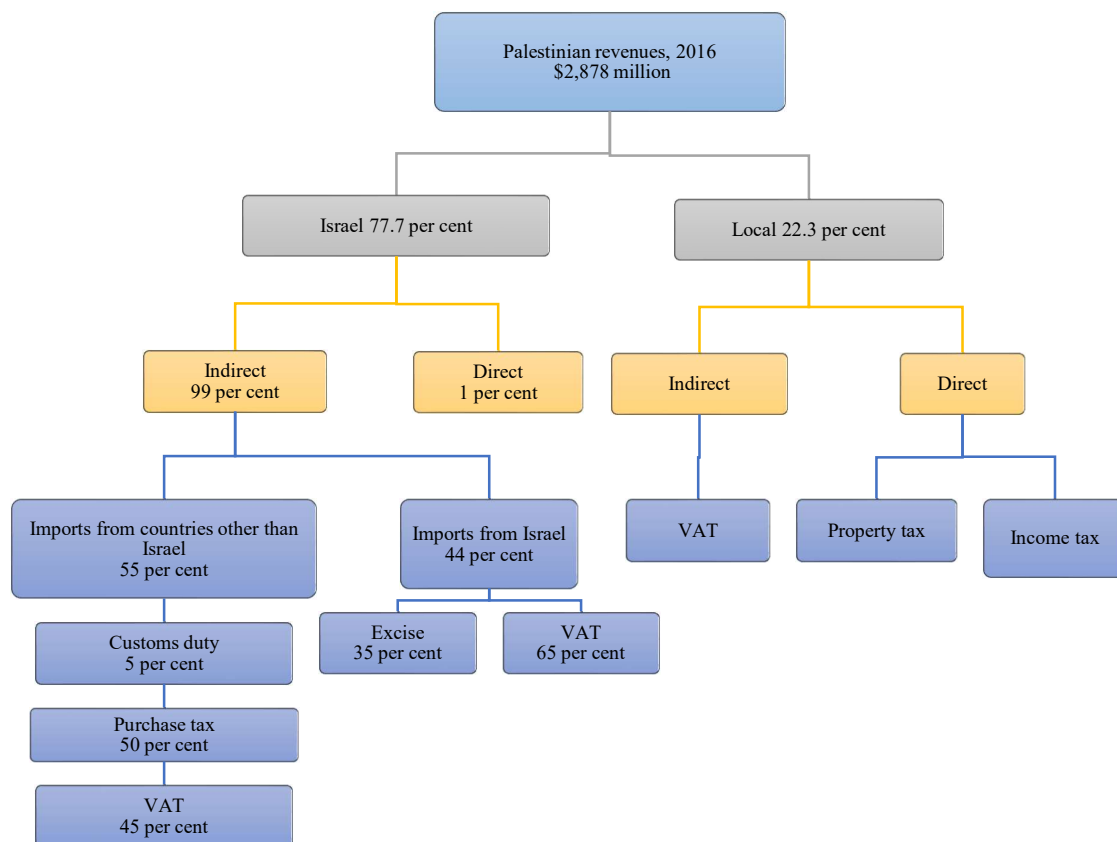
¹ The clearance system is the mechanism by which all direct and indirect tax and customs revenues collected by the Government of Israel on behalf of PNA are transferred. The system was established under articles VII and XXXV of the Paris Protocol based on the official documents accompanying the goods, that is, the clearance invoice and customs declaration form as proof of the revenues generated. With regard to income tax, 75 per cent of the income tax collected from Palestinians working in Israel and 100 per cent of the income tax of those working in settlements should be transferred to PNA. Finally, articles III, V and VI of the Protocol address Palestinian trade policies, including the regulation of goods imported and exported.

cannot claim a clearance bill and does not receive any taxes or customs revenues for the goods, and the revenues from the goods go to the treasury of Israel.

The revenues that the Palestinian treasury collected from direct and indirect taxes in 2016 amounted to \$2.89 billion, excluding non-tax revenues of \$577 million, as shown in figure 1. About 22.3 per cent of total tax revenues are domestic revenues and 77.7 per cent are from Palestinian foreign trade flows with Israel or a third country. Notably, about 99 per cent of clearance transfers by Israel to PNA are composed of indirect taxes, while the remaining 1 per cent represents income tax deducted from the pay of Palestinian workers in Israel. As depicted in the figure, about 55 per cent of foreign trade revenues come from taxes on goods imported from countries other than Israel, half of which are purchase tax. However, 65 per cent of the taxes levied on goods imported from Israel are VAT and 35 per cent are fuel excises; fuel is imported from Israel exclusively (for more information on the Palestinian taxation system and revenues, see UNCTAD, 2014a).

Figure 1

Distribution of Palestinian National Authority revenues from direct and indirect sources, 2016



Source: UNCTAD calculations, based on data from the Palestinian Ministry of Finance.

3. Palestinian tariff structure and revenues from foreign trade by type of goods

The amount of Palestinian tax revenues generated from goods imported from third countries depends on the tariff structure of Israel and the rates of customs duty and purchase tax set by Israel, which are defined by the type and use of goods. Rates in the tariff structure of Israel vary depending on the nature of goods, whether final, semi-final, luxury, complementary or intermediate. The current structure serves the trade and industrial interests of Israel solely. Israel uses the purchase tax and the uplift rate, which constitute a large portion of the public revenues of Israel, as instruments for achieving its industrial policy goals and protection, which are consistent with World Trade Organization terms. Israel levies a purchase tax on some goods produced in Israel and increases the tax on some imported goods by adding the uplift tax. This raises the costs of importing goods from third countries, thereby driving Palestinian merchants to favour products from Israel.

The percentage of customs duty and purchase tax as part of total Palestinian fiscal revenues in the period 2012–2017 is shown in table 1. Import tax revenues accounted for 34 per cent of total revenues from third-country imports; VAT represented 48 per cent, followed by purchase tax of 44 per cent and customs duty at a rate of 6 per cent. In total, import tax revenues from third countries account for 55 per cent of indirect tax revenues.

Table 1
Palestinian revenues from import taxes based on customs declarations
(Millions of dollars)

Year	Customs duty	VAT	Purchase tax	Protection tax	Total import taxes	Value of imports
2012	41	256	216	0.2	513	1 741
2013	39	302	263	0.2	604	1 838
2014	44	451	337	0.1	732	2 072
2015	46	371	337	0.1	754	2 201
2016	49	404	400	0.1	853	2 364
2017	53	451	455	0.1	959	2 585

Source: UNCTAD calculations, based on data from the Palestinian Ministry of Finance Customs and Excise Department.

III. Fiscal leakage and tax evasion

This chapter discusses some of the concepts related to fiscal leakage and the causes and sources of each type of leakage within the focus of this study, including the nature and mechanisms of the evasion of customs duties and taxes. In addition, causes of fiscal leakage are further analysed and used as the basis for estimating the value of such leakages (see chapter V).

A. Evasion and smuggling: Mechanisms, types and relation to the Israeli market

Both the evasion of customs duties and smuggling are important sources of Palestinian fiscal leakage. As demonstrated by UNCTAD (2014a), these two sources entail losses of revenues from direct imports destined for the Occupied Palestinian Territory and transiting Israel and losses of revenues from indirect imports coming through Israel. Evasion and smuggling in the Palestinian case can therefore be defined as goods entering the Palestinian market from the Israeli market that:

- Do not have the required official documents (clearance bill, customs declaration, consignment note and/or tax invoice from large companies from Israel) or have falsified or counterfeit documents. In both cases, the goods are considered illegal and are treated as smuggled goods.
- Have the required official documents but are not submitted to the PNA tax authority. In such cases, merchants conceal transactions to hide the actual levels of sales and reduce their income tax liability. This source of evasion is particularly common in the Palestinian case because it arises from the unique clearance system in place.
- Have the required official documents but with a manipulated value, quantity or quality. For example, some goods are cleared under falsified customs classifications that entail lower tariff rates under the Harmonized System. In other cases, goods classified on the list of banned items are recorded as allowed items, the quantities of goods recorded are manipulated through the declaration of smaller quantities or the type of the goods is concealed.

Furthermore, geopolitical factors are among those underpinning the specific nature of the evasion of customs duties in the Palestinian case compared with other countries. These factors result from the spillover of occupation into all aspects of Palestinian life, trade, markets and movement of people and goods. Under such conditions, markets, villages and cities in the West Bank are turned into enclaves with crossings and borders open to Israel in one direction only. In addition, the division of the Occupied Palestinian Territory into three areas, namely Area A under Palestinian administrative and security (policing) control, Area B under Palestinian administrative control but security control by Israel and Area C under direct military and administrative control by Israel (in which settlements are expanding), exacerbates the problem, since these areas are open to the Israeli market without any Palestinian control of crossings and borders. Moreover, areas adjacent to the Israeli–Palestinian borders are isolated from the rest of the West Bank. As such, goods that enter Area C from the Israeli market could be smuggled to Areas A and B through local roads connecting Palestinian villages and towns.

B. Sources and channels of evasion and smuggling

The absence of Palestinian oversight or control of internal crossings and external customs borders is one of the major causes of the spread of the evasion of customs duties and taxes and the smuggling of goods. In addition, the complex and elaborate security measures of Israel have incentivized a greater portion of Palestinian merchants to favour importing from the Israeli market rather than from other countries. This has, in turn, increased imports from Israel to about 75 per cent of the total and has also contributed to increasing smuggling from the Israeli market. Studies on this issue have outlined the many reasons that have exacerbated this phenomenon over the years (Alawneh, 2000; Sabri, 2004; UNCTAD, 2012; UNCTAD, 2013) and concluded the following:

- The weak economic role of PNA and its weak oversight mechanisms have negatively affected the implementation of trade and tax policies, while Israel continues to control Palestinian trade and tax policies as stipulated in the Paris Protocol.
- The weak human, financial and technical capacities of the Palestinian customs police, in addition to full control by Israel of borders, crossings and Area C, have exacerbated the evasion of customs duty and undermined measures to combat it.
- The geographical factor plays a part in turning the West Bank into an attractive environment for smuggling, whereby goods may be transported without having to pass through the four official crossing points intended to be used for goods entering areas under PNA jurisdiction.
- There is weak coordination between PNA and Israel with regard to the exchange of information that would facilitate Palestinian control of trade.
- There are low levels of awareness about the evasion of customs duties and taxes among the Palestinian private sector and weak media outreach by Palestinian customs.
- Other drivers of customs evasion include illegal profiteering, disregard of national economic interests and the high tax burden on the private sector, in particular through indirect taxes.

There are many underlying reasons for evasion and smuggling. However, two reasons pertain in the Palestinian case only and do not apply in other countries. The first is related to the Paris Protocol framework governing Israeli–Palestinian economic and trade relations, which has established a quasi-customs union with open borders, coupled with expanding Israeli settlements that sever West Bank regions and markets from each other. The second is the lack of Palestinian sovereignty over customs borders and crossings, which are fully controlled by Israel without any Palestinian presence, and the lack of Palestinian jurisdiction in Area C.

C. Indicators of smuggling into the Palestinian market

The preceding discussion asserts the expansion of this phenomenon, which encompasses all sorts of goods and commodities. However, the question arises as to the extent of the phenomenon. The

following review addresses this question with reference to previous studies, available field data and estimates of the size of smuggling in statements by officials:

- UNCTAD and Palestinian Shippers Council (2014) shows that smuggling is on the rise in all Palestinian regions, in particular in areas adjacent to borders with Israel. For example, informal trading has become the norm in the Dhahariya area and Barta'a, where more than 70 per cent of shops are not registered and that trade widely in goods smuggled from Israel. Field work revealed that the unfair competition that resulted from the expansion of smuggling undermined the capacities of the formal Palestinian private sector.
- MAS (2016) finds that illicit trade in tobacco accounts for 30 per cent of the Palestinian tobacco market, half of which is smuggled from Jordan. The report estimates that smuggled tobacco from Jordan results in \$50 million per year in lost revenues to the Palestinian treasury.
- According to the Palestinian customs police, smuggling cases reported in 2015–2017 reached 12,000. About 4,100 cases were reported in 2017 alone, a rise of 10 per cent compared with previous years (*Al-Hayat Al-Jadida*, 2017). According to the customs department and the customs police, smuggled goods constitute about 40 per cent of imported goods. In addition, Prosecution of Anti-Economic Crimes estimates that customs evasion resulting from importing goods from Israel amounts to more than \$800 million in lost revenues per year (*Al-Hadath*, 2018).
- According to the Palestinian Ministry of Finance Clearance Department, in 2017, more than 15,000 fake clearance invoices were seized and there were about 1,500 unregistered merchants importing goods from the Israeli market to the Palestinian market.²
- The Palestinian Ministry of National Economy estimates that PNA loses more than \$150 million per year from the smuggling of cigarettes and waterpipe tobacco alone, from both Israel and Jordan, and the smuggling of products from settlements has been on the rise in recent years.³
- The Palestinian Ministry of Agriculture continuously reports on the smuggling of agricultural products, in particular products that are banned from entering the Palestinian market during local harvesting seasons to prevent a sharp drop in the prices of the products of Palestinian farmers. According to the Ministry of Agriculture, smuggled goods cause price distortions in the local market and undermine the effectiveness of ministry policies.⁴
- The private sector regularly resorts to smuggling to be able to earn profits and compete with informal rivals (UNCTAD and Palestinian Shippers Council, 2014). Smuggling constitutes about 30–70 per cent of their business, compared with 100 per cent for informal businesses, which do not maintain a tax file or any official trade documents.

² Interview with the Director General of the Palestinian Ministry of Finance Clearance Department, 16 June 2018.

³ Interview with the Director of the Palestinian Ministry of National Economy Policy Assessment Department, 16 June 2018.

⁴ Interview with the Marketing Director of the Palestinian Ministry of Agriculture, 14 May 2018.

There are many indicators of the spread and expansion of smuggling from the Israeli market to the Palestinian market and of its negative economic impacts on the treasury and in distorting prices in the Palestinian market. Regardless of the differing estimates of smuggling, in general, there is agreement among experts and officials on the significance of this phenomenon. Chapters 5 and 6 provide estimates of the fiscal leakage and losses incurred by the Palestinian economy.

IV. The Palestinian fiscal crisis and previous estimates of fiscal leakage and losses

The trade and taxation regime currently in operation has long burdened the Palestinian economy. The many shortcomings of the Paris Protocol have allowed fiscal leakage to the treasury of Israel and entailed a lack of Palestinian sovereignty, which has led to the loss of control of tax collection, minimization of the tax base and weakening of access to information and tax records. The fiscal ramifications have limited the ability of PNA to respond to frequent humanitarian crises and meet other economic commitments and obligations.

Since 2008, PNA has set a long-term objective of reducing the budget deficit, achieving financial sustainability and reducing dependence on donor aid. Results were seen in the narrowing of the budget deficit from 29 per cent of GDP in 2008 to 8 per cent of GDP in 2017.

At the same time, however, the private sector did not expand activities enough to create investment and increase production to create jobs, and thus remained incapable of reducing the financial burden on PNA. Neither could it stimulate an expansion in the tax base to increase the PNA tax revenues and reduce the pressure on PNA as the employer of last resort. Despite all efforts, the public budget continues to run a deficit and the overall fiscal situation has deteriorated, as tax revenues have failed to increase sufficiently to meet expenditure obligations, while donor funding has been on a declining trend and remains below expectations.

Despite the fact that PNA revenues rose from \$1.56 billion in 2008 to \$3.65 billion in 2017, it was not enough to cover all necessary expenditures. As was the case a decade previously, the budget deficit before donor support stood at \$1.1 billion in 2017. The chronic fiscal crisis of PNA has led to a greater focus on current expenditures and the neglect of development expenditures, which have averaged 3 per cent of GDP in the last 10 years. It should be stressed that the costs of low levels of expenditure on development could be significant, in particular with a weak economic structure and restrained production base.

Financial fragility has increased due to the decline in and uncertainty of donor aid and revenues and the growing stock of public debt. In 2017, donor support to the PNA budget reached \$540 million or a quarter of a billion less than the budget gap in that year. As such, PNA was forced to borrow from domestic banks and accumulate arrears to private sector contractors and public pension funds. Under such circumstances, PNA has no alternative other than to further reduce expenditures on public services and increase reliance on (the increasingly difficult to obtain) funding from domestic banks, as well as to continue to accumulate arrears to the private sector. This poses a serious threat to the sustainability of PNA that cannot be mitigated unless donors commit to disbursing sufficient aid when needed and, above all, without the removal of the occupation-related constraints on economic growth (Misayef, 2017; UNCTAD, 2016).

One of the main factors that affect the financial sustainability of PNA is control by Israel of the flow of Palestinian clearance revenues. Such revenues are collected by the Government of Israel on behalf of PNA in accordance with the stipulations in the Paris Protocol. In 2002, 2006, 2011 and 2014, Israel froze Palestinian clearance revenues for political reasons. Despite the eventual release of revenues, such practices undermine the economic and financial stability of PNA, in particular given that public expenditure is a key driver of economic growth and that clearance

revenues constitute about 70 per cent of total revenues (World Bank, 2012). The suspension of clearance revenues limits the ability of PNA to meet its contractual obligations to the private sector and pay the salaries of public sector employees on time. It also limits the prospects of private investment by fostering a climate of uncertainty and increased risks to private sector contractors and creditors.

Previous research on Palestinian fiscal leakage and losses and customs evasion

Identifying the sources and assessing the size of Palestinian fiscal and non-fiscal leakage and losses to Israel are challenging tasks, considering the many sources and channels of leakage and losses and the complexity of the multifaceted financial issues under a framework fully controlled by Israel. Indeed, the concept of fiscal losses and the costs of occupation is much broader than that of fiscal leakage. There are many types of fiscal leakage resulting from different sources, mainly from the following:

- Indirect imports, which are related to indirect taxes.
- Smuggling of goods from the Israeli market.
- Shuttle trade of tobacco and other goods coming from Jordan through the Allenby Bridge crossing, which is under the administration of Israel.
- Undervaluation or misdeclaration of the actual value of goods that enter the Palestinian market from Israel or third countries.
- Use of subscriber identity module cards from Israel in the Occupied Palestinian Territory, which leads to leakage to telecommunications companies in Israel. More than half a million Palestinians use cards brought from telecommunications companies in Israel and VAT on these services which should be collected by the Palestinian treasury goes to the treasury of Israel (MAS, 2018a).
- Direct taxes on Palestinian workers in Israel and settlements.

In addition, there are fiscal losses related to the freezing of clearance funds and the associated economic effects such as the loss of interest paid on these funds and other economic repercussions.

A range of fiscal losses further results from the lack of sovereignty over natural resources such as land, water and minerals, among many others. Moreover, the Palestinian public sector imports goods and services from Israel, such as petroleum, energy, water, health services, sanitation and waste services, and Israel has a monopoly on exports to the Palestinian market of some high-value goods, such as agricultural products, animal feed and medical products.

The customs union with Israel also creates another source of indirect fiscal loss, that is, the loss resulting from denying Palestinians an independent trade and customs policy to regulate their imports from the Israeli market. Meanwhile, the trade policy and standards of Israel are applied to imported goods produced in Israel and third countries. However, if Palestinian imports from Israel and from a third country were subject to an independent Palestinian trade regime, replacing the tariff structure of Israel, significant levels of fiscal leakage could be identified and stopped (Misayef, 2017).

The discussion so far shows the complexity and multifaceted problem of Palestinian fiscal leakage and losses. Several international and Palestinian organizations have attempted to estimate the size of the losses and investigate means for curtailing them. As a result, some PNA financial dues have been redeemed from Israel after strenuous efforts. For example, the collection of part of the exit fees levied on travellers to Jordan and part of the purchase tax revenues of Israel on goods produced in Israel have recently been transferred to PNA. However, the refusal by companies in Israel to pay the latter tax has led to the loss of the bulk of this tax revenue. In addition, other Palestinian demands are ongoing, such as for the reduction of the 3 per cent administrative fee that Israel charges on all transfers to PNA as collection fees and costs, the transfers related to passenger departure taxes and the taxes on the incomes of Palestinian workers in Israel.

The following review of previous studies on the fiscal leakage covers studies focused on the evasion of customs duties and taxes or indirect leakage that ensues from the nature of the trade framework under the Paris Protocol. Most of these studies provide a generic review of fiscal leakage and none provides quantitative research, in particular with regard to smuggling. UNCTAD (2014a) was the first to provide detailed estimates of the fiscal leakage. UNCTAD and Palestinian Shippers Council (2014) also addressed customs evasion and was followed by World Bank (2016a), which also addressed the overall fiscal leakage.

1. UNCTAD reports and studies

UNCTAD (2014a) focuses on the fiscal leakage resulting from Palestinian imports from and through the Israeli market and the ensuing customs evasion. The study shows that the average annual fiscal leakage from these two sources in 2010 and 2011 was about \$310 million, or about 3.6 per cent of the Palestinian GDP and 18 per cent of the total tax revenues of PNA. About 40 per cent of the leakage is related to indirect imports via Israel and the remaining 60 per cent is related to customs evasion associated with goods from the Israeli market. The study concludes that there is a pressing need to introduce significant changes to the Palestinian trade regime and the framework governing Israeli–Palestinian economic relations and for acknowledgment by Israel of Palestinian fiscal rights, both direct and indirect.

UNCTAD and Palestinian Shippers Council (2014) includes a dialogic field study aimed at estimating the value of smuggled goods and specifying their types, with a particular focus on goods smuggled from Israel to the Palestinian market. The report suggests that around 30 per cent of total Palestinian imports from Israel are smuggled goods, equivalent to some \$890 million in 2013, or 26 per cent of the value of total Palestinian imports from Israel in that year. Based on 2013 data, Palestinian tax and customs losses are estimated at a minimum of \$346 million per year in lost revenues. It is imperative to take into consideration the upward trend of smuggling from one year to the next (see chapter V).

UNCTAD reports have also shown the inevitable consequences of occupation, which can be seen in the distorted economic structures, declining levels of productivity and deteriorating economic indicators. UNCTAD (2016) highlighted the distorted low-productivity structure of the industrial and agricultural sectors, weakened by the policies of the occupation and stripped of their natural resources, land and water.

This situation results in considerable economic losses and costs to the Palestinian economy and society, as reported to the General Assembly of the United Nations, including in a review of the economic costs of the occupation and some of the estimated fiscal losses in the different economic sectors (United Nations, 2016). The report provides a typology of the different types of direct and indirect losses and costs, as well as those resulting from the existing narrow economic policy space. In particular, the report lists the following sources of losses that are difficult to quantify and estimate: human capital losses, the loss of natural resources, economic losses associated with opportunity costs, micro and macroeconomic losses and the loss of public finances, in addition to a myriad of social losses. All this has undermined the development process and distorted the components of the Palestinian economy.

2. Palestinian reports

Reports by the Palestinian government to the Ad Hoc Liaison Committee (2017; 2018a; 2018b) provide an update on the Palestinian economic and fiscal situation, financial rights and leakage from the Palestinian treasury to Israel resulting from the unilateral application and misapplication of the terms and provisions of the Paris Protocol. These reports largely conform with UNCTAD reports and studies on the Palestinian fiscal leakage, some of which provide updated figures. The State of Palestine reports point to the outstanding matters that need to be rectified according to the Protocol to restore some of the lost revenues and increase Palestinian revenues by an estimated \$300 million per year. This does not include funds accumulated over the years that Israel should transfer to the Palestinian treasury. The main points highlighted by the State of Palestine reports are as follows:

- **VAT clearance mechanism:** This mechanism is outdated and misused by Israeli authorities, resulting in more than \$120 million in lost revenues to the Palestinian treasury per year. The current system is paper-based, slow, vulnerable to fraud and dependent on the cooperation of the private sector with PNA in declaring VAT data. A joint electronic system should be established to link the databases of the two sides and focus on sales data rather than purchase data. In addition, an automated system should be established for transferring the invoices of imports entering the Gaza Strip through the Karam Abu Salem crossing and from Israel. Using such invoices, Palestinians would be able to more accurately estimate VAT revenues collected on goods entering Gaza, in particular given that 88 per cent of the revenues of Gaza are not transferred to the Palestinian treasury.⁵ Israel collects these invoices but does not share them with Palestinians, and has accumulated large amounts owed but never transferred to the Palestinian treasury.⁶
- **Handling or administrative fees:** In accordance with the Paris Protocol, Israel deducts a 3 per cent fee from the clearance revenues it collects on behalf of PNA, then transfers

⁵ The loss of the revenues of Gaza directly affect the Palestinian treasury, depleting its resources. About 43 per cent of the budget's current expenditure is allocated to Gaza, while clearance revenues from Gaza constitute 12 per cent of total clearance revenues and the total revenues of Gaza constitute only 7 per cent of the total revenues of PNA. In the past, the revenues of Gaza, whether clearance revenues or domestic revenue collection, accounted for about 30 per cent of PNA revenues, compared with only 7 per cent at present. The decline is due to two reasons, namely, the political division that precludes the official Palestinian authorities from collecting clearance invoices and the fact that domestic collection in Gaza is no longer under their jurisdiction; and the restriction by Israel on clearance revenue data and movement of goods entering Gaza (Palestinian Ministry of Finance, 2018).

⁶ Following a lengthy process of negotiations, at end-2017, Israel transferred NIS83 million to the Palestinian treasury. These funds represent the accumulated VAT levied on goods entering Gaza since January 2016. An additional NIS110 million was also transferred, which represents the duplicate, cancelled and counterfeit VAT invoices claimed by Palestinians.

these revenues to PNA to cover the handling or administrative costs involved in the collection of taxes. At the time of negotiating the terms of the Protocol, Palestinian taxes and revenues were around \$624 million per year and handling fees were only \$18 million. Since then, PNA revenues have tripled, leading to a significant increase in the administrative fees paid to Israel. The World Bank (2016a) recommended that this fee be set at 0.6 per cent, commensurate with the share of Palestinian imports to total imports handled by the Israel customs authority; this would increase Palestinian revenues by around \$40 million–\$50 million per year. In 2017, Israel collected over \$2.3 billion in taxes and deducted around \$70 million in handling fees. In addition, in 1996, Israel began to collect the 3 per cent handling fee on the excise taxes imposed on fuel purchases, even though there are no administrative costs involved in handling these taxes as they are direct imports made according to arrangements between the private sectors in the two economies. This has augmented the funds paid to Israel and does not conform with the concept of collecting handling fees on imports from third countries only. It should be noted that 50 per cent of PNA clearance revenues are composed of imports from the Israeli market and the other 50 per cent of imports from third countries. The State of Palestine reports demanded the renegotiation of the handling fees along the line of the 0.6 per cent recommended by the World Bank, along with the removal of the handling fee on fuel excise taxes and VAT on purchases from Israel imposed in 1996.

- **Passenger exit fee:** The Paris Protocol defines the operations of international border crossings, at which Israel should collect an exit fee of \$26 from each passenger. The passenger fee for the first 750,000 passengers each year is to be divided at 54 and 46 per cent, whereby Israel receives the equivalent of \$14 of the passenger fee and Palestinians receive \$12. If the number of passengers exceeds 750,000, Palestinians will receive \$16 per passenger, or the equivalent of 62 per cent of the fee. In 2008, Israel unilaterally raised the exit fees to \$40 for Palestinian passengers and \$46 for foreign passengers. However, the same formula is applied as to the original exit fee arrangement and not to the new higher fee. From 2008 to end-2017, Israel transferred only \$68 million, while Palestinian exit fees due up to April 2017 are estimated at around \$145 million.
- **Medical stamp fees:** Around 90,000 Palestinians work in Israel each year. According to the Paris Protocol, Israel is to transfer to Palestinians, on a monthly basis, all deductions imposed under the laws of Israel on Palestinian workers in Israel. These deductions include an equalization levy, a health stamp, social security and pension funds. Since the signature of the Protocol, Israel has not fulfilled its obligations and has only transferred a small portion of withheld funds. In 2006, Israel froze all transfers, which were already lower than the accrued funds. By end-2013, withheld Palestinian health stamps had reached \$255 million, or about 1.8 per cent of the Palestinian GDP in 2013, and Israel stated that the transfer of these funds was contingent on the settlement of the Palestinian debt claimed by the electricity and water companies of Israel. In September 2016, the Government of Israel and the Palestinian government reached a settlement and Israel released to the Palestinian treasury \$310 million of withheld health insurance payments accrued until September 2016. Israel also agreed to provide the Palestinian government

with detailed information about these funds and to transfer health stamps to the Palestinian government each month.⁷

- Indirect imports and revenue leakage from Area C: The State of Palestine reports show that the Palestinian government loses around \$30 million in customs duties on indirect imports and indicate a total of \$20 million in lost revenues in Area C. In addition, PNA incurs significant losses in tax revenues (VAT and purchase tax related to indirect imports) and there is increasing smuggling and illicit trade in Area C, in particular given that Palestinian tax authority and customs police are not allowed to access Area C.
- Commercial and economic activities in Area C: The Paris Protocol requires Israel to levy VAT and income tax in Area C on behalf of PNA and transfer them to the Palestinian treasury. Around 2,000 commercial enterprises or individuals from Israel work in Area C in industrial, agricultural, fuel and gas-related and retail activities. Prior to 2000, Israel collected VAT, income tax, property tax and operational fees from these enterprises and transferred the collected revenues to Palestinians. After 2000, Israel stopped transferring tax revenues collected from commercial enterprises of Israel in Area C to Palestinians or providing any information about their activities. The State of Palestine reports estimate that Israel has received \$20 million per year for the last 18 years, or \$360 million, in taxes and fees from Area C, which should have been transferred to the Palestinian treasury. Based on this, PNA demands that its customs authority should be given access to Area C to monitor the movement of goods and curb smuggling and illicit trade.

3. World Bank reports

In 2014, the World Bank issued its first study on fiscal losses, which provides partial estimates of the costs of occupation in Area C. The study shows that the direct and indirect economic costs incurred by specific sectors in Area C have adverse effects on the Palestinian GDP. Alleviating legal and physical restrictions in Area C would increase GDP by 23 per cent, or \$2.9 billion, in direct costs, and 12 per cent, or \$1.5 billion, in indirect costs. This 35 per cent of GDP implies some \$800 million in lost tax revenues. Ending the occupation of Area C would also result in an estimated 35 per cent increase in employment (World Bank, 2014).

In a report to the Ad Hoc Liaison Committee, the World Bank further elaborated on the PNA fiscal leakage to Israel (World Bank, 2016a). The report unmaskes fiscal losses associated with the flawed application of the Paris Protocol, which have compounded the hardships suffered by the Palestinian people. The report touches upon indirect imports, undervaluation and the misdeclaration of the actual value of direct and indirect imports. Deductions from Palestinian workers in Israel, as prescribed under the laws of Israel, are also highlighted. Specifically, the report refers to the equalization levy, health insurance fees, income taxes and other fiscal leakage from Area C, as well as departure fees levied on travellers to and from Jordan through the Allenby Bridge crossing. The main points highlighted by the report are as follows:

⁷ After repeated official requests from PNA, Israel transferred the health stamps and equalization levy deductions for the period September 2016–July 2017 to the Palestinian treasury but stopped transferring new outstanding amounts. The cumulative annual deducted amounts are expected to be around \$30 million. To date, Israel has not provided PNA with the information or the remaining amounts

- Palestinian fiscal losses (excluding revenues collected by Israel in Area C, which have not been accurately estimated due to a lack of information) are estimated at \$285 million in 2014, or about 2.2 per cent of GDP.
- Losses resulting from the undervaluation or misdeclaration of the actual value of purchased goods are twofold, namely, imports from Israel and imports from third countries. The declared value of the former is lower than 23 per cent of the actual value and is estimated at \$103.7 million in 2014, or 17 per cent of clearance revenues from Israeli–Palestinian trade flows; the declared value of imports from third countries is lower than 32 per cent of the actual value and is estimated at \$53 million in 2014.
- A large amount of deductions from the income of Palestinian workers withheld by Israel have not yet been transferred to the Palestinian treasury and are estimated at \$699 million, or about 5.3 per cent of GDP in 2014.
- Other fiscal leakages and losses resulting from misapplication of the Paris Protocol include the deduction of handling or administrative fees of 3 per cent from Palestinian clearance revenues, as noted above. By applying the proportional values of the administrative costs of clearing Palestinian imports entering through Israeli ports, the World Bank concluded that this fee should be reduced from 3 to 0.6 per cent.
- The World Bank, using a gravity model developed by the Bank of Israel, estimates that the amount of indirect Palestinian imports via Israel but originating in third countries was around \$726 million in 2014, comprising 35 per cent of Palestinian imports from Israel, excluding water, electricity and fuel, while an earlier Bank of Israel (2010) estimate is higher, at 38.3 per cent. By applying the average customs tariff on imports, the World Bank estimates that the fiscal leakage resulting from indirect imports in 2014 was \$30.6 million.

The World Bank (2016b) study on the Palestinian wired and wireless telecommunications sector addresses the missed opportunities and losses incurred due to measures taken and the control of information resources and frequencies by Israel. The study states that in 2013–2015, the sector’s losses ranged from \$436 million to \$1,150 million, which translates to VAT fiscal losses to PNA of \$70 million–\$184 million in that period, and these estimates do not take into account treasury losses in profit taxes.

4. Other studies and reports

The Economic and Social Commission for Western Asia (2015) discusses the impact of restrictions by Israel on Palestinian economic sectors using a computable general equilibrium model. The study confirms that weak economic performance and restricted access to scarce Palestinian resources are mainly caused by restrictions by Israel on the Palestinian economy. Reducing restrictions by Israel in Area C would increase the Palestinian GDP by 12 per cent, or \$860 million, and decrease unemployment by 27 per cent. The report also measures the opportunity cost associated with the restrictions under occupation, which prevent the Palestinian treasury from increasing its revenues in the event that GDP rises to that level.

Misyef (2017) investigates the available and applicable alternatives to the Palestinian tariff structure. The study evaluates costs arising from the customs union, compared with a scenario

of an independent Palestinian tariff schedule apart from that of Israel. These costs, estimated at \$1.4 billion, comprise indirect taxes: VAT, purchase taxes and customs duties. This high amount is mainly related to agricultural products, which have the highest tariff rates and purchase taxes. If agricultural products (which comprise a share of about \$847 million of indirect taxes) are excluded, these costs, or the potential savings from adopting a separate tariff regime, drop to \$541 million; petroleum and its derivatives are excluded from the calculation of costs, as they would still be imported from Israel. A second scenario assumes the continuation of the status quo but with the application of an autonomous trade and tariff policy by exploiting the policy space available under the Paris Protocol with regard to lists A1, A2 and B and setting tariff rates at higher levels in accordance with the objectives of a Palestinian industrial policy. Under this scenario, revenues from import taxes and customs duties are expected to reach \$5.1 billion; an increase of \$305 million above the current level (based on 2015 data).

V. Estimating some of the fiscal costs of occupation for the Palestinian people: Leakage and other fiscal losses

The concept of the Palestinian fiscal costs due to occupation is part of the overall economic costs of occupation. It is a broader concept than the leakage of Palestinian public revenues to the treasury of Israel, because it also includes other fiscal losses caused by policies and measures imposed by the occupying Power but that have not leaked to the treasury of Israel.

This chapter presents estimates of the fiscal leakage and other fiscal losses arising from the current framework of trade and economic relations with Israel within the structure of the Paris Protocol, the constraints imposed by occupation and the lack of Palestinian sovereignty in the economic sphere. Estimates of each source of leakage and other fiscal losses are calculated separately based on official data for 2015 and other available data and information. The individual estimates are then aggregated to reach an estimate of the fiscal costs of occupation (leakage and other fiscal losses). The sources of fiscal leakage include those caused by indirect imports, the evasion of customs duties and the misapplication of the Paris Protocol provisions. The chapter also examines non-recurring sources of leakage resulting from the withholding of Palestinian clearance revenues by Israel at certain points in time. Finally, the chapter discusses the sources of other fiscal losses in the form of public revenues lost due to the lack of Palestinian sovereignty and the control by Israel of economic resources, crossings and borders, and other measures imposed by the occupying Power that negatively affect the availability of Palestinian fiscal resources. However, this chapter assesses only those sources of Palestinian fiscal leakage to Israel and other fiscal losses for which data are available and that can be surveyed and assessed. It is important to keep in mind that there are other sources that could result in fiscal leakage or losses and which should be assessed once data become available. There is a need for further research and investigation to arrive at broader, comprehensive estimates of fiscal losses and the other economic costs of the Israeli occupation to the Palestinian economy in different spheres, including public finance.

A. Fiscal leakage from indirect imports

Indirect imports are Palestinian imports registered as if they were of Israeli origin, but that actually originate from a third country. As stipulated by the Paris Protocol, Palestinian imports of Israeli origin are exempt from Palestinian import tax. Therefore, revenues from import taxes on such indirect imports are supposed to be received by PNA but are leaked to the treasury of Israel. The methodology used to estimate the fiscal leakage from indirect imports is based on the rates of the tariff schedule of Israel applied to Palestinian trade flows as registered in the official statistical records of the actual imports for each commodity, as follows:⁸

⁸ Estimates in the previous studies reviewed in this study were based on the customs and purchase tax rates applied on total imports from Israel by applying the average rate on total imports. However, estimates in this study are calculated based on the tariff rate on the actual imports of each commodity at the Harmonized System 8-digit level, which gives more accurate results. Estimates of smuggled goods, however, are based on the average tariff rates on the total value of smuggled goods, due to limitations in official data

- Palestinian imports from the Israeli market are classified based on the Harmonized System 8-digit level. Each commodity is grouped by type of effective import tax (customs duty and purchase tax).
- All imported goods that have already paid import taxes are excluded, as are goods that must be imported from Israel only (such as public sector purchases, fuel, gas, energy, cars, engines, fresh agricultural products produced in Israel, cigarettes and tobacco), because PNA collects the majority of taxes on these commodities directly through the clearance system. Since VAT is not levied on agricultural products, they are also excluded from the calculation.
- All goods imported from the Israeli market not subject to import taxes are excluded.
- The Bank of Israel (2010) indicates that 38.3 per cent of Palestinian imports from Israel are indirect imports. This percentage is used to calculate the tax revenues from indirect imports based on the current tariff schedule of Israel for goods, based on the following:
 - The value of goods imported from Israel subject to customs duties multiplied by the applicable tariff rate
 - The value of goods imported from Israel subject to purchase tax multiplied by the purchase tax rate
 - Calculating VAT on import taxes, then deducting VAT collected through the clearance system to obtain the net amount or VAT difference;⁹
 - Applying the 38.3 per cent rate on the values calculated for the above three items.

Based on this methodology and using data for 2015, the fiscal leakage from all indirect import taxes, whether through foregone VAT, purchase taxes or customs duties, is estimated at \$129 million, as shown in table 2. This estimated value is equivalent to 1 per cent of the Palestinian GDP and about 4.9 per cent of total tax revenues in 2015.¹⁰

⁹ For imports from a third country, VAT is calculated after import taxes are added to the value of the imports; the value of this tax is therefore higher compared with calculating it based on the value of imports from Israel. Since VAT is collected through the clearing system, the difference is only included in the calculation of fiscal leakage

¹⁰ UNCTAD (2014a) estimates the fiscal leakage resulting from indirect imports as an annual average of \$115.3 million in 2010 and 2011. This value in figures is lower than the estimate shown in table 3, yet as a ratio of GDP and total revenues it is higher, in particular with regard to tax revenues. The difference in estimates is mainly caused by differences in the imports and tariff structures of the different imported goods, as well as by the change in the percentage of registered imports from Israel and a significant increase in tax revenues in the interim between the two studies.

Table 2

Fiscal leakage from indirect Palestinian imports via Israel, 2015

Description	Number of goods	Value based	Import tax	Value of 38.3
		on PCBS data	revenues	per cent
(Millions of dollars)				
Electricity imports from Israel	..	479.3	..	..
Commodity imports from Israel, excluding electricity	1 360	2 565.4	..	..
Petroleum, gas, cars, motorcycles, engines and cigarettes and tobacco*	52	661.3	..	..
Agricultural products (fresh fruits and vegetables not produced in Israel*)	30	43.4	..	..
Products not subject to custom duties or purchase tax*	514	813.9	..	..
Commodity imports from Israel subject to import taxes (customs duty)**	764	1 046.9	..	..
Commodity imports subject to both customs duty and purchase tax	68	59.9	10.9	4.2
Commodity imports subject to customs duty only	670	951.3	244.2	93.5
Commodity imports subject to purchase tax only	26	35.8	41.0	15.7
Net VAT on import taxes with the value of imports	..	..	40.8	15.6
Total fiscal leakage from indirect imports	..	..	..	129.0
Fiscal leakage from indirect imports, as percentage of:	..	..	..	..
GDP (\$12 673 million)	..	..	..	1.02 per cent
Total tax revenues (\$2 654 million)	..	..	..	4.86 per cent

Source: PCBS, 2015.

Notes: * Imports from Israel not subject to import taxes; no fiscal leakage is incurred although they may be classified as indirect imports.

** Fiscal leakage is calculated only for these indirect imports. The value of import taxes is calculated based on the tariff rate applied to each specific commodity; the 38.3 per cent rate is applied to the value of these revenues to obtain the indirect import revenues from Israel.

B. Fiscal leakage from the evasion of customs duties and taxes

1. The evasion of customs duties and taxes in the Palestinian context

The main cause of the evasion of customs duties and taxes on goods imported to the Palestinian market is the fact that all borders and crossings in the Occupied Palestinian Territory and vast areas of the West Bank are under the control of Israel. Added to this is the fact that Israel has not implemented agreements regarding direct and immediate exchanges of intratrade data and does not work within a common computerized clearance system. For example, VAT is still cleared through an outdated mechanism that is not applied appropriately by Israel. The manual, paper-based collection of clearance invoices results in the loss of a large portion of Palestinian revenues, estimated at about \$120 million per year (State of Palestine, 2018b). The current system depends mainly on the ability of Palestinians to collect paper invoices from the private sector. The State of Palestine report demands the creation and operationalization of a joint electronic system with an interconnected up-to-date database that collects reliable invoices and papers electronically.

The evasion of customs duties and taxes arising from imports from Israel to the Occupied Palestinian Territory is related to three main issues, discussed in this section. First, there are differences in the registered trade statistics resulting from the concealment and non-submission

of clearance invoices. Second, there are losses resulting from the evasion of customs duties and taxes as demonstrated in the records of the customs police. Third, the entry of goods to the Palestinian market without documentation is estimated to be at 25–35 per cent of total Palestinian imports from Israel.

Distorted trade data

There is a discrepancy in the value of official Palestinian trade statistics and the trade statistics of Israel in any given year, in particular between the export statistics published by the Israel Central Bureau of Statistics and the import statistics published by PCBS. The discrepancy is likely caused in both cases by the source of information. In the Occupied Palestinian Territory, merchants declare clearance invoices to the Palestinian tax authority, which shares this information with PCBS. This means that invoices that are not presented to the tax authority are not included in PCBS statistics or may be presented at a different time from when the commodity was imported.

The Palestinian Ministry of Finance estimates losses from this type of evasion at \$120 million per year (State of Palestine, 2018b). However, Palestinian estimates and those of Israel differ markedly. Clearance bills of Palestinian imports are issued by the tax authority of Israel and are strictly monitored and recorded. The discrepancy in the official statistics on imports from Israel to the Occupied Palestinian Territory in the period 2015–2017 are shown in table 3. The difference constituted 20 per cent of total Palestinian imports from Israel in 2017, which is indicative of the scale of tax evasion related to Palestinian imports from Israel, noting its fluctuation over the years due to the manner of counting agricultural imports. In 2014, for example, PCBS values of exports from Israel to the Palestinian market were \$220 million less than the values recorded by the Israel Central Bureau of Statistics. This seems to be due to the mechanism of collecting data on agricultural imports from Israel, which depends mainly on the number of import and export licences to and from Israel as reported by Palestinian farmers to the Ministry of Agriculture. From 2014 on, the calculation method was revised and the Ministry of Agriculture of Israel began to share accurate estimates of agricultural imports with the Palestinian Ministry of Finance. This enabled the rectification of the statistical methodology of calculation and the inclusion of agricultural products and production of more reliable and regular data after 2014. This largely explains the difference in records of trade with Israel and its fluctuation over the years.¹¹ The statistical difference shown in table 3 can be regarded as an indicator of evasion and its economic implications, namely, the losses resulting from the concealment or non-submission of clearance invoices to the Palestinian tax authority. Much of the negative difference in the table is likely related to agricultural products from Israel.

¹¹ Interview with the Director of PCBS Foreign Trade Statistics, 27 November 2018.

Table 3
Official statistics on products entering the Palestinian market
(Millions of dollars)

Year	PCBS data on Palestinian imports from Israel	Israel Central Bureau of Statistics data on exports from Israel to the Occupied Palestinian Territory	Difference
2015	3 045	3 379	-334
2016	3 123	3 359	-236
2017	3 010	3 623	-613

Source: UNCTAD calculations, based on data from the Israel Central Bureau of Statistics and PCBS.

Smuggling

Official Palestinian customs police records provide further indicators of the value of smuggling, which helps to gauge the size of this phenomenon and its implications. Smuggled goods seized by the customs police in 2013–2017 by main commodity group are shown in the annex to this study; the data suggest that there is a concentration in the smuggling of construction materials, fuel and agricultural products. The tariff and tax rates applied to these vary widely. For example, customs duties and excise on fuel and cigarettes are considerably high when compared with other duty-free commodities. However, all commodities are subject to VAT, which is another source of Palestinian fiscal leakage to the treasury of Israel. According to customs police reports, the value of smuggled goods seized in 2014–2017 was around \$117 million, averaging \$29 million per year. These figures are much less than the value of goods the customs police could control if it had access to Area C or areas adjacent to borders with Israel.

MAS (2018b) states that smuggling has increased significantly in the last four years, in particular diesel smuggling. According to the customs police, the value of the monthly consumption of diesel (about 95 million litres per month) is estimated at around \$60 million and smuggled diesel accounts for \$120 million in lost revenues per year. The study also indicates that 17–25 per cent of diesel smuggled from Israel comes through Area C to areas under PNA jurisdiction, as smugglers take advantage of the absence of Palestinian customs police.

Undocumented imports

Another channel of fiscal leakage, discussed in chapter IV, concerns the entry of goods to the Palestinian market without documentation. It is estimated that the evasion of customs duties affects about 35 per cent of total Palestinian imports from the Israeli market.

2. Estimating fiscal leakage resulting from the evasion of customs duties and taxes

The preceding discussion indicates the pervasiveness of the evasion of customs duties and taxes and its magnitude in the Palestinian market. However, there are no precise aggregate estimates of its size. This section attempts to provide such estimates. To avoid double counting, estimates of fiscal leakage are not based on figures cited in previous chapters. Instead, calculations are based on a new evaluation of the expert estimates and data from previous studies.

As outlined in chapter IV, goods entering the Palestinian market without documentation are estimated as at 25–35 per cent of the total Palestinian imports from Israel.¹² Other estimates give an even higher figure, of up to 40 per cent of the total registered imports from Israel, according to the Palestinian Ministry of Finance.¹³

Following a conservative approach, this study excludes electricity purchases, which accounted for 16 per cent of imports from Israel in 2015, and takes a midpoint estimate of 30 per cent, based on the 25–35 per cent estimate cited in other studies, for goods entering the Palestinian market without documentation.¹⁴

Imports from Israel (excluding electricity purchases) were valued at \$2,565 million in 2015 (\$3,044 million - \$479 million = \$2,565 million); applying the 30 per cent estimate gives a value of \$769.5 million for smuggled goods from Israel to the Palestinian market. Smuggled goods in 2010–2011 were estimated to average around \$726.5 million (UNCTAD, 2014a), implying a slight increase in the evasion of customs duties and taxes, consistent with a similar rise in total imports from Israel.

To estimate the fiscal leakage from the evasion of customs duties and taxes, the following assumptions are made:

- Smuggled goods constitute 30 per cent of total Palestinian imports from the Israeli market, excluding electricity purchases.
- Not all smuggled imports from Israel are subject to import taxes; some smuggled imports therefore do not result in revenue losses. Records of actual imports show that 69 per cent of goods imported from Israel are subject to import taxes. Accordingly, the value of smuggled goods subject to import taxes is estimated at \$531 million (table 4).
- The average rates of customs duties and purchase taxes on all imports from Israel (whether subject to import taxes or not) are estimated at 13 and 6 per cent respectively.¹⁵ These rates are applied to the \$531 million. It should be noted that the average rates of customs duties and purchase taxes are calculated based on actual trade data for imports from Israel in 2015 for individual commodities at the Harmonized System 8-digit level and based on the tariff schedule of Israel related to each commodity in 2015.
- A VAT rate of 16 per cent is applied to the value of smuggled goods and to the value of import taxes that were evaded (table 4, rows 5 and 6).

¹² According to customs police reports and seizure records, around 65 per cent of the evasion of customs duties and taxes represent goods that do not have documentation and 35 per cent, goods with fake or undervalued invoices or for which the merchant has a clearance invoice but does not have a tax file.

¹³ Interviews with officials at the Palestinian Ministry of Finance Customs Control Authority and Customs and Excise Department, 15 June 2018.

¹⁴ UNCTAD (2014a) estimates this type of leakage at 25 per cent. The reason for the increase is due to the fact that the previous study applies the percentage to all Palestinian imports from Israel, but this study excludes electricity imports (16 per cent of total imports). In addition, some indicators suggest that the phenomenon of the evasion of customs duties and taxes has been on the rise in the past four years, in particular with regard to smuggled diesel.

¹⁵ The 13 per cent calculated for the average customs duty rate on imports from Israel is higher than the average customs duty rate for imports from Israel (6.5 per cent) because the Palestinian basket of imports from Israel is different from that of Israel from the outside world, which is subject to lower tariff rates.

Table 4
Fiscal leakage from smuggling, 2015

Item	Value or percentage	Value of leakage (Millions of dollars)
Total value of smuggled goods	\$769.5 million	..
Value of smuggled goods subject to import taxes - 69 per cent of row 1	\$530.9 million	..
Rate of customs duties on goods imported from Israel - 13 per cent of row 2	13 per cent	69.0
Rate of purchase tax on imported goods subject to purchase tax - 6 per cent of row 2	6 per cent	84.9
Rate of VAT - 16 per cent of row 2	16 per cent	31.8
Rate of VAT - 16 per cent of row 3 + row 4	16 per cent	16.1
Amount of fiscal leakage from the evasion of customs duties and taxes on imports	..	201.8
Fiscal leakage as a ratio of:	..	..
GDP (\$12 673 million)	..	1.6 per cent
Total tax revenues (\$2 654 million)	..	7.6 per cent

Source: UNCTAD calculations.

Total fiscal leakage to the treasury of Israel resulting from the evasion of customs duties and taxes on imports to the Occupied Palestinian Territory are estimated at nearly \$202 million in 2015, or about 1.6 per cent of the Palestinian GDP and 7.6 per cent of the total Palestinian tax revenues.

C. Other sources of leakage

This section focuses on leakage related to the deduction of a high level of handling or administrative fees in return for clearing imports destined for the Occupied Palestinian Territory coming through Israel; the Palestinian telecommunications sector; the lack of transfers of VAT and income tax levied on commercial and economic activities in Area C; and the unequal sharing formula for passenger exit fees at the Allenby Bridge crossing.

1. Fiscal leakage from administrative fees on clearance revenues

In accordance with the Paris Protocol, Israel deducts a 3 per cent fee from the clearance revenues it collects on behalf of PNA to cover the handling or administrative costs involved in the collection of taxes. At the time of negotiating the terms of the Protocol, Palestinian taxes and revenues were around \$624 million per year and handling fees were only \$18 million. Since then, PNA revenues have tripled, leading to a significant increase in the administrative fees paid to Israel. In 2017, Israel collected over \$2.3 billion in taxes and deducted around \$70 million in handling fees (State of Palestine, 2017). The World Bank (2016a) recommended that this fee be set at 0.6 per cent, commensurate with the share of Palestinian imports to total imports handled by the Israel customs authority; this would reduce the handling fee leakage and increase Palestinian revenues by around \$40 million–\$50 million per year. Additionally, in 1996, Israel began to collect the 3 per cent handling fee on the excise taxes imposed on fuel purchases and on clearance revenues from petroleum derivatives (gasoline, diesel, kerosene, gas, etc.), even

though there are no administrative costs involved in handling these taxes as they are direct imports made according to arrangements between the private sectors in the two economies.

According to PCBS data, Palestinian purchases of petroleum and its derivatives amounted to about \$11,150 million in 1996–2017, subject to 65 per cent in excise and other taxes, on average. The central clearing data of the Palestinian Ministry of Finance shows that the fuel excise contributed 32 per cent of total clearance revenues in the same period. The total value of clearance revenues collected in the same period was \$23.3 billion. The 3 per cent handling fee on that amount equals \$699 million, about \$224 million of which was deducted as fees on Palestinian tax revenues from direct fuel imports from Israel.

For example, the State of Palestine report (2018b) indicates that, in 2015, Israel collected \$64 million in handling fees, around \$24 million from fuel excise and \$40 million from handling fees on other imports. As handling fees should not be deducted from direct imports, the deductions from the excise of petroleum and its derivatives are considered a source of fiscal leakage. Leakage resulting from handling fees levied on other imports is estimated at \$32 million. Consequently, Palestinian fiscal leakage to the treasury of Israel in 2015 resulting from the deduction of excessive handling fees on clearance revenues is estimated at some \$56 million, namely, \$24 million from petroleum excise and \$32 million from taxes on other imports.

2. Fiscal leakage associated with the Palestinian telecommunications sector

The Palestinian financial and insurance sector and the telecommunications and information sector are of increasing significance to the Palestinian economy, contributing to 8 per cent of GDP in recent years. It is not possible to arrive at accurate estimates of the fiscal leakage associated with the two sectors without a detailed, in-depth study. However, it is possible to gauge the magnitude of the fiscal and economic losses incurred by the two sectors by comparing Palestinian statistics on trade in services with those of Israel. Statistical data exhibit wide variations. Recorded Palestinian services imports averaged \$143 million in 2015–2017, while recorded service exports from Israel averaged \$684 million in the same period, a difference of \$541 million. This highlights the size of services imported from Israel that are not recorded by the Palestinian authorities and constitute lost Palestinian financial entitlements of tax and customs revenues, in particular VAT.

To date, no studies have been conducted on the economic or financial losses in the services sector, except for one World Bank (2016b) study on the telecommunications sector, in which the economic losses are estimated to be in the range of \$436 million to \$1,150 million in 2013–2015. This represents 1.2 per cent and 3 per cent of GDP. These figures indicate Palestinian losses of VAT revenues (fiscal leakage, excluding corporate taxes) in the range of \$70 million to \$184 million in the same period. Assuming an economic loss as a ratio of GDP in 2015 at the midpoint of the range given by the World Bank, that is, 2.1 per cent of GDP, the sector's losses were \$266 million in 2015.¹⁶ Consequently, the associated fiscal leakage from VAT losses alone may have been \$42.6 million, equivalent to 0.34 per cent of the Palestinian GDP or 1.6 per cent of total tax revenues in 2015.

¹⁶ The midpoint assumption is conservative since without the constraints imposed by occupation and with full Palestinian economic sovereignty Palestinians could have further developed and expanded the telecommunications sector, in particular since the economy grew in 2013–2015.

3. Fiscal leakage from commercial and economic activities in Area C

Under the Paris Protocol, Israel is obliged to apply the Palestinian tax system to levy VAT and income tax in Area C on behalf of the Palestinian authority and transfer that revenue to the Palestinian treasury based on the principle of the place of final consumption and the geographic location of income generation. Around 2,000 commercial enterprises or individuals from Israel work in Area C, performing various activities, related to services, industry, agriculture, fuel, gas and retail, among others (State of Palestine, 2018b). Israel collected VAT, income tax, property tax and operational fees from these enterprises and transferred them to PNA until 2000. Israel has since not done so and has not provided any information about the activities of these enterprises.

The State of Palestine report (2018b) estimates that, in the period 2001–2017, Israel collected \$320 million in VAT, income tax, property tax and other fees in Area C that was not transferred to the Palestinian treasury. This figure represents 0.25 per cent of the Palestinian GDP in that period. Palestinian fiscal leakage resulting from commercial and economic activities in Area C in 2015 may therefore be estimated at \$32 million, or 1.2 per cent of total tax revenues in that year.

4. Fiscal leakage from passenger exit fees at the Allenby Bridge crossing

In the annex on redeployment and security arrangements, the Paris Protocol states that Israel should collect an exit fee of \$26 from each passenger at the Allenby Bridge crossing and transfer a share to PNA, calculated as follows:

- The passenger fee for the first 750,000 passengers each year is to be divided at 46.2 per cent (to the Palestinian treasury) and 53.8 per cent (to the treasury of Israel). PNA is to pay Israel \$1 per passenger for services.
- If the number of passengers exceeds 750,000, Palestinians will receive \$16 per passenger and Israel will receive \$10, that is, the fee is divided at 61.5 per cent (to the Palestinian treasury) and 38.5 per cent (to the treasury of Israel).

The State of Palestine report (2018b) states that Israel has more than once unilaterally raised the exit fees without consultation with Palestinians in accordance with the provisions of the Paris Protocol in this regard. In addition, transfers to PNA since 1994 have been irregular and partial. According to Palestinian Ministry of Finance estimates, withheld Palestinian exit fees up to April 2017 are around \$145 million, or 0.10 per cent of GDP in 2017.

The World Bank (2016a) indicates that, in 2008, Israel raised the exit fees to \$40 for Palestinian passengers and \$46 for foreign passengers. In 2009, fees were raised to \$43 and \$50, respectively. The total number of passengers in 2014 was 918,126, of which 730,138 were Palestinians and 187,988 were foreign passengers. In accordance with the established sharing formula, the Palestinian treasury should have received \$20 million in 2014, or around 0.16 per cent of GDP. The exit fees withheld by Israel in 2008–2016 are estimated at \$67 million, or 0.096 per cent of GDP in that period. This suggests fiscal leakage from this source in 2015 at an estimated \$12.2 million, or 0.46 per cent of total tax revenues.

D. Total annual fiscal leakage from the sources surveyed

Although this study attempts to provide thorough documentation of all previous estimates of possible sources of leakage that can be identified, it may still be short of data on some other sources yet to be revealed in future investigations. In addition, many other sources of Palestinian losses resulting from the occupation, although not leaked to the treasury of Israel, are not covered in this report (see section E). The total value of fiscal leakage resulting from the six sources discussed in this section are estimated at \$473.6 million in 2015, or about 3.7 per cent of GDP and 17.8 of total Palestinian tax revenues, as shown in table 5. In other words, had the fiscal leakage to Israel been arrested, the public deficit (on a commitment basis) in 2015 could have been reduced by 33 per cent, from \$1,431 million to \$950 million, or from 11.3 to 7.6 per cent of GDP.

Table 5
Estimated total fiscal leakage to Israel by source, 2015

Source of fiscal leakage	Value of fiscal leakage (Millions of dollars)	Fiscal leakage as a ratio of	
		GDP	Total tax revenues (Percentage)
(1) Indirect importing	129	1.02	4.86
(2) Evasion of customs duties and taxes	202	1.59	7.60
(3) Handling fees levied by Israel	56	0.44	2.11
(4) Telecommunications sector	43	0.34	1.61
(5) Economic activities in area C	32	0.25	1.21
(6) Passenger exit fees to Jordan at Allenby Bridge crossing	12	0.096	0.46
Total	473.6	3.74	17.84
GDP	12 673	..	..
Total tax revenues	2 654	..	..

Source: UNCTAD calculations.

E. Other fiscal losses related to occupation

In chapter I, a differentiation was highlighted between Palestinian fiscal losses (part of the economic costs of the Israeli occupation) and the narrower concept of Palestinian fiscal leakage to Israel. Leakage, which is only one of the many elements of the fiscal losses and costs of the occupation, is mainly a result of the flawed and unilateral application of the Paris Protocol by Israel. However, Palestinian losses of public revenues are the fiscal costs of protracted occupation, representing all public revenues that could have been collected by the Palestinian treasury if the occupation did not exist, whether leaked to the treasury of Israel instead of the Palestinian treasury or not captured by either. In other words, in addition to the Palestinian fiscal leakage, the fiscal costs of occupation include all direct and indirect fiscal losses, which could result from many sources, such as the following:

- Control of Palestinian natural resources and revenues by the occupying Power
- Military operations and actions

- The isolation and annexation of East Jerusalem by the occupying Power
- The protracted economic siege imposed on the Gaza Strip
- The closure policy in the West Bank
- The demolition of buildings and uprooting of trees

This section analyses some but not all of the other Palestinian fiscal losses that can be surveyed at the present time.

1. Fiscal losses from the control of Israel of Area C

The World Bank (2014) discusses the significant output, labour and tax revenues that Area C has the potential to contribute to the Palestinian economy. Area C represents 60 per cent of the land area of the West Bank. Since Area C is still under the control of Israel, the right of the State of Palestine to benefit from the economic potential of Area C is limited. According to the World Bank, the likely potential benefit from alleviating the restrictions imposed by Israel in Area C is equal to 35 per cent of the Palestinian GDP, a potential increase in tax revenues of 7.6 per cent of GDP, or \$960 million in 2015. The World Bank emphasizes that losses resulting from not tapping the economic potential of Area C are estimated at \$3.5 billion per year. This situation has weakened the Palestinian economy, stripping it of the ability to benefit from these economic resources in agriculture, tourism, trade and natural resources. The economic resources could have reduced the Palestinian budget deficit.

2. Fiscal losses from the undervaluation of imports

The manipulation of the values of imports is common in many countries. Merchants often opt to forge bills to reduce their tax liabilities. However, the prevalence of underinvoicing differs from one country to another depending on the level of law enforcement by the relevant customs and other authorities. In the Palestinian context, prevalence rates are high. High customs rates set by Israel on specific imports are conducive to the economic interests of Israel and not necessarily to those of such a small and distorted economy as is the Palestinian economy. Other factors include the porous borders and crossing points between Israel and the Occupied Palestinian Territory and the movement of goods from Israel to the Occupied Palestinian Territory within an uncontrolled customs envelope, as well as the lack of Palestinian sovereignty and presence at borders with other countries. In addition, Israel imposes security and non-tariff barriers on Palestinian imports from third countries and does not allow the Palestinian tariff structure to differ from its own.

Merchants resort to manipulating bills to minimize taxable profits and evade the tax burden. Studies indicate that undervaluation is higher for imports from third countries than for imports from the Israeli market (World Bank, 2016a). This may be due to the higher costs entailed and to the restrictions set by Israel that affect Palestinian direct importing from third countries, which also explains why Palestinian merchants depend heavily on imports from Israel. An additional motivation for the undervaluation of imports from Israel is to evade the high taxes in Israel and compete with smuggled goods and informal traders who evade import taxes.

In the same context, the World Bank (2016a) states that the declared value of imports from Israel is 23 per cent lower than its actual value (the declared value is 77 per cent of the actual value of goods) and is 32 per cent lower for imports from a third country (the declared value is 68 per cent of the actual value). To arrive at firm estimates of Palestinian fiscal losses resulting from underinvoicing, the analysis here builds on statistical records of imports from Israel and third countries, investigating the types of taxes levied on these imports and whether they provide a strong incentive for merchants to use underinvoicing. The analysis also uses estimates of the levels and proportions of underinvoicing specified in the World Bank (2016a).

3. Fiscal losses from the undervaluation of imports from Israel

The following approach is applied to estimate losses from this source:

- Exclusion of all goods that are not undervalued, including public sector purchases of electricity, fuel, gas and some other commodities imported to the Palestinian market through agreements with large companies.
- Adoption of the percentage of the undervaluation of imports from Israel estimated by the World Bank (2016a), that is, 23 per cent. The actual value of these imports therefore equals the declared value multiplied by 0.77.
- Application of the 16 per cent VAT rate on the difference between the actual and declared values in customs declarations.

As shown in table 6, in 2015, the total estimated difference between the actual values and declared values of imports from Israel that may have been undervalued is \$210 million, which causes a loss to the Palestinian treasury of about \$34 million per year, that is, the VAT that should have been levied on the difference between the two values.

4. Fiscal losses from the undervaluation of imports from countries other than Israel

Estimates of losses from this source follow the same mechanism as that used to estimate the losses from the undervaluation of imports from Israel, but with two differences, namely, the level or percentage of undervaluation of third-country imports is 32 per cent, not 23 per cent; and these imports are subject to all import taxes, including customs duties and purchase taxes, and not VAT only.

Table 6
Estimated fiscal losses from the undervaluation of imports from Israel, 2015

Classification of imports by type of underinvoicing	Value (Millions of dollars)	Number of goods
(1) Total commodity imports, excluding electricity	2 565	1 360
(2) Total commodity imports, excluding petroleum, gas, cigarettes, fresh fruits and imports from large companies*	1 860.7	1 278
(3) Commodity imports that are underinvoiced - declared value = (1) - (2)	704.3	82
(4) The real value of imports = (3) / 77 per cent	914.7	..

(5) The difference between the real values and the declared values = (4) - (3)	210.4	..
(6) Fiscal losses (VAT) resulting from underinvoicing of imports from Israel = (5) x 16 per cent	33.7	..

Source: UNCTAD calculations, based on data from PCBS external trade statistics.

Note: * Eight large companies work independently from the bills clearing system and present detailed account statements, which most likely declare the real value of goods.

The following approach is applied to estimate losses from this source:

- Adoption of the percentage of the undervaluation of imports from third countries estimated by the World Bank (2016a), that is, 32 per cent. The declared value of these imports as stated in customs declarations equals 68 per cent of their real value.
- Classification of all Palestinian imports from third countries at the Harmonized System 8-digit level and based on the recorded actual value of each commodity, not the estimated value.
- Calculation of import taxes using the customs duty and purchase tax rates multiplied by the value of imports for each individual commodity.
- Exclusion of all goods that cannot be undervalued, such as cars, cigarettes and other commodities.
- Exclusion of imports exempted from import taxes.
- Application of the 32 per cent rate to calculate tax revenues based on the actual values of imports, assuming taxes actually collected equal 68 per cent of total tax revenues, had the real values been declared. This means that total tax revenues from the estimated real value of imports equals the amount of actual collected taxes divided by 68 per cent.
- Calculation of the difference between the estimated real values of import taxes and the actual collected values for undervalued imports.

Accordingly, tax losses to the Palestinian treasury resulting from the undervaluation of imports from third countries amount to about \$53 million per year, based on 2014 and 2015 data. The World Bank calculation of losses relies on averages of the customs duty rate in the tariff schedule of Israel applied to the Palestinian import basket. The estimates in this study, by contrast, depend on more detailed, disaggregated records of imports at the Harmonized System 8-digit level.

The World Bank estimation appears to be a conservative one. According to the Palestinian Ministry of Finance, the level or percentage of undervaluation, in particular for imports from third countries, reaches 40 per cent, or even 50 per cent for some commodities.¹⁷ These higher percentages are revealed by data collected through re-evaluation processes by the Palestinian customs authority. However, they have not been used in calculating the estimates of fiscal losses in this study, to keep the estimates within the level of the conservative approach followed in the study.

¹⁷ Interviews with the Director of the Palestinian Ministry of Finance Import Department and the Director of the Risk Management Unit at the Palestinian Ministry of Finance Customs and Excise Department, 18 April 2018.

The total losses resulting from the undervaluation of imports from third countries are estimated at \$138.6 million, that is, \$33.7 million higher than the losses from the undervaluation of imports from Israel (table 7). This is because third-country imports are subject to import taxes (customs duty and purchase tax) and VAT while, under the customs union governing imports from Israel, only VAT revenues are lost when imports from Israel are undervalued.

Table 7

Estimated fiscal losses from the undervaluation of imports from third countries, 2015
(Millions of dollars)

Imports from third countries	Number of commodities	Declared value	Tax revenues from imports		Lost revenue
			Declared values	Estimated real values	
Value of total imports	3 065	2 157.2	..	..	..
Commodities with real value invoices, such as cars, cigarettes, etc.	382	683.7	1 496.3	1 496.3	No loss
Duty-free imports (exempted from import taxes)	1 347	955.5	152.9	152.9	No loss
Imports subject to custom duty	1 194	430	128.5	189.0	60.5
Imports subject to purchase tax	38	180	105	154.4	49.4
Imports subject to custom duty and purchase tax	104	88	61	89.7	28.7
Total fiscal losses	..	..	..	..	138.6

Source: UNCTAD calculations, based on data from PCBS external trade statistics.

Total fiscal losses from the undervaluation of imports

Total lost tax revenues resulting from the undervaluation of Palestinian imports is estimated at \$173.3 million in 2015, or \$33.7 million and \$138.6 million from commodity imports from Israel and third countries, respectively. These losses are not considered part of the fiscal leakage to Israel because these revenues are not collected by Israel and might even cause losses to the treasury of Israel if merchants from Israel also undervalued such imports.

5. Fiscal losses from shuttle trading at the Allenby Bridge crossing

In addition to losses associated with the smuggling of goods from Israel, there are fiscal losses resulting from the smuggling of goods from the local market and the Jordanian market as well, in particular cigarettes and tobacco. The smuggling of cigarettes and tobacco is driven by the high rate of taxes imposed on cigarettes, of up to 85 per cent of the value. Revenues from the tobacco tax constitute 25 per cent of domestic revenues.

A household survey by PCBS indicates that tobacco imports make up 71 per cent of cigarettes and tobacco consumed and their value is \$450 million (PCBS, 2018). However, the Palestinian Ministry of Finance estimates that tobacco consumption is at \$550 million.¹⁸ The \$100 million difference between the two figures is an indication of the magnitude of tobacco smuggling. In 2017, tax revenues from tobacco amounted to \$420 million.¹⁹ The illicit trade in tobacco, in

¹⁸ Interview with the Head of the Tobacco Department of the Palestinian Ministry of Finance Customs Authority, 15 July 2018.

¹⁹ Ibid.

which customs duties and taxes are evaded, constituted 30 per cent of the Palestinian tobacco market, which has resulted in \$110 million in lost revenues per year. Half of the smuggled cigarettes likely came from Jordan through the Allenby Bridge crossing.

Accordingly, if only the tax evasion from the smuggled tobacco from Jordan is considered, and local products are excluded, the estimated fiscal loss was at least at \$55 million in 2015, or 0.43 per cent of GDP. These losses are also the result of the fact that Israel prevents Palestinian customs personnel from being present to fulfil their duties at border crossings and the Allenby Bridge crossing.

F. Total recurrent fiscal leakage and other losses: Fiscal costs of occupation

This section sums up the findings of this study on the fiscal leakage and losses used to calculate the aggregate estimate of total fiscal leakage and losses. Determining the actual magnitude of leakage and losses will help to assess its economic and financial consequences. It is difficult to differentiate between fiscal leakage and losses, considering their interconnected sources and channels. Palestinian losses can be defined as the revenues to the Palestinian Treasury lost due to the occupation and the nature of the economic relationship under the Paris Protocol and its misapplication, which does not leak to the treasury of Israel. The smuggling of goods, for example, implies losses to the treasury of Israel just as it does to the Palestinian treasury. However, fiscal leakage represents a financial right of PNA, also resulting from the misapplication and one-sided application of the Paris Protocol, which accrues to the treasury of Israel. Some of the funds leaked to Israel have been recovered, but others, such as passenger exit fees, are still being withheld. Whatever the type of leakage, all of them have adverse economic and financial effects on the financial position of PNA, as well as on the growth of the Palestinian economy.

The previous sections detail the estimates of the leakage of Palestinian fiscal revenues to Israel and of the Palestinian fiscal losses due to the occupation that are not a result of leakage. The sum of these two components represents the fiscal costs of the Israeli occupation to the Palestinian people. However, the assessments and estimates in this study do not exhaust all sources of probable fiscal leakage or losses. The study covers only those sources for which data are currently available. In other words, the estimates presented in this study may be revised as more data and evidence become available.

The estimated total annual recurrent Palestinian fiscal leakage and losses, that is, the fiscal costs resulting from the occupation that can be quantitatively substantiated, are significant and are estimated at \$1.66 billion, equivalent to 13.1 per cent of GDP or 62.6 per cent of total tax revenues in 2015 (table 8).

Table 8
Total annual fiscal costs of occupation by source, 2015

Source or type of leakage or loss	Value in one year (Millions of dollars)	Value as a percentage of	
		GDP	Tax revenues (Percentage)
Total fiscal leakage (table 5)	473.6	3.74	17.84

Fiscal losses resulting from control of Area C by Israel	960.0	7.58	36.17
Fiscal losses resulting from underinvoicing of total commodity imports	172.3	1.36	6.49
Fiscal losses resulting from the smuggling of goods from Jordan	55.0	0.43	2.07
Other fiscal losses	1 187.3	9.37	44.37
Total fiscal costs of occupation	1 660.9	13.11	62.57

Source: UNCTAD calculations.

G. Non-recurrent fiscal leakage and losses from the withholding of clearance revenues by Israel

Israel repeatedly suspends or delays the transfer of clearance revenues without prior arrangement or warning. The Government of Israel collects Palestinian tax revenues on behalf of PNA and is required to transfer it to the Palestinian Ministry of Finance on a monthly basis through the clearance system. In 1997–2015, Israel suspended the transfer of Palestinian clearance revenues from time to time for varying periods, sometimes for as long as 24 months (during the second intifada), as shown in table 9. The total withheld dues during these suspension periods reached \$2.4 billion. In July 2018, the Government of Israel enacted a law freezing funds paid by PNA with affinity to terrorism out of funds transferred to it by Israel, which mandates the deduction from clearance revenues an amount equivalent to the payments made by PNA to families of Palestinian prisoners in Israel and Palestinians killed in attacks or alleged attacks against Israelis. Consequently, in February 2019, Israel informed PNA that it would deduct \$11.5 million per month (\$138 million annually) and PNA declared that it would not accept anything less than the full amount of its rightful revenues (Office of the United Nations Special Coordinator for the Middle East Peace Process, 2019). The ramifications of this fiscal challenge are underscored by the fact that clearance revenue accounts for 65 per cent of total PNA revenue, or 15 per cent of GDP. This is another source of fiscal leakage and losses, which will further strain the already fragile Palestinian fiscal position and increase the fiscal costs of occupation. This study does not assess the impact of this development, which was concurrent with the completion of the study, but it should be the focus of future studies. This use of clearance revenues for political ends prompted the Palestinian government to reiterate its urgent call for fundamental changes to the Paris Protocol or even to transcend it with a new arrangement that provides for Palestinian sovereignty over Palestinian funds and resources. Vulnerability to the suspension of Palestinian clearance revenues not only undermines the ability of PNA to plan and manage its finances and development projects, but also poses a significant challenge to its ability to meet its financial obligations, in particular paying the wage bill and covering current expenditures in the public budget. This represents another source of fiscal leakage and loss, as it forces PNA to resort to borrowing from local banks and paying interest at extremely high interest rates on NIS-denominated loans. At the same time, the treasury of Israel profits from the interest paid on withheld Palestinian funds at interest rates paid on promissory notes of the treasury of Israel.

Table 9

Palestinian fiscal leakage and costs from the withholding of Palestinian clearance revenues

Due date	Release date	Duration of suspension (Months)	Withheld amount (Millions of dollars)	Interest rate on NIS deposits (Percentage)	Fiscal leakage (Millions of dollars)	Interest rate on NIS loans (Percentage)	Fiscal loss or cost (Millions of dollars)
January 1997	August 1997	1	87	14.5	1.0	18.7	1.36
December 2000	December 2002	24	500	7.3	72.5	12.9	129.0
March 2006	July 2007	16	1 100	5.2	76.4	13.2	193.6
May 2011	May 2011	0.5	100	3	0.13	11.7	0.49
November 2011	November 2011	0.5	100	3.0	0.13	11.7	0.49
November 2012	January 2013	3	100	1.9	0.49	9.2	2.3
January 2015	April 2015	3	450	0.2	0.20	7.8	8.78
Total					\$150.9		\$336.0

Source: UNCTAD calculations, based on IMF, 2016.

Note: The official exchange rates published by the Palestinian Monetary Authority have been used to convert the values from NIS to United States dollars for the given periods.

Estimates of fiscal leakage and losses resulting from the withholding of Palestinian clearance revenues are calculated using the interest rates paid on NIS-denominated loans from the Palestinian Monetary Authority and interest rates on promissory notes of the treasury of Israel from the Bank of Israel, respectively, since the revenues withheld by the Government of Israel and the payments and loans of the Palestinian government are in NIS. As shown in table 9, based on the amount of the clearance revenues withheld, the duration of the suspension and the interest rates at the time of suspension, the cumulative Palestinian fiscal leakage and losses from this source are estimated at \$151 million and \$336 million, respectively. To avoid double counting, the first estimated sum should be considered as part of the second estimate, leaving an estimate of net fiscal costs of around \$185 million.

VI. Cumulative fiscal leakage and losses and their impacts on the economy and employment

A. Introduction

The estimates of fiscal leakage and losses presented in chapter V are indicators of part of the cost incurred, in only one year, by the Palestinian people as a result of the enduring Israeli occupation. As noted, the fiscal leakages covered in this study are a part of the fiscal losses, which in turn are a part of the greater economic costs of the Israeli occupation. The latter is measured by the difference between the position of PNA under two scenarios, namely, the current fiscal position of PNA under the status quo, which gives Palestinian policymakers a narrow policy space, and the assumption that occupation is removed and the State of Palestine has fiscal sovereignty over all sources of public revenues and expenditures. In other words, the cost of the Israeli occupation includes all direct and indirect losses caused by the occupation measures and control of all Palestinian resources and revenues.

Many reports and studies have addressed aspects of the economic costs of the occupation and its size and repercussions, which appear to be significant, some of which are as follows:

- UNCTAD (2009) assesses the costs resulting from the narrow policy space available under the occupation and within the terms of the Paris Protocol. The UNCTAD macroeconometric model of the Palestinian economy is used to simulate the economy under two different policy scenarios, namely, a baseline scenario, which assumes the status quo of narrow policy space, and an alternative scenario, which assumes that PNA has control of its policy instruments and is capable of implementing an independent policy framework that governs trade, tax, exchange rates and the labour market. The study concludes that under the alternative scenario, the Palestinian GDP would increase by 24 per cent and unemployment would decline by 19 per cent.
- The World Bank (2014) assesses part of the economic costs of occupation in Area C, under a scenario that assumes that PNA controlled the resources and revenues of Area C without physical, legal or regulatory restrictions on Palestinian investments or production. The study provides an estimate of the direct and indirect economic costs of the occupation in different sectors, including agriculture, Dead Sea minerals, quarries, construction, tourism, communications and cosmetics. These costs are estimated at 35 per cent of GDP, equivalent to \$4.4 billion in 2015. Under this scenario, employment could have increased by some 35 per cent.
- According to estimates by the Palestinian Ministry of National Economy and Applied Research Institute Jerusalem (2011), the total costs of the occupation reached about \$6.9 million, or 85 per cent of GDP, in 2010. While focusing mainly on the impact of the strict restrictions imposed on the Palestinian people and denial of their right to control or access their natural resources, these estimates do not take into account other sources of losses such as security measures by Israel. However, the estimates include the impact of the economic siege on the Gaza Strip, restrictions on the use of water and natural resources (such as natural gas fields) and restrictions on the movement of individuals and domestic and imported goods, in addition to losses associated with restrictions on tourism activities

in the Dead Sea area, the uprooting of trees and the destruction of public facilities, among other costs.

- Another assessment by the Applied Research Institute Jerusalem (2015) focuses on the indirect costs and revenue losses resulting from the measures of occupation and restrictions on the movement of individuals and trade in the West Bank and on the development of natural gas fields, fisheries, irrigation water and agriculture. The assessment of direct costs associated with the destruction of Palestinian infrastructure, the demolition of houses and the Israeli military operation in Gaza in 2014 amounts to 74 per cent of GDP, or \$9.95 billion in 2014.
- A study by Mustafa (2016) discusses restrictions by Israel on economic activities related to natural resource-based industries in the Occupied Palestinian Territory, including construction stone, sand dunes in Gaza, phosphate and mineral resources in the Dead Sea and petroleum and natural gas. The study concludes that control by Israel of the stone sector in Area C cost the Palestinian people around 0.7 per cent of GDP, or \$900 million, in 2015.

It should be emphasized that the value added of previous studies and reports is to identify the scope and potential scale of the costs of the occupation incurred by the Palestinian people. It should also be stressed that they are all individual case studies focused on specific sources and overlooking others. None are inclusive of all types and sources of costs nor do they follow a comprehensive approach that considers the co-related direct and indirect costs in the different economic sectors. Recognizing that these studies are not able to penetrate deeply enough into the multilayered costs of occupation, the General Assembly of the United Nations has adopted successive resolutions since 2014, namely, resolutions 69/20, 70/12, 71/20, 72/13 and 73/18, that stress the need to establish a systematic, in-depth, comprehensive and sustainable approach to assess the economic costs of the occupation and their repercussions. These resolutions request UNCTAD to provide the General Assembly with regular reports on the topic.

All estimates of the study summarized in table 8 are based on the statistics of the year of the study (2015), in addition to the non-recurring leakage resulting from the withholding of Palestinian clearance revenues (see table 9). This chapter presents monetary estimates of both the fiscal leakage and costs that accumulated in 2000–2017 and investigates their repercussions on the Palestinian economy and labour market in the same period. The UNCTAD macroeconomic model is used to simulate the Palestinian economy under alternative policy scenarios. The specified start year, 2000, marks the end of the interim period of the Oslo Accords and the assumed expiry date of the Paris Protocol, which continues to be in force.

B. Cumulative fiscal leakage and costs in the period 2000–2017

Fiscal leakage is a recurring problem accumulating on an annual basis and is not specific to any single year. It is a result of occupation and the manner in which the Paris Protocol is implemented. As shown in table 8, the annual fiscal leakage from the Palestinian treasury to the treasury of Israel is assumed to be on average 3.74 per cent of GDP. Using this ratio, the annual fiscal leakage for the period 2000–2017 is estimated, showing the accumulated revenues that

were supposed to reach the Palestinian treasury over the period, instead of which, the treasury of Israel receives these revenues and benefits from actual or implicit returns on investment from holding these funds (table 10). Assuming these revenues are retained as deposits in the Bank of Israel or other banks in Israel, the amount of fiscal leakage increases with compounded interest on the accumulated funds. As shown in the table, the cumulative fiscal leakage identified in the period of the study, without calculating cumulative interest, reached about \$5.6 billion, an amount that could increase total public revenues by 17.6 per cent and could have reduced the current public deficit (on a cash basis) by 42 per cent in the same period. Adding the cumulative interests calculated for the same period adds \$1 billion, for a total of \$6.6 billion, or about 4.4 per cent of GDP in the period, equivalent to 20.7 per cent of total Palestinian public revenues, or 50 per cent of current public deficit on a cash basis.

Table 10
Cumulative fiscal leakage

Year	Annual fiscal leakage at 3.74 per cent of GDP (Millions of dollars)	Cumulative fiscal leakage	Interest rate on NIS-denominated deposits based on Bank of Israel rates (Percentage)	Cumulative interest (Millions of dollars)	Cumulative fiscal leakage, including interest (Millions of dollars)
2000	161.3	161.3	9.8	15.8	177.1
2001	149.7	311.1	7.1	38.9	349.9
2002	205.5	516.6	7.1	78.3	594.9
2003	148.4	665.0	7.8	136.1	801.1
2004	161.9	826.9	4.3	177.7	1 004.6
2005	180.7	1 007.6	3.7	221.9	1 229.5
2006	183.6	1 191.2	5.3	296.2	1 487.4
2007	282.3	1 473.5	4.0	367.4	1 840.9
2008	249.6	1 723.1	3.7	445.6	2 168.7
2009	271.8	1 995.0	7.7	633.5	2 628.4
2010	333.4	2 328.3	1.6	681.5	3 009.8
2011	391.7	2 720.0	2.9	780.8	3 500.8
2012	421.9	3 141.8	2.4	874.2	4 016.0
2013	466.7	3 608.5	1.4	936.9	4 545.4
2014	475.6	4 048.0	0.6	967.5	5 051.6
2015	474.2	4 558.2	0.1	974.7	5 532.9
2016	502.1	5 060.3	0.1	980.8	6 041.1
2017	542.2	5 602.3	0.1	987.3	6 589.9

Source: UNCTAD calculations, based on PCBS national accounts data.

Note: Annual fiscal leakage includes non-recurrent leakage resulting from the withholding of Palestinian clearance revenues (see table 9).

The fiscal costs of occupation, however, are a much graver problem, as it includes fiscal leakage and the lost public revenues that could have been collected by the Palestinian treasury under the scenario of fiscal sovereignty. Using the other fiscal costs of occupation as a percentage of GDP (13.1 per cent) as identified in table 8, the cumulative fiscal costs are calculated separately for each year. PNA is forced to borrow from local banks at high interest rates on NIS-denominated loans to deal with lost resources and to meet its financial obligations, and this exacerbates the

cost of lost public revenues. The estimated cumulative monetary value of Palestinian fiscal costs in the period 2000–2017, including the cost of borrowing, is shown in table 11.

Table 11
Cumulative fiscal costs of occupation

Year	Annual costs at 13.1 per cent of GDP (Millions of dollars)	Cumulative fiscal costs (Millions of dollars)	Interest rate on NIS-denominated credit based on Palestinian Monetary Authority rates (Percentage)	Cumulative interest (Millions of dollars)	Cumulative costs, including interest (Millions of dollars)
2000	565.5	565.5	12.9	72.9	638.4
2001	524.9	1 090.4	16.4	263.3	1 353.7
2002	595.2	1 685.6	15.5	415.9	2 101.4
2003	520.2	2 205.8	13.7	774.0	2 979.7
2004	567.6	2 773.3	13.5	1 251.4	4 024.8
2005	633.4	3 406.8	13.5	1 880.2	5 287.0
2006	643.7	4 050.5	13.2	2 664.7	6 715.2
2007	915.4	4 965.9	12.7	3 416.9	8 382.8
2008	874.9	5 840.8	12.0	4 531.7	10 372.5
2009	952.9	6 793.7	11.0	5 775.9	12 569.6
2010	1 168.5	7 962.2	10.9	7 277.0	15 239.2
2011	1 373.0	9 335.2	11.7	9 222.0	18 557.2
2012	1 478.7	10 813.9	11.3	11 485.0	22 298.9
2013	1 637.9	12 451.8	11.6	14 254.1	26 705.9
2014	1 667.0	14 118.8	11.0	17 362.8	31 481.7
2015	1 670.2	15 789.0	10.2	20 729.2	36 518.2
2016	1 760.1	17 549.1	9.1	24 199.0	41 748.1
2017	1 900.7	19 449.8	9.3	28 241.6	47 691.4

Source: UNCTAD calculations, based on PCBS national accounts data.

Note: Annual fiscal leakage includes non-recurrent leakage resulting from the withholding of Palestinian clearance revenues (see table 9).

As shown in table 11, the total cumulative fiscal costs that can be identified, without cumulative interest, amount to \$19.5 billion; this would have increased total public revenues by 62 per cent. Adding the cumulative interest calculated for the same 18-year period increases the fiscal costs by \$28.3 billion, to reach a total of \$47.7 billion, or about threefold the Palestinian GDP in 2017 and 33 per cent of the value of the Palestinian GDP in the 18-year period. This could have turned the chronic Palestinian public deficit into a surplus.

C. Impact of fiscal leakage and costs on output and employment

The previous sections present a monetary estimation of the cumulative fiscal costs and leakage from the Palestinian treasury. However, what if there were no fiscal leakage or costs? How would the economy and employment in the Occupied Palestinian Territory have performed?

To address these questions, the UNCTAD macroeconomic model is used to simulate the Palestinian economy under alternative policy scenarios. This involves adding the value of the annual fiscal leakage (real prices converted using the government expenditure deflator; base year

2015) to public revenues and adding the same values to public expenditures, so that the impact on the budget is neutral. Table 12 compares the Palestinian GDP and employment levels under the baseline scenario, which assumes status quo conditions (i.e. leakage) in the analysis period, with the no-leakage scenario. Under the latter, the Palestinian GDP could have been 7.3 per cent above the levels in the baseline scenario in the period 2000–2017. In addition, the potential cumulative increase in the Palestinian GDP could have amounted to \$12.5 billion in the same period, equivalent to 86 per cent of the Palestinian GDP in 2017 (figure 2). Similarly, employment under the no-leakage scenario could have been 6.1 per cent higher, equivalent to 42,000 jobs per year, or 766,000 jobs in the 2000–2017 period (figure 3). The overall unemployment rate could have been 4 per cent, or 5 per cent less among women and 4 per cent less among men (figure 4).

Table 12

Impact of fiscal leakage on Palestinian gross domestic product and employment

Year	GDP (Millions of dollars; base year 2015)				Employment (Number of jobs)			
	Baseline scenario	No-leakage scenario	Difference	Difference (Percentage)	Baseline scenario	No-leakage scenario	Difference	Difference (Percentage)
2000	7 466.1	8 118.5	652.4	8.7	510 638	519 145	8 507	1.7
2001	6 942.9	7 661.4	718.5	10.3	469 457	485 609	16 153	3.4
2002	6 016.9	6 704.5	687.7	11.4	483 205	507 924	24 719	5.1
2003	6 025.3	6 592.5	567.2	9.4	491 603	520 872	29 269	6.0
2004	7 491.9	8 175.8	683.9	9.1	526 646	560 635	33 989	6.5
2005	8 064.4	8 845.4	781.0	9.7	565 578	604 261	38 684	6.8
2006	8 149.1	9 002.5	853.4	10.5	582 071	626 136	44 065	7.6
2007	8 355.9	9 073.5	717.6	8.6	606 055	653 603	47 549	7.8
2008	8 454.8	9 002.1	547.3	6.5	628 102	674 245	46 144	7.3
2009	10 187.9	10 913.0	725.1	7.1	666 284	715 183	48 900	7.3
2010	10 133.1	10 789.1	656.1	6.5	726 929	777 705	50 776	7.0
2011	10 698.3	11 413.4	715.1	6.7	780 339	832 802	52 464	6.7
2012	11 706.4	12 437.0	730.5	6.2	831 168	885 826	54 658	6.6
2013	11 520.2	12 192.6	672.4	5.8	872 014	925 995	53 981	6.2
2014	11 171.9	11 808.5	636.6	5.8	901 064	954 176	53 112	5.9
2015	11 692.5	12 325.0	635.5	5.7	917 202	970 485	53 284	5.8
2016	12 500.2	13 178.2	678.1	5.4	952 678	1 006 721	54 043	5.7
2017	13 084.7	13 807.2	722.5	5.4	987 691	1 043 535	55 844	5.7
Total	1 699 662.4	182 040.2	12 377.8	7.3	12 498 725	13 264 866	766 141	6.1

Source: UNCTAD calculations.

Note: Annual fiscal leakage includes non-recurrent leakage resulting from the withholding of Palestinian clearance revenues (see table 9).

The UNCTAD macroeconomic model is also used to assess the impact of the fiscal costs of occupation on the economy, employment and the unemployment rate, by simulating a fiscal sovereignty scenario, which assumes Palestinian sovereignty over financial resources and revenues without the restrictions of occupation. As under the no-leakage scenario, annual fiscal costs (real prices; base year 2015) are added to public revenues and public expenditures, so that the impact on the public deficit is neutral. Table 13 compares GDP and employment levels under

the baseline scenario – which reflects the reality in the period 2000–2017, including the fiscal leakage and losses of Palestinian public revenues – with the fiscal sovereignty scenario.

Table 13

Impact of fiscal costs of occupation on Palestinian gross domestic product and employment

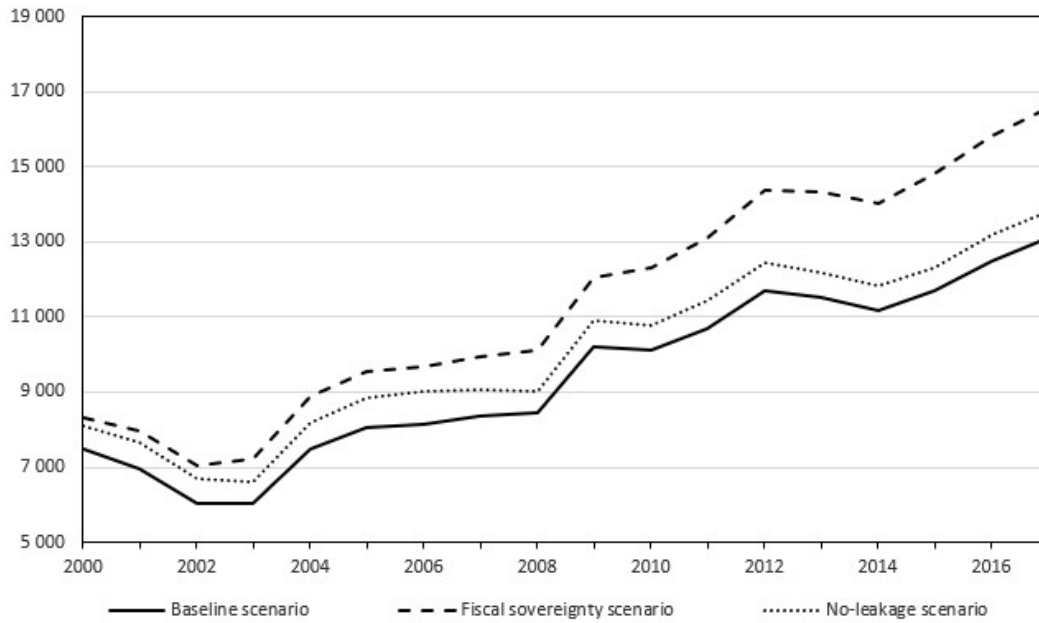
Year	GDP (Millions of dollars; base year 2015)				Employment (Number of jobs)			
	Baseline scenario	Fiscal sovereignty scenario	Difference	Difference (Percentage)	Baseline scenario	Fiscal sovereignty scenario	Difference	Difference (Percentage)
2000	7 466	8 326	859.7	11.5	510 638	521 746	11 108	2.2
2001	6 943	7 948	1 004.8	14.5	469 457	491 407	21 950	4.7
2002	6 017	7 023	1 005.8	16.7	483 205	517 955	34 749	7.2
2003	6 025	7 213	1 187.9	19.7	491 603	540 249	48 646	9.9
2004	7 492	8 878	1 385.9	18.5	526 646	586 871	60 225	11.4
2005	8 064	9 539	1 474.6	18.3	565 578	635 115	69 537	12.3
2006	8 149	9 690	1 541.1	18.9	582 071	661 108	79 037	13.6
2007	8 356	9 954	1 597.6	19.1	606 055	696 898	90 843	15.0
2008	8 455	10 097	1 642.3	19.4	628 102	726 402	98 300	15.7
2009	10 188	12 063	1 874.8	18.4	666 284	774 952	108 669	16.3
2010	10 133	12 309	2 175.9	21.5	726 929	851 181	124 252	17.1
2011	10 698	13 116	2 417.3	22.6	780 339	918 282	137 943	17.7
2012	11 706	14 396	2 689.9	23.0	831 168	985 427	154 258	18.6
2013	11 520	14 331	2 810.6	24.4	872 014	1 037 701	165 687	19.0
2014	11 172	14 029	2 857.1	25.6	901 064	1 077 508	176 444	19.6
2015	11 693	14 794	3 101.9	26.5	917 202	1 109 266	192 064	20.9
2016	12 500	15 831	3 331.0	26.6	952 678	1 159 457	206 779	21.7
2017	13 085	16 571	3 486.2	26.6	987 691	1 210 237	222 546	22.5
Total	169 662	206 107	36 444.4	21.5	12 498 725	14 501 761	2 003 035	16.0

Source: UNCTAD calculations.

Note: Annual fiscal leakage includes non-recurrent leakage resulting from the withholding of Palestinian clearance revenues (see table 9).

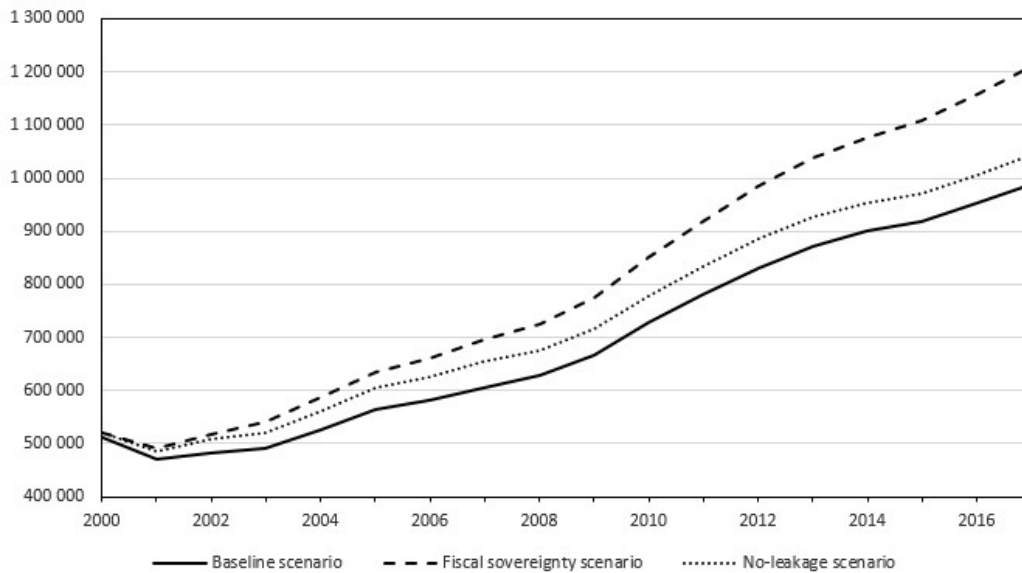
As shown in table 13, under the fiscal sovereignty scenario, the Palestinian GDP could have been 21.5 per cent higher than its levels in the baseline scenario in the simulation period. The potential cumulative increase in the Palestinian GDP is estimated at \$36.4 billion in the same period, equivalent to 266 per cent of Palestinian real GDP in 2017 (figure 2). Furthermore, employment could have been higher than under the baseline scenario by 16 per cent, equivalent to 111,000 additional jobs per year, or a total of 2 million jobs in the simulation period (figure 3). The overall unemployment rate could have been 9 per cent lower: 9.2 per cent lower among women and 8.9 per cent lower among men (figure 4).

Figure 2
Gross domestic product under three scenarios
(Millions of dollars)



Source: UNCTAD calculations.

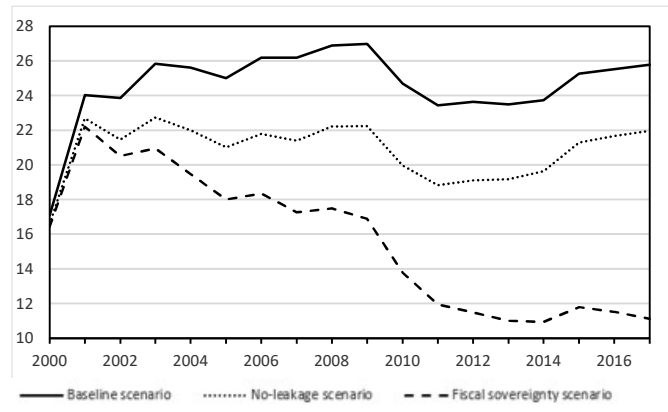
Figure 3
Potential employment under three scenarios
(Number of jobs)



Source: UNCTAD calculations.

Figure 4

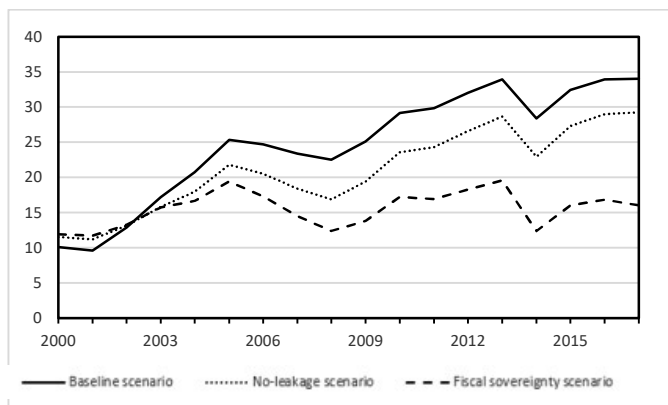
(a)
Unemployment rates under three scenarios
(Percentage)



(b)
Unemployment rates, men
(Percentage)



(c)
Unemployment rates, women
(Percentage)



Source: UNCTAD calculations.

VII. Conclusion and recommendations

The signing of the Paris Protocol inspired a new state of optimism about the Palestinian economy. Expectations relied, inter alia, on the positive indicators of improved control and monitoring of public revenues and the maintenance of sustainable sources thereof. All of that was built on the hopes that under the Paris Protocol, PNA would be able to benefit from reasonable policy space. However, over 25 years, this optimism has dissipated, leaving PNA constrained and tied to trade and fiscal policies that do not foster the growth or development of its economy. The Paris Protocol has fostered a reality that allows only minimum policy space, leading to an enduring loss of revenues and a lack of control over the largest portion of these resources and resulting in fiscal leakage and losses from many sources, in addition to the temporary or permanent seizure by Israel of Palestinian revenues, a stark violation of the terms of the Paris Protocol.

The analysis in this study highlights a number of enduring phenomena in the Palestinian context which have been exacerbated over the years, namely, the smuggling of goods from Israel to the Palestinian market, increased fiscal leakage resulting from indirect imports from Israel and the inability of PNA to control the undervaluation of imports and monitor the movement of imports from Israel or other parties because of full control by Israel over all borders and crossings. All of these have compounded the challenges faced by PNA in collecting tax revenues and controlling these sources and have resulted in significant revenue losses. This has, in turn, led to a chronic budget deficit and further minimized the fiscal and policy space available to PNA.

To cover the financing gap, Palestinian fiscal policies have become increasingly dependent on international aid, borrowing from local banks, accumulating public sector arrears and rationalizing expenditures. These policies have slowed down economic growth by reducing developmental expenditures to less than 3 per cent of total public expenditures. These conditions have left Palestinian economic policies weak and fragile. The most critically affected of these were fiscal policies, which are concerned with the provision of public services, stimulating aggregate demand and extending investment and development expenditures. However, fiscal policies have fallen short of assuming their role due to the loss of large portions of direct and indirect public revenues, as discussed in this study.

In short, the narrow policy space undermines the ability of PNA to adopt an effective fiscal policy. As such, there is a pressing need to introduce fundamental reforms to the current trade and taxation system under the Paris Protocol, which has been in place for a quarter of a century.²⁰ This also entails a fundamental change in the working mechanism at border crossings, import policies and import control mechanisms. A new trade arrangement should be put in place upon ending the work with the expired Protocol, which was supposed to prevail for an interim five-year period only.

A. Cumulative fiscal leakage and losses and their impact on growth and employment

Estimates of Palestinian fiscal losses that can be accounted for reached about \$1.7 billion in 2015 or 13.1 per cent of GDP, of which fiscal leakage accounted for \$473.4 million, or 3.7 per cent of GDP, and other fiscal losses accounted for \$1.2 billion, or 9.47 per cent of GDP.

²⁰ The Protocol effectively locked in, with some exceptions, the customs union imposed in 1967 upon occupation.

The study estimates the cumulative monetary value of the fiscal leakage in the period 2000–2017 at around \$5.6 billion, equivalent to 39 per cent of GDP in 2017. This could have increased total tax revenues by 17.6 per cent and reduced the current public deficit (on a cash basis) by 42 per cent in the 18-year period. If the cumulative interest calculated on the fiscal leakage in the same period is added, the monetary value of the cumulative leakage increases by \$1 billion to reach \$6.6 billion. This is equivalent to 46 per cent of GDP in 2017, or 4.4 of per cent of GDP in the 18-year period, a 20.7 per cent loss in public revenues, or 50 per cent of the current budget deficit (on a cash basis for the entire period).

However, the cumulative fiscal costs of the occupation (including leakage and other fiscal losses) in the same period is estimated at \$19.5 billion, equivalent to 150 per cent of GDP in 2017. The estimate of the total fiscal costs should also include the compounded interest that the Palestinian government has to pay on the money borrowed to fill the fiscal gap resulting from the loss of public revenues. The latter is estimated at \$28.2 billion. This raises the total monetary value of the fiscal costs of occupation, from the sources considered in this study, to \$47.7 billion in the period 2000–2017. This sum is more than three times the value of the Palestinian GDP in 2017.

The UNCTAD macroeconometric model of the Palestinian economy is used to simulate the economy under different scenarios, to assess economic performance under a scenario that assumes no fiscal leakage to the treasury of Israel and that the resources leaked were instead captured by the Palestinian treasury each year in the period 2000–2017. Under this scenario, GDP would have been 7.3 per cent higher in the period. The cumulative increase in GDP in the 18-year period would have reached \$12.5 billion (real 2015 prices), equivalent to 86 per cent of the value of the Palestinian GDP in 2017. Furthermore, on average, an additional 42,000 job opportunities would have been generated per year, an increase of 6.1 per cent in the period. The rate of unemployment would have been 4 per cent lower; 5 per cent lower among women and 4 per cent lower among men.

The UNCTAD model is also used to assess the performance of the Palestinian economy under a scenario that assumes no fiscal costs (neither leakage nor other fiscal losses) resulting from the Israeli occupation and assumes the sovereignty of the State of Palestine over its fiscal affairs. Under this scenario, GDP would have been 21.5 per cent higher in the period 2000–2017. The cumulative increase in GDP in the 18-year period would have reached \$36.4 billion (real 2015 prices), equivalent to 266 per cent of the value of the Palestinian GDP in 2017. Furthermore, on average, an additional 111,000 job opportunities would have been generated per year, a total of 2 million jobs in the 18-year period. The rate of unemployment would have been 9 per cent lower; 9.2 per cent lower among women and 8.9 per cent lower among men.

B. Recommendations

- Future Israeli–Palestinian negotiations should identify, address and rectify all outstanding issues regarding recurrent and accumulated fiscal dues to the Palestinian government. This also requires a new transparent arrangement for sharing information related to these dues, whether or not they have already been transferred to the Palestinian treasury.
- Handling fees should be renegotiated to change the fees to an ad valorem fee that takes into consideration the proportion of Palestinian imports to total Palestinian and Israeli

imports processed by the Israel customs authority, cancelling the handling fees on clearance revenues from imports from Israel, including on petroleum derivatives.

- The current paper-based clearing system for settling trading transactions between the Palestinian and Israeli markets should be upgraded to an interconnected automated system, allowing for the exchange of information in a fast, complete and accurate manner.
- The Israeli authorities should be urged to fully cooperate in the instantaneous sharing of records of imports from third countries to allow Palestinian authorities to take the necessary measures against smuggled goods and to combat tax evasion.
- The condition set by Israel related to the date of issuance of valid clearance bills, whereby a bill must be less than six months old to be cleared by Israel, should be cancelled.
- The biased treatment of Palestinian imports transiting via Israeli ports should be rectified and all non-tariff barriers should be lifted, in line with the commitments of Israel under the Agreement on Trade Facilitation of the World Trade Organization. This would foster direct importing, lower transaction and transit costs and reduce fiscal losses resulting from indirect imports.
- The presence of Palestinian customs officers should be allowed at border crossings to inspect and clear goods imported to the Occupied Palestinian Territory. As a temporary alternative, both parties should negotiate a mechanism for transporting and storing imported goods in Palestinian warehouses to ensure clearance by Palestinian customs. This would curb the phenomenon of undervaluation and thereby reduce fiscal leakage from this source.
- The Palestinian customs authority should be allowed to operate and monitor and inspect goods in Area C and thereby control smuggling from the Israeli market.
- A comprehensive training strategy should be devised for developing the tax and customs systems and deploying smart technologies in customs, tax, audit and risk management, as there is a pressing need to develop the capacities of the Palestinian customs authority, enhance skills and increase the number of personnel, in order to build the required capacity for a future sovereign Palestinian State.

Annex

Total value of smuggled goods without documents by commodity group, 2013–2017 (Dollars)

Commodity group	Value
Live animals	724 995
Alcohol	247 142
Animal feed	12 879 496
Cigarettes	3 040 071
Construction goods	37 960 809
Food products	4 325 638
Electricity	1 440 962
Fuels	1 854 768
Medicines	32 844
Medical supplies	1 204 178
Agriculture	14 990 935
Beauty products	867 511
Cleansing materials	382 441
Plastics	1 827 431
Containers	32 562
Carton	694 992
Cloth	2 086 460
Footwear	843 196
Glass	186 146
House appliances	46 070
Machinery	1 373 270
Electronics	931 917
Tyres	304 670
Cars	18 675 762
Spare parts	1 230 969
Miscellaneous tools	186 762
Heavy machinery	684 486
Furniture	493 039
Toys	171 209
Miscellaneous	309 199
Factory waste	658 022
Total	110 589 953

Source: UNCTAD calculations.

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