November 5, 1992

WHY ECONOMIC GROWTH IS CRITICAL TO ARAB-ISRAELI PEACE

INTRODUCTION

Lasting peace and stability in the Middle East require that Arabs and Israelis have a stake in a prosperous, economically interdependent region. For this reason the attention focused on economics by the multilateral Economic Development Working Group (EDWG) meeting in Paris, France, on October 29 and 30 is long overdue.[1] Despite an entire year of peace negotiations and high expectations, there has been little concrete progress. No doubt the road to peace will be long and difficult. But economic reform should not wait.

Israel's economy is struggling to absorb immigrants from the former Soviet Union and Ethiopia, requiring it to borrow billions of dollars with an American guarantee of repayment. The economies in the Israeli-occupied West Bank and Gaza Strip, as well as in neighboring Jordan, are in shambles. To lay the groundwork for a stable, long-term peace, as well as to address immediate problems, the United States should give high priority to encouraging growth-oriented, free market reforms throughout the region.

Economic factors fuel the Arab-Israeli conflict. Poverty in the West Bank and Gaza, especially in comparison to Israeli living standards, was a major reason for the outbreak of the Palestinian revolt against Israeli control, or "intifada," in 1987. This revolt has made matters much worse, however, and the economies in the West Bank and Gaza are now near collapse. Widespread unemployment also is contributing to the rise of militant, anti-Western Islamic fundamentalism in the West Bank, Gaza, and Jordan.

1 The EDWG is open to all the participants in the bilateral peace talks, such as Israel, the Palestinians, Jordan, Syria, and Lebanon, as well as other Arab and major industrial states, ranging from Egypt and Saudi Arabia to the U.S., France, Germany, and Japan. The last round met in Brussels in May 1992. Israel did not attend, however, because it refused to meet with Palestinians from Jerusalem, those living outside of the West Bank and Gaza, or those affiliated with the Palestine Liberation Organization.

The Israeli government for decades has overregulated and overtaxed its people, leading to a weak, slow-growing economy. Israeli leaders have been reluctant to cut wasteful government spending, sell off government enterprises, and remove government red tape and restrictions from entrepreneurs. As a result, Israel is heavily dependent on foreign aid to remain afloat. The sluggish Israeli economy further exacerbates Palestinian unemployment, since 40 percent of the Palestinian labor force typically seeks work in Israel but increasingly finds fewer jobs and lower wages.

Jordan's economy is in desperate shape. The Iraqi invasion of Kuwait, the 1990 United Nations embargo against Iraq, and the 1991 Gulf War forced hundreds of thousands of workers in the Gulf countries to flee to Jordan, straining an already impoverished economy. Saudi Arabia and the U.S. then cut off foreign aid to Jordan in response to King Hussein's sympathy for Iraq, adding to the country's economic woes.

Compounding all this is the 46-year-long Arab boycott against Israel that denies Israeli, Palestinian, and Jordanian businessmen access to neighboring markets and drives away foreign investors.

Economic growth cannot solve the Arab-Israeli conflict. It is a necessary but not a sufficient requirement for peace. But stronger economies can strengthen pro-Western political moderates and increase the confidence of regional leaders to take the risks necessary to achieve peace.[2]

The United States, therefore, should promote a policy of "Economic Growth for Peace," making economic reform a top priority in both the multilateral and bilateral Middle East peace talks. Specifically it should:

✔ **Urge the Arab countries to end their economic boycott against Israel.** Israelis, Palestinians, and other Arabs all suffer because of this boycott. It should be ended immediately.

✔ **Revitalize the U.S.-Israel Joint Economic Development Group (JEDG) to encourage Israel to press forward with comprehensive free market reforms.** Established in 1984, this group helped Israel control hyperinflation. Since 1990, however, it has been dormant. It should be revived to help Israel make the reforms needed to create a growing economy.

✔ **Urge the Israelis and Palestinians to deal immediately with the problem of Palestinian violence against other Palestinians.** Violent gangs of nationalists and Islamic fundamentalists have killed hundreds in the West Bank and Gaza. Until order and calm are established, Israel cannot be expected to withdraw from these territories, and strong economic growth will be impossible.

2 Egypt is also in desperate need of economic reform to create jobs for a rapidly growing population, strengthen moderate pro-Western forces within the country, and counter the growing Islamic fundamentalist movement which opposes peace with Israel and strong ties to the West. See James A. Phillips, "Options for the U.S. As Egypt's Time of Reckoning Nears," Heritage Foundation *Backgrounder* No. 546, November 10, 1986.

- ✔ **Urge the Israeli, Palestinian, and Jordanian delegations to establish a trilateral Economic Development Working Group.** Progress is much more likely in direct talks between the parties who have the most to gain than in the multilateral talks where many political and economic interests compete for attention. This trilateral working group should assemble economic data on the territories, discuss Palestinian economic policy and trade relations for the interim period of autonomy, and explore ways to boost tourism.

- ✔ **Establish a U.S.-Jordan Joint Economic Development Group (JEDG).** Jordan must take quick action to revive its crippled economy. U.S. officials and private free market economic development experts should help Jordan liberalize its economy and develop export industries, just as they help Israel.

- ✔ **Review all U.S. non-military assistance to Middle East countries with a long-term view to phasing it out.** Foreign aid is in part responsible for the region's economic problems. To make certain that such aid does not block economic reform, and to give Middle East countries an incentive to move quickly with economic reforms, the U.S. should begin planning a phase-out of aid.

THE WEST BANK AND GAZA: REVOLT AGAINST POVERTY

Peace talks between Israel, the Palestinians, Jordan, Lebanon, and Syria commenced on October 30, 1991, under the sponsorship of the U.S. So far there has been little concrete progress and continuing negotiations no doubt will be long and difficult. These talks have many aims. Among them: satisfying the desires of the Palestinian people for self-government, of Israel for secure and recognized national borders, and of Jordan for regional stability and a settlement of the Palestinian problem.

But no matter what the outcome of these negotiations, economic opportunity and interdependence will be key elements to a lasting regional peace. The opening of Economic Development Working Group talks in Paris on October 29 and 30, which included the parties to the peace negotiations, a number of Middle East countries, and various industrialized countries, focused attention on the need for an economic transformation in the Middle East.

The current round of peace and economic talks occurs amidst a four-year-long Palestinian revolt, or intifada, in the West Bank and Gaza that began in December 1987. Despite Palestinian calls for statehood, however, the intifada was not entirely politically motivated. The Arab-Israeli conflict is exacerbated by urban poverty. Just weeks after the outbreak of the intifada, Rashad al-Shawa, the Palestinian mayor of Gaza City, told an Israeli newspaper:

> People in the Gaza Strip have a sense of injustice and deprivation, they feel they have nothing to lose. They work for you as garbage men and dishwashers, and they feel like slaves....The latest wave of riots is only one more expression of the people's despair and frustration. The present wave... is a spontaneous expression of popular rage, which begins with a small pupil in elementary school and concludes with the worker who returns every day from Israel, sees the good life there, but is forced to live here in subhuman conditions.

Israeli economic analyst Daniel Doron, Director of the Israel Center for Social and Economic Progress, agrees that a lack of economic opportunity is a cause of the intifada. "Arabs of all walks of life are sending a message that everyone is ignoring," writes Doron. "A major reason for their growing frustration—surely not the most important, but important enough that they keep repeating it—is the repressive economic regime Israel has imposed upon them."[3]

The Palestinians in the West Bank and Gaza are no strangers to poverty. Egypt did little to improve Gaza's economy when it ruled the area between 1948 and 1967. Annual per capita income during that period was less than $500, measured in 1990 dollars.[4] Similarly, when Jordan controlled the West Bank, businessmen and skilled workers emigrated in droves in search of jobs since the annual per capita income was only $809, measured in 1990 dollars. In fact, the term "Green Line," which is used to describe the border between pre-1967 Israel and the territories, refers to the fact that from an airplane, Israel, which placed a high priority on agricultural development, could be distinguished easily from the West Bank and Gaza, which were virtual deserts.[5]

Growing, Interdependent Economies. Under Israeli occupation beginning in June 1967, the Palestinian economy improved steadily. By 1987 Gazan per capita income had risen to $1,648, measured in constant 1990 dollars. In the West Bank, per capita income reached $2,379. The number of telephone subscribers in the territories multiplied six-fold and the number of tractors increased nine-fold.[6]

Further, since the beginning of the occupation, the economies of Israel, the West Bank, and Gaza have become interdependent. By 1987, for example, nearly 40 percent of the Palestinian labor force was employed within Israel. More than 90 percent of Gaza's imports and 88 percent of the West Bank's imports came from Israel. Likewise, 85 percent of Gaza's exports and 65 percent of the West Bank's exports went to Israel.

However, Palestinian children born since 1967—more than 60 percent of the population of the territories—do not compare their lives with those of their parents under Arab rule. Young Palestinians compare themselves with Israelis. By that standard, the economic reality in the West Bank and Gaza remains dismal. Arab wages are seldom more than one-third of those in Israel for similar work. Furthermore, 36 percent of the Gazan population live three or more to a room compared to less than one percent of Jews in Israel.[7]

3 See Daniel Doron, "The Profits of Peace," *The New Republic*, May 30, 1988, pp. 22-24. Later analyses picked up the economic trail. See Brigadier General Aryeh Shalev, *The Intifada: Causes and Effects* (Tel Aviv: Jaffee Center for Strategic Studies, 1991); and "The Enraged Proletariat" in Ze'ev Schiff and Ehud Ya'ari, *Intifada: Israel's Third Front* (New York: Simon & Schuster, 1987), pp. 79-100.

4 Patrick Clawson and Howard Rosen, *The Economic Consequences of Peace for Israel, The Palestinians and Jordan* (Washington, D.C.: Washington Institute for Near East Policy, 1991), Table 2.

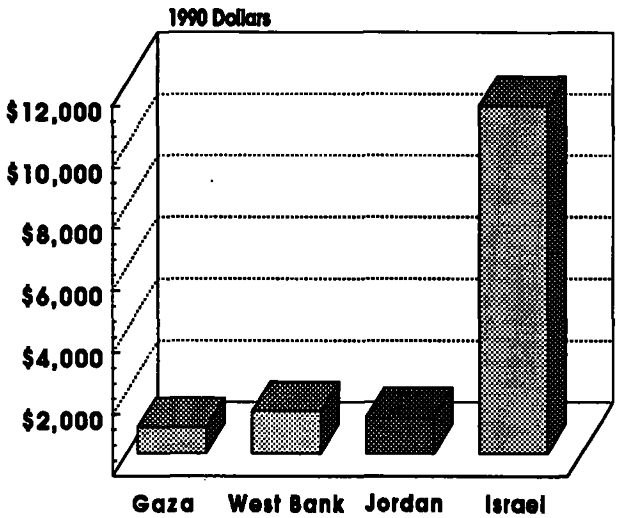
5 See Tom Bethell's interview with Daniel Doron, director of the Israel Center for Social and Economic Progress, "On the Road To Jerusalem," *The American Spectator*, May 1990, p. 11.

6 Schiff and Ya'ari, *op. cit.*, p. 84.

7 *Israeli Statistical Abstract*, No. 42 (1991), Israel Central Bureau of Statistics (Jerusalem), pp. 302 and 722.

Denying Economic Opportunity. The frustration and poverty suffered by the Palestinians in the West Bank and Gaza are caused in part by Israeli economic policies. For both agriculture and industry, Israel has built a tax and regulatory regime in the territories to discourage Palestinian self-sufficiency and competition with Israeli goods and services. Since 1967, the Israeli military has issued more than 1,500 regulations covering the entire spectrum of Palestinian economic activity. Many have nothing to do with security concerns. Order 1015, for example, required Palestinians to obtain the military's permission to possess fruit trees or seedlings other than those needed for personal consumption. An appendix later limited the order to grapes and plums, but Order 1039 extended the list to include eggplants and tomatoes in the Jericho region.[8]

1991 Per Capita GNP Comparison: Israel Dominates its Neighbors



Note: Data for West Bank and Gaza are estimates. Accurate data are unavailable.
Sources: Embassy of Israel, Jordan Information Bureau, World Bank.
Heritage DataChart

The Israeli government also overregulates its own citizens and denies them full economic freedom. Agricultural regulations, for example, fill an 833-page book of two columns per page. Many Israelis, however, are able to secure from their government special privileges or exemptions. Palestinians, by contrast, have no political mechanism to work for economic change. This adds to their frustration. "Mostly unorganized laborers and small entrepreneurs, Palestinians lack the defenses Israelis have evolved to protect themselves from the system: an old boys' network, membership in organizations that solicit tax exemptions, and privileges of all sorts," notes Daniel Doron. "Thus, Israel's onerous economic system further inflames the Arabs' radical nationalism and xenophobia just as political manipulation of the economy radicalizes less advantaged Jewish groups...and incites violent labor strife among even patriotic citizens such as El Al workers."[9]

Going From Bad to Worse. Since the outbreak of the 1987 Palestinian intifada, the economic situation has gone from bad to worse. Unemployment in the West Bank is at least 25 percent. In Gaza it is nearly 50 percent. Palestinian per capita income in Gaza

8 For a detailed description of Israeli control of Palestinian agriculture, see Richard Drury and Robert Winn, *Plowshares and Swords: The Economics of Occupation* (Boston: Beacon Press, 1992).

9 Doron, *op. cit.*, pp. 22-24.

has fallen from $1,648 to about $850. Per capita income in the West Bank dropped from $2,379 to about $1,400. By contrast, Israel's per capita income was $11,276 in 1991. The frustration among Palestinians due to the failure of the intifada to evict Israel from the West Bank and Gaza, therefore, is intensified by their desparate economic conditions.

ECONOMIC CONDITIONS IN ISRAEL

While Israel's economy is very strong in comparison to its neighbors', historically it has been dominated by state direction and control. Over the past two decades it has experienced serious problems. Between 1950 and 1973, Israel's average per capita income grew by 5.6 percent per year. Since then it has averaged less than one percent annual growth, and in 1990 actually declined.

The reason for this poor performance is that Israel's economy is severely harmed by excessive government control.[10] For example, Israel's top marginal tax rate on monthly income of over $3,000 is 50 percent. This makes it very difficult for Israeli entrepreneurs to accumulate capital and launch new businesses. Red tape further constrains entrepreneurs. Between 1985 and 1989, for example, only 50 percent of the applications for new investment projects processed by the Israeli Investment Center were approved, according to Meir Eldar, a policy analyst at Israel's Institute for Advanced Strategic and Political Studies. Furthermore, Eldar estimates that an entrepreneur may pay consultants, accountants, and lawyers for as much as 500 working days of advice to navigate through the labyrinth of Israeli bureaucracy to obtain final approval for an investment project. This can cost between $250 and $1,000 a day.[11]

Few Jobs for Immigrants. The results of the Israeli government's mismanagement of the economy has been a woeful inability to successfully employ masses of Soviet and Ethiopian Jews. Unemployment is nearly 11 percent nationally and 40 percent among Soviet Jews. In the highly regulated, highly taxed Israeli economy, Soviet immigrants have fewer employment opportunities and thus must take the lowest paying jobs. Soviet Jewish engineers and doctors, therefore, sweep streets and musicians work as janitors.

Israel's stagnant economy exacerbates the economic problems of the West Bank and Gaza, with which it is closely tied. This is primarily because the 40 percent of Palestinians from the occupied territories that typically work in Israel see their jobs threatened or eliminated by Israel's poor economic condition. Further, competition for low paying jobs from Jewish immigrants makes work in Israel even more difficult for Palestinians to find.

10 See Joel C. Rosenberg "Land of Promise: Restoring Israel's Economic Miracle," *Policy Review*, Fall 1991, pp. 60-65.

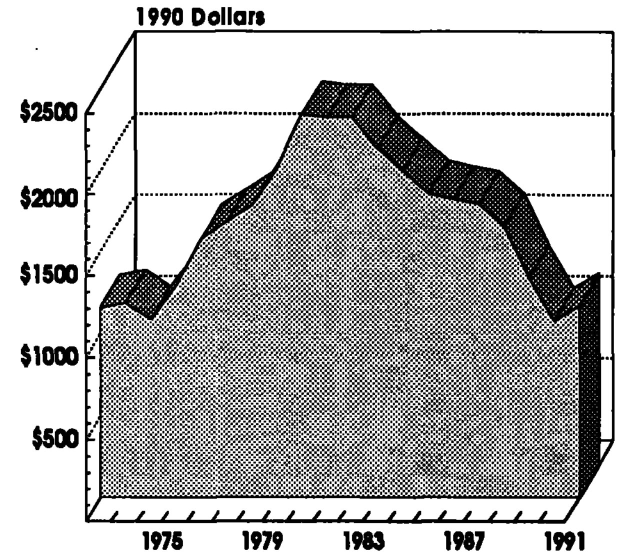
11 See Meir Eldar, "Toward Growth and Independence: Establishment of Free Export Processing Zones in Israel," Institute for Advanced Strategic and Political Studies (Jerusalem), February 1992, p. 11.

ECONOMIC CONDITIONS IN JORDAN

Jordan's economy is centralized and extremely inefficient. The government employs over one-third of the labor force and accounts for over 65 percent of the country's $2.8 billion GNP. Transfer payments are almost 30 percent of the national budget and, of course, military expenditures are enormous—over 20 percent of the budget. The Jordanian government completely owns or controls the majority shares in key sectors of the economy such as Royal Jordanian Airlines, and the phosphate, potash, cement, and fertilizer industries. Water, food, electricity, and gas are subsidized, though a restructuring program by the International Monetary Fund (IMF) is working with Jordan to eliminate subsidies as well as reduce the government budget and deficit and privatize the airlines.

Per Capita GNP in Jordan: 1972-1991

Living Standards Have Been Halved in Last Decade



Source: The World Bank. Heritage DataChart

Jordan's economy is also extremely vulnerable because it is so closely tied to the economy of the Persian Gulf states. Falling oil prices in the 1980s caused a steady decline in Jordan's income because workers in the Gulf states sent less money back home and oil-exporting countries reduced their aid to Jordan. Per capita income, for example, declined from $2,329 in 1982 to $1,657 in 1988.[12] The war against Iraq then cost Jordan an estimated $1.8 billion in lost trade with Iraq, Kuwait, and other Gulf states. The war also flooded Jordan with more than 300,000 Palestinians fleeing the Gulf. Furthermore, Saudi Arabia cut off $360 million in aid and the U.S. cut off $35 million in aid to Jordan in retaliation for King Hussein's tilt toward Saddam Hussein. These factors drove unemployment to 25 percent, inflation to 14 percent, and Jordan's foreign debt to more than $8.5 billion. Per capita income in 1991 was only $1,172.

12 The World Bank, *World Tables: 1989-1990 Edition*, p. 333, converted to constant 1990 American dollars using the U.S. consumer price index.

This year, Jordan's economy has improved. The reason: Palestinians from the Gulf, now convinced they have nowhere else to go, have transferred $1.4 billion in savings to Jordanian banks. This has financed a housing boom and the creation of many small businesses. Unemployment has dropped to around 18 percent today, inflation is down to just 5 percent, and Jordan's GNP is expected to grow 7.5 percent by year's end. This boom, however, is not expected to last. Further, prospects for long-term Jordanian growth are hampered by a huge foreign debt—despite several major reschedulings by international banks and foreign governments.

BOYCOTTING PROSPERITY

All of the countries of the Middle East have been harmed by the economic boycott maintained for the past four decades by Arab countries against Israel. In 1946, Arab states began a "primary" boycott against direct trade with Jews in what was then British-ruled Palestine. This was expanded in 1951 to include a "secondary" boycott against any company worldwide conducting business with Israel, and a "tertiary" boycott against companies doing business with other companies doing business with Israel.

The Arab boycott has been harmful to both Jews and Arabs. According to the Federation of Israeli Chambers of Commerce, it has cost Israel an estimated $45 billion in lost trade and investment over the last four decades. It also prevents Jordan from tapping the Palestinian and Israeli markets of more than 6.8 million people — over two times Jordan's population. The boycott also harms Palestinians. "Neighboring Arab countries are logical markets for the products of the West Bank and Gaza," according to Fuad Sahouri, chairman of the Arab American Business and Professional Association. "Unfortunately, the political ramifications of the Arab economic boycott against Israel has, for the most part, prevented Palestinian manufacturers from exporting to the Arab world."[13]

RADICALISM: CONSEQUENCE AND CAUSE OF ARAB POVERTY

The poor economic conditions, lack of opportunities for individuals to prosper through their own work, and the high costs of the Arab boycott have contributed to another problem that threatens Middle East peace and American national security: Islamic fundamentalism.

Increasingly, Islamic fundamentalist groups in Jordan, the West Bank, and Gaza such as the Muslim Brotherhood, Hamas (Islamic Resistance Movement) and Islamic Jihad—groups funded by Iran and Saudi Arabia—exploit severe poverty and despair to build their membership and radicalize the uncommitted. According to Robert Satloff, Deputy Director of the Washington Institute for Near East Policy: "Islamic groups have been the prime beneficiaries of the anger and frustration of even highly ed-

13 Interview with author, September 1992.

ucated Jordanians, whose expectations of rising social and economic status are left unfulfilled in today's climate of austerity, recession and mass unemployment."[14]

Islamic fundamentalists have gained power in Jordan. Their opportunity for political victory was set up in the winter of 1989 when the IMF insisted that as part of an emergency restructuring program, Jordan cut military expenditures and raise the price of items ranging from gasoline to cigarettes by removing subsidies. By April 1989, Jordan's southern cities erupted in riots against the resulting high prices and economic hardship caused by the IMF austerity program, and the Jordanian government's overall mismanagement of the economy. By November 1989, in Jordan's first open parliamentary elections in 22 years, the Muslim Brotherhood—Islamic fundamentalists who staunchly oppose any negotiation with Israel—won a stunning twenty of the eighty seats in the Jordanian Parliament.[15] Today it holds 22 seats while six other seats are held by independent, non-Brotherhood Islamic fundamentalist legislators. Their slogan: "Islam is the solution."

Islamic fundamentalists are a threat to Middle East peace first because of their utter rejection of Israel's right to exist. Further, their particular hatred of the United States causes them to oppose the U.S. playing a leading political role in the region. Whether in Jordan, the West Bank and Gaza, or elsewhere in the Middle East, Islamic fundamentalist objectives—including a penal code based on the Koran, second-class citizenship for all non-Muslims, warfare against non-Muslims only, and an ultimate union of all Muslims living in peace under one ruler—are not conducive to pluralism, free markets, and regional peace.[16]

Feeding on Poverty. Islamic fundamentalism is feeding on the poverty and despair in the West Bank and Gaza. Gazans, far poorer than West Bank Palestinians, are also more attracted to radical religious doctrines. Residents of refugee camps, where the worst economic conditions prevail, are attracted in still greater numbers to these doctrines than are more prosperous business owners and merchants. Furthermore, Palestinian youth and the college-educated are at the center of the Islamic revival, in part because they see for themselves a bleak economic future, a trend found in other Arab countries that are also seeing a surge in Islamic fundamentalism. Only one in eight Palestinian college graduates, for example, finds work in his profession in the West Bank and Gaza.[17]

The radical Hamas and Islamic Jihad factions are now bitterly fighting the PLO for political and economic control of the territories and are winning power. Hamas members, for example, won decisively the elections for the Hebron and Ramallah Chambers of Commerce.[18] In 1989, Hamas was said to control more than 40 percent of all

14 See Robert Satloff, "They Cannot Stop Our Tongues: Islamic Activism in Jordan," *Policy Papers Number Five*, Washington Institute for Near East Policy, 1986, p. v.

15 See Robert Satloff, "Jordan Looks Inward," *Current History*, February 1990.

16 See Daniel Pipes, "Fundamentalist Muslims and U.S. Policy," Heritage Foundation *International Briefing*, August 10, 1984, p. 6.

17 Schiff and Ya'ari, *op. cit.*, p. 91.

18 See Pinhas Inbari, "Hamas Seen Supplanting PLO in Territories," *Al Hamishmar*, March 11, 1992, translated in *Foreign Broadcast Information Service—Near East and South Asia*, March 12, 1992; and Khaled Abu Toamah,

Gazan mosques. This number has surely grown and the total number of mosques in Gaza has grown 140 percent since 1967.[19]

Islamic fundamentalism and radical Palestinian nationalism not only feed on economic hardship, however, they help create it. Followers of these two movements call for the elimination of Israel. They also call for the deaths of those who stand in their way. In the West Bank and Gaza at least 723 Palestinians were killed by other Palestinians between December 1987 and August 1992—an average of more than a dozen per month. Thus, when Arab-on-Arab violence is added to denials of economic freedom by the Israeli government, the conditions for economic growth in the West Bank and Gaza are even weaker.

PREREQUISITE FOR ECONOMIC GROWTH: THE RULE OF LAW

The Palestinian-Israeli peace process faces a dilemma. On the one hand, economic growth and prosperity in the West Bank and Gaza would help mitigate the violence, foster economic interdependence, and facilitate a peaceful resolution. On the other hand, economic growth requires order and calm.

Whether in the inner cities of America or the West Bank and Gaza, order and daily calm, the "rule of law," is a prerequisite to economic freedom. But factional or gang violence has plagued the occupied territories. Furthermore, arbitrary and unjustified acts of violence by Israeli authorities against Palestinians contribute to a vicious circle of retaliation. The lack of law and order makes peaceful coexistence impossible. The "rule of law" in this context does not necessarily mean that Israeli law and Israeli law enforcers—the military—must be in control of the Palestinians. It does mean that protection of life, liberty, and property must be fundamental elements of how the territories are administered.

Whatever arrangement is finally agreed upon as a result of the peace talks, whether some form of autonomy or an independent Palestinian state, control of domestic violence in the West Bank and Gaza will be a prerequisite. Best would be for Palestinians themselves to control the Arab-on-Arab violence. Bethlehem's mayor Elias Freij, for example, told Israeli radio in August that:

> We cannot allow the creation of a vacuum [between a withdrawal of Israeli forces and the creation of a Palestinian police force]. So, I think the first item on the agenda—my advice to our delegation—is now to talk with Israel and reach an agreement about the formation of a strong, well-trained, well-disciplined Palestinian police force, so when the moment comes for the Israelis to withdraw, our police force will be ready.[20]

"The Uncharted Terrain of Palestinian Politics," *The Jerusalem Report*, June 4, 1992, pp. 30-32.

19 For an excellent analysis, including detailed examinations of Islamic Jihad—"the most radical, violent, and innovative of the Islamic organizations" in the territories—and Hamas—a "wing of the Muslim Brotherhood"—see Robert Satloff's "Islam in the Uprising," *Orbis*, Summer 1989. See also Schiff's and Ya'ari's chapter on "The Islamic Resistance Movement," *op. cit.*, pp. 220-239.

20 Jerusalem's Kol Israel radio, August 29, 1992, translated in *Foreign Broadcast Information Service—Near East and South Asia*, September 1, 1992.

SMALL BUSINESS: THE KEY TO JOB CREATION AND ECONOMIC GROWTH

As Israeli, Palestinian, and Jordanian policy makers seek ways of improving their own economies, and as the U.S. considers ways to promote economic development in that region, they should recognize that small businesses usually account for most of the job creation in any country and thus are the engines of economic growth. Small businesses are run by entrepreneurs willing to take risks. These businesses can adapt more quickly than large firms to changes in the market and so find profitable niches. Small businesses usually have lower startup and overhead costs than do larger enterprises. They can often be started in a home or garage. Thus small businesses are especially important to countries that have problems attracting foreign investment.

The proportion of small business in Israel, however, is much smaller than in the U.S. Only 42 percent of the Israeli labor force is employed by firms with less than 100 people, compared to 57 percent of the U.S. labor force.[21] This is in large part because Israel's government favors big business with huge subsidies and tax incentives. In addition, high taxes and intrusive government regulations fall especially hard on small enterprises. Yet despite these and many other advantages given to large manufacturing firms and military industries, many are inefficient money-losers and currently are downsizing and laying off workers.

The region's economic future probably does not lie in luring Honda to Haifa or Westinghouse to the West Bank. Risk-averse corporations are unlikely to invest large sums of money in the area until peace has been established and proved to be durable. Rather, the region's economic future lies in creating conditions that allow entrepreneurs and small businesses to flourish. This means creating a clear and orderly legal system that protects private property rights and enforces contracts. It means removing entry barriers such as high taxes and excessive regulations. It also means creating institutions that extend credit and allow people to accumulate and invest capital.[22]

Enormous Informal Sector. Given such conditions, the prospects for a dramatic increase in small business creation in the region are very good. Israelis have a strong entrepreneurial tradition. They have, for example, circumvented tax and regulatory obstacles and created an enormous informal sector. The underground economy is variously estimated at somewhere between 15 percent and 30 percent of Israel's GNP.

Palestinians are also very entrepreneurial. The number of Arab businesses in the Israeli-occupied territories has doubled since 1983 virtually without Israeli government assistance. Israeli government barriers, however, prevent their growth. In the West Bank and Gaza, 93 percent of all industrial firms employ fewer than ten workers. The average enterprise has four workers. The Center for Jewish-Arab Economic Development estimates there is $50 million in private Palestinian capital hidden away or depos-

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21 See Israel's *Statistical Abstract*, 1991, p. 422, and the U.S. *Statistical Abstract*, 1991, p. 532. See also Ziv Hellman, "Small Businessmen Losing Ground in Israel," *Jerusalem Post - International Edition*, September 15, 1990, p. 21.

22 For more, see David L. Birch, *Job Creation in America: How Our Smallest Companies Put the Most People to Work* (New York: The Free Press, 1987).

ited overseas that could be invested in Arab businesses were the conditions for risk-taking and investment improved dramatically.[23]

Outside the West Bank and Gaza, many Palestinian entrepreneurs are also quite successful. "Scattered from Amman to Atlanta, they form a global community of wealth and power united by a single cause. They are Palestinian entrepreneurs and...they favor prosperity over military power," began a 1989 *Fortune* magazine profile of some of the world's wealthiest Palestinians. These entrepreneurs include the president of the largest private bank in the Arab world, owners of the Middle East's leading private international construction company, and an American real estate developer who owns the Ritz-Carlton hotels in New York City and Washington, D.C.[24]

"An economic development strategy for the occupied territories must be built on the intangible quality of entrepreneurship and root itself in people prepared to incur the risks required to achieve an economic objective," writes Harold Dick, a specialist on the Palestinian economy. He warns, however, that foreign aid can be harmful to the Palestinians. "Money is a particularly blunt instrument and can be detrimental to the entrepreneurial process. Authentic economic development will function through credit and joint venture schemes, accompanied by technical support."[25]

THE FOREIGN AID DILEMMA[26]

Calls for economic reform in other countries inevitably lead to calls for foreign aid as a means to such reforms. Israel and Egypt already are the two largest recipients of U.S. aid. Relief organizations in the West Bank and Gaza also receive U.S. aid, though in much smaller amounts. U.S. aid to Jordan was cut off in 1991 as a result of King Hussein's tilt toward Saddam Hussein during the Persian Gulf War. As economic reform talks proceed, and as a Middle East peace agreement is formulated, no doubt the participants will call for massive new aid and the U.S. might be tempted to "purchase" economic reform and peace. The consequences of agreeing to such handouts, however, must be seriously considered.

U.S. aid has done little to help any country in the world abandon destructive economic policies for free markets. In fact, foreign aid, by covering the costs of unsound economic policies, often slows economic reform. In the 1980s, for example, the U.S., with its allies, funneled billions of dollars through the International Monetary Fund and World Bank to debtor countries, especially Argentina, Brazil, and Mexico. These countries promised economic reforms in exchange for funds but substantial reforms did not materialize. It was only in the late 1980s, when the U.S. made clear to the governments of these countries that massive new aid would not be forthcoming, that re-

23 See Sue Fishkoff, "The Delicate Business of Coexistence," *Jerusalem Post - International Edition*, July 18, 1992, p. 10.

24 Shawn Tully, "The Big Moneymen of Palestine, Inc.," *Fortune*, July 31, 1989, pp. 176-186.

25 Harold Dick, "Toward a Strategy for Development: Empowerment and Entrepreneurship," in George T. Abed, ed. *The Palestinian Economy: Studies in Development Under Prolonged Occupation* New York: Routledge Press, 1988), pp. 311-327.

26 Edward L. Hudgins, Director of the Center for International Economic Growth, helped prepare this section.

formers in these countries were able successfully to promote radical, free market reforms.

	Population	U.S. Aid
1992 U.S. Foreign Economic Assistance		
Egypt	58 million	$815 million
Gaza Strip	645,000	$16.7 million*
Israel	5.1 million	$1.2 billion
Jordan	3.3 million	$ 0**
West Bank	1.1 million	combined with Gaza *

*The $16.7 million is distributed among relief organizations that operate in both the Gaza Strip and the West Bank.

**Jordan received $35 million in 1990. Congress cut off aid in 1991 due to Jordan's tilt toward Saddam Hussein during the Gulf War.

Sources: Population figures: Embassies of Egypt, Israel, and Jordan.
Aid figures: U.S. Agency for International Development.

Certainly, U.S. military aid —$1.8 billion annually— has helped Israel survive in the face of forty years of hostilities from her neighbors. Israel has also proved a faithful friend in a troubled and turbulent region. Israel provided a check on Soviet-backed aggression in the region and continues to provide the U.S. valuable intelligence, docking rights, and prepositioning sites for U.S. military equipment and supplies.

U.S. economic aid to Israel—$1.2 billion annually—however, also has been a classic case of how foreign assistance can slow economic reform. As long as U.S. aid covers the costs of Israel's economic mistakes, Israel has little incentive to change its policies. Despite billions of dollars in U.S. economic aid to Israel over the past two decades, Israel's economy has fluctuated between weak growth and recession. Israel's governments over those years were slow even to consider selling off government enterprises or reducing regulations on businesses. Public sector payrolls remain bloated and taxes high.

The U.S. government recently agreed to provide guarantees for $10 billion in loans to be sought by the Israeli government. These further reduce incentives for Israel to eliminate wasteful spending from the country's budget.[27] The government now is able to continue its wasteful ways and borrow to cover its cost. This will mean even greater Israeli government debt in the future. In case of default, the U.S. taxpayer will have to foot the bill.

Some of its advocates maintain that foreign economic assistance to Israel and Egypt aims both at helping local economies and promoting regional political stability. They maintain that the Egyptian government would not have been able to accept the Camp David peace accords without U.S. funds. American aid allowed the Egyptian government to spend more on public works projects, subsidies, and other handouts to "buy" domestic peace and to blunt domestic critics of the accords. But while aid might have bought short-term peace, it has done long-term economic harm to Egypt. Rather than

27 See Edward L. Hudgins and Joel C. Rosenberg, "Economic Reform, Not Loan Guarantees: Israel's Only Path to Prosperity," Heritage Foundation *Backgrounder* No. 881, February 13, 1992.

use foreign assistance to cover the costs of a transition to the free market, Egypt used aid as a narcotic to avoid dealing with the economy's real illness.[28] This meant that in the long term the economy grew worse. This has opened the way for Islamic fundamentalists to capitalize on the government's economic failures. By seriously harming Egypt's or any other country's economy, therefore, aid can actually undermine long-term political stability.

Jordan may well be the next "obvious" candidate for massive new U.S. foreign aid handouts. King Hussein likely will want to be able to pump money into the economy to head off criticism of a peace accord with Israel. But this approach is fraught with danger. Jordan's perilous economic situation is due in part to its dependence on aid from Saudi Arabia, other Gulf countries, and the U.S., which was cut off during the showdown with Saddam Hussein. Jordan no longer can afford to be dependant on foreign aid. It thus has a strong incentive to begin now to develop a free market economy and begin trading with Israel, Europe, and the West.

CHANGING ATTITUDES TOWARDS ECONOMIC GROWTH

A growing number of Palestinian leaders appear to favor economic cooperation with Israel. Palestinian activist Sari Nusseibeh calls for "a new integrated economic order in the region based on open borders and cooperation." Bethlehem's Palestinian mayor Elias Freij says he would like to see Israel, Jordan, and the Palestinians form a "Benelux" trade area modelled after Belgium, the Netherlands, and Luxembourg. "I think we need each other economically and politically," says Freij.

Jordan Aims for Peace and Prosperity. Jordanian leaders say improving their country's depressed economy is a major reason they are participating in the peace process. At the opening of the October 1991 Middle East peace talks in Madrid, Jordanian Foreign Minister Kamil Abu Jaber declared that his country seeks a "peace that will focus on region-wide issues such as...the economic balance among the peoples of the area through joint development programs." There is also an emerging realization among Jordan's leadership that peace with Israel, economic liberalization, and growing export opportunities are the keys to Jordan's future. In an October 1991 speech to the national parliament, Jordan's King Hussein stressed that in the post-Cold War era "competition will essentially be economic and scientific...not military." Says a senior Jordanian official: "I would like to see Jordan become the Japan of the Middle East," concentrating on developing a viable export industry aimed at the West. That, by necessity, means making peace with Israel. Remarks one Jordanian diplomat, "Israel is Jordan's window to the world."[29]

Talking to Capitalists, Not Stone Throwers. Israeli leaders across that country's political spectrum increasingly place importance on economic development in the territories. "We understand very well that to be an island of prosperity in an ocean of poverty will be a mistake," said Israeli Foreign Minister Shimon Peres of the Labor Party

28 Phillips, *op. cit.*

29 Personal interviews with the author. Officials asked not to be identified.

in a September 1992 speech. Peres also told the *Wall Street Journal* that "if we can create an economic dynamism that constantly improves the standard of living in the region, it will give the impetus to the political process as well."[30] Many Likud Party leaders agree. "I think we've seen in the last four decades that the better off people are economically, the easier they are to deal with politically," says Moshe Arens, Likud's Defense Minister in the previous Israeli government. "We'd like to have capitalists talking to us from Gaza. It's much easier than talking to stone throwers," he adds. In 1991, following recommendations of Ezra Sadan, Israel's former Director General of the Ministry of Agriculture who directed a government study of economic conditions in the territories, Arens began to take small steps to reduce taxes and bureaucratic obstacles to Palestinian small business creation.

NEEDED: A U.S. POLICY OF "ECONOMIC GROWTH FOR PEACE"

At the multilateral EDWG talks and the bilateral talks in Washington, the U.S. should encourage the Israelis, Palestinians, and Jordanians to pursue a policy of "Economic Growth for Peace."[31] Economic reform, development, and cooperation offer Arabs and Israelis tangible and immediate benefits from the peace process.

Specifically, the U.S. should:

✔ **Urge the Arab countries to end their economic boycott against Israel.**

For more than four decades, the Arab states have banned all direct and indirect trade with Israel and products made with Israeli raw material. This has harmed Israel, the Palestinians and Jordan. The boycott should be ended immediately.

The U.S. should insist that Saudi Arabia take the lead in declaring the boycott null and void. Saudi Arabia owes its very existence to the U.S. as a result of Operation Desert Shield and Operation Desert Storm in 1990 and 1991. Saudi Arabia today can afford to be bold in its policy toward Israel. The PLO was discredited in the eyes of Saudi leaders after Yasser Arafat openly embraced Saddam Hussein, the Iraqi military is largely destroyed, and American-Saudi relations are at an all-time high following President's Bush's commitment to sell the Saudis advanced fighter jets. The Saudis should thus follow Egypt's lead and begin the process of normalizing relations with Israel by ending its adherence to the Arab boycott.

✔ **Revitalize the U.S.-Israel Joint Economic Development Group (JEDG) to encourage Israel to press forward with bold, comprehensive free market economic reform.**

30 Amy Dockser Marcus, "Israel's Peres Sees Key to Peace in Cooperative Efforts With Arabs," *The Wall Street Journal*, September 21, 1992.

31 Joel C. Rosenberg, "For Middle East Peace, Let Palestinians Get Rich," *The Wall Street Journal*, July 8, 1992.

The U.S.-Israel JEDG, made up of State Department economic officers and private consultants, was created in 1984 by then-U.S. Secretary of State George Shultz and then-Israeli Prime Minister Shimon Peres to stabilize Israel's hyperinflation. The JEDG's advice helped reduce the annual inflation rate from over 400 percent to around 20 percent. From 1985 through 1990, the group met twice annually to discuss further opportunities for Israeli economic reform. But the Israeli government adopted only a few of the JEDG's recommendations. Since the debate over U.S. loan guarantees for Israel, however, the group has not met.

Less government intervention in the economy, not foreign handouts, will allow Israel to attract foreign investment, make Israeli capital more productive, and spark sustainable economic growth. Economic prosperity will enable Israel to successfully absorb Jews eager to flee an imploding former Soviet Union. A growing, prosperous Israel also will be boon to Palestinians in the West Bank and Gaza Strip, 40 percent of whom typically work in Israel and are hardest hit by massive immigration and Israel's sluggish economy.

It is time, therefore, for the JEDG to meet again to monitor Prime Minister Yitzhak Rabin's economic program and discuss strategies to:

- ✘ **Reduce Israeli government spending.** Israel's 1992 budget is equivalent to 72 percent of the country's GNP.

- ✘ **Reform the tax code and reduce corporate and personal rates.** Corporate taxes are as high as 40 percent and the top marginal rate on personal annual income over $36,000 is 50 percent.

- ✘ **Speed privatization of state-owned enterprises, banks, and land.** The government owns 160 companies, controls the four major banks and 93 percent of Israel's pre-1967 land.

- ✘ **Eliminate barriers to the creation of small businesses.** Israel's thriving underground economy is caused by time- and capital-consuming regulations, government-sanctioned monopolies and cartels, onerous labor laws, and a punitive tax code.[32]

✔ **Urge the Israelis and Palestinians to deal directly and immediately with the problem of Palestinian violence against other Palestinians.**

Law and order is critical to a successful autonomy agreement and to economic development and cooperation. If Palestinians rather than Israelis establish this order, they make a stronger case for self-rule and autonomy and pave the way to real economic growth.

32 See Rosenberg, "Land of Promise"; Daniel Doron, *"Israel's Economic Challenge: How the U.S. Can Help," Heritage Lecture* No. 350, 1991; and Alvin Rabushka, *Scorecard on the Israeli Economy: A Review of 1991* (Jerusalem: Institute for Advanced Strategic and Political Studies, March 1992).

✔ **Urge the Israeli and Palestinian-Jordanian delegations to establish a trilateral Economic Development Working Group.**

Trilateral discussions are far more likely to produce actual agreements on economic development and cooperation than multilateral discussions that include Syrians, Lebanese, Gulf countries, Europeans, and Japanese. This is because the Israelis, Palestinians, and Jordanians have the most to gain from increased interdependence.

One issue that might be tackled immediately is travel and tourism. "The West Bank is probably the richest [land] in the world in respect to religious shrines dear to followers of the three great religions," notes Palestinian economist Hisham Awartani.[33] Thus the most viable form of job creation and economic cooperation exists in the area of tourism. Officials should discuss ways to make it easier for tourists to obtain visas, cross borders, and exchange currency.

In addition, the trilateral group should:

- ✘ **Assemble detailed, up-to-date data on the economies of the West Bank and Gaza.** Israeli's statistics on the economies of the West Bank and Gaza are questionable because so much activity occurs in the underground economy.

- ✘ **Discuss what kind of economic policy Palestinians will pursue under autonomy.** What kind of tax code will exist, how will the taxes be collected, and what will they be used to pay for? With initial tax revenues expected to be low, how can the Palestinian private sector provide services typically thought of as public responsibilities, such as garbage collection? How can the Palestinians avoid establishing the sort of massive bureaucracy that has hindered economic growth in Israel and throughout the Arab world?

- ✘ **Negotiate interim trade arrangements between Israel, the West Bank, Gaza, and Jordan under autonomy.** Do the Israelis, Palestinians, and Jordanians intend free movement of goods, services, labor, and capital?

✔ **Establish a U.S.-Jordan Joint Economic Development Group (JEDG).**

With Saudi and U.S. foreign aid to Jordan cut off and a crushing foreign debt, Jordan must reform its economy and strengthen its private sector. With Iraq and Kuwait closed to Jordanian goods and services, Jordan must look for new markets. With highly educated and skilled Palestinian refugees from the Gulf states now living in Jordan and bringing their savings with them, Jordan has a unique opportunity to develop hundreds

33 See Hisham Awartani, "Palestinian-Israeli Economic Relations: Is Cooperation Possible?" delivered to a conference on "The Economics of Middle East Peace" at Harvard University's Institute for Economic and Social Policy in the Middle East, November 14-16, 1991.

of small export businesses. These factors provide a window of opportunity for the U.S. to help Jordan make the transition from dependency on aid and debt to a strong commitment to the free market and export promotion. A growing free market economy would strengthen moderate, pro-Western politicians in Jordan and work to erode the support for Islamic fundamentalists who exploit Jordanian poverty for their own political gain.

In addition to providing technical advice on how to reduce Jordan's budget, downsize its bloated bureaucracy, and privatize major industries, a U.S.-Jordanian JEDG, modelled after the one with Israel, could also help Jordan establish free export processing zones (FEPZs). Highly successful in East Asia, FEPZs are extremely low-tax, minimum regulation industrial parks. Their purpose is to attract foreign and domestic investment, develop export industries and create jobs. There are currently no such zones in Jordan.[34] Private free market economic development experts should be invited to work with U.S. trade officials as part of the delegation to the U.S.-Jordan JEDG.

✔ Review all U.S. non-military assistance to the Middle East with a long-term view to phasing it out.

What Israel, Jordan, the Palestinians, and Egypt need are free markets that allow entrepreneurs to open businesses and offer goods and services to paying customers wherever they might live. Foreign aid, by covering the costs of failed economic policies, actually removes an incentive to economic reform.

Some American policy makers might think it necessary to "reward" the participants in the peace negotiations with more foreign assistance on the conclusion of a peace treaty. But such aid might buy short-term peace at the cost of long-term economic progress. An economy weakened through addiction to aid could well become politically unstable. The U.S. thus should seriously consider its adverse effects before offering massive new aid to Jordan, the Palestinians, or other participants in the peace process.

The U.S. government should conduct a thorough review of the harmful effects of such aid. It should begin planning a long-term phase down of such assistance. Washington should be especially wary of backing any peace proposal that requires huge U.S. government handouts that could undermine both local economies in the short term and local political stability in the long term. If Washington wishes to "purchase peace" with such handouts, the adverse economic effects that can result must be kept clearly in mind and the burden of proof for such funds must rest on the advocates of such aid.

34 For a detailed examination of FEPZs in Asia and their potential utility in the Near East, see Meir Eldar's "Toward Economic Growth and Independence: Establishment of Free Export Processing Zones in Israel," Institute for Advanced Strategic and Political Studies (Jerusalem), February 1992. See also Andrew B. Brick, "The Asian Development Miracle: Taiwan as Model," *Heritage Lecture* No. 399, 1992.

CONCLUSION

Despite an entire year of Middle East peace negotiations, little has really changed for Arabs and Jews in the region. Multiple rounds of peace talks have produced high expectations but little concrete progress. Meanwhile, Israel's economy struggles to absorb Soviet and Ethiopian Jewish immigrants, economic conditions in the West Bank and Gaza Strip are going from bad to worse, and Jordan continues to face severe poverty and massive foreign debts. No doubt the road to peace will be long and difficult. But economic reform cannot wait and indeed can help pave the way to peace.

Economic factors fuel the Arab-Israeli conflict. Poverty in the West Bank and Gaza, especially in comparison to Israeli living standards, was a key reason for the outbreak of the 1987 Palestinian intifada revolt against Israeli control. Widespread unemployment today is contributing to the rise of militant, anti-Western Islamic fundamentalism in the West Bank, Gaza, and Jordan.

Excessive Israeli and Jordanian government interference in their economies hinders the prospects for growth. Palestinian violence against other Palestinians in the West Bank and Gaza makes economic development there virtually impossible. Compounding all this is the 46-year-long Arab boycott against Israel that denies Israeli, Palestinian, and Jordanian businessmen access to neighboring markets and drives away foreign investors.

Top Priority. The U.S., therefore, should promote a policy of "Economic Growth for Peace." Such a policy should press Arabs to end their boycott, assist free market economic reform in Israel and Jordan, urge Israelis and Palestinians to deal with the problem of Arab-on-Arab violence in the territories, and review current U.S. aid policy in the Middle East with a view toward a long-term phase-down.

Economic growth cannot solve the Arab-Israeli conflict. But stronger economies can strengthen pro-Western political moderates and increase the confidence of regional leaders to take the risks necessary to achieve peace. For this reason, "Economic Growth for Peace" should be a top U.S. priority.

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