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WEST BANK AND GAZA INVESTMENT CLIMATE ASSESSMENT:

UNLOCKING THE POTENTIAL OF THE PRIVATE SECTOR

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ACRONYMS AND ABBREVIATIONS

ASYCUDA	Automated System for Customs Data
CEM	Country Economic Memorandum
EC	European Commission
EUBAM	European Union's Border Assistance Mission
GoI	Government of Israel
MENA	Middle East North Africa
MOET	Ministry of Economy and Trade
MOF	Ministry of Finance
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PSI	Palestine Standards Institution
WBG	West Bank and Gaza
WCO	World Customs Organization
WTO	World Trade Organization

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EXECUTIVE SUMMARY

A. ICA Findings

i. Forty years of occupation in WBG has left a heavily distorted economy in a state of that is almost completely dependent on the Israeli economy. While other countries in the region have grown and industrialized, the Palestinian economy retains the hallmarks of a less developed economy. The size of the average industrial enterprise is about four workers, no larger than it was in 1927. While, the share of agriculture in GDP has declined, services and the public sector have been expanding rapidly, driven by donor funding and remittances from the export of labor. The share of industry remains low at around 12-13 percent. In contrast, in Jordan the industrial sector accounts for nearly 30 percent of GDP. It was hoped that with limited autonomy arising from the Oslo Accords of September 1993, the Palestinian private sector would take off. Free of the constraints imposed by military occupation, Palestinian entrepreneurs would rapidly invest and the thriving economy would attract foreign investment. Unfortunately, this did not materialize and the economy has suffered even more since Oslo.

ii. Despite the ongoing peace process, Israeli settlements continued to expand and Palestinian violence increased. The cycle of violence and Israeli closures ultimately resulted in a second *Intifadah*, which led to a dramatic fall in domestic investment and the loss of most of what little foreign investment that had entered. The recovery of the Palestinian private sector faces two critical issues. First is the Israeli closures regime. This policy, which broadly consists of comprehensive restrictions on the movement of people and goods within the West Bank, highly constricted movement of goods across the border with Israel, and a near total separation of economic and social interaction between the territories of Gaza and the West Bank, has resulted in a highly fragmented Palestinian economy. The closures have made it nearly impossible for Palestinian enterprises to meet delivery schedules and have dramatically raised costs, effectively excluding most Palestinian producers from the world economy.

iii. But the Palestinian private sector faces another and more fundamental problem. Palestinian industry developed to provide low cost, labor intensive products such as garments, furniture and shoes for the heavily protected domestic and Israeli markets. However, the Israeli economy is undergoing profound structural change. As incomes have risen, production costs have increased and Israel is moving toward higher value products and services. At the same time, it has reduced protection and opened its markets to low cost imports. The Palestinian enterprises, squeezed between rising costs and falling protection, can no longer compete in their traditional low value, labor intensive products such as garments and footwear.

iv. To survive, Palestinian enterprises will have to move toward higher value added goods and also expand their potential markets. While Israel will remain the largest trading partner for the time being, Palestinian producers cannot rely on Israel indefinitely and must seek out new markets. But to successfully enter new markets they will have to increase their productivity, lower costs and improve quality. It is the purpose of this Investment Climate Assessment (ICA) to look at what hinders the move to new markets and what can be done to encourage it.

v. An ICA is a standard World Bank study that has been completed in many countries around the world. Its purpose is to link the business environment, or what is termed the Investment Climate, directly to firm level performance and make specific policy recommendations to help the private sector grow and prosper. The ICA is based on all available information but is underpinned by an enterprise survey; conducted in this case by the Palestinian Central Bureau of Statistics in face to face interviews with 401 enterprises throughout WBG. Being a standard survey, it allows a comparison between the investment climate in WBG and other countries.

vi. The ICA reveals that shrinking market access and the lack of free movement are the main constraints to growth for Palestinian enterprises. Relative to other countries in the region, the Palestinian investment climate is good: petty corruption is low, the bureaucracy is relatively efficient and financial markets are well developed. Despite this, Palestinian enterprises have not invested enough to maintain their international competitiveness. Managers know they need to invest and have access to the necessary resources. However, they are unwilling to do so unless they are assured secure and predictable access to both domestic and international markets.

vii. Most Palestinian enterprises are no longer internationally competitive in the low value goods they specialize in. Enterprises are very small—the average size is less than five workers—and average capacity utilization for manufacturing enterprises is only about 50 percent. Few firms invest. Most machinery is over 10 years old, less than 26 percent of the surveyed enterprises did any worker training and only a small share had international quality standards. In addition, since the WBG economy is tied to Israel, it has a higher cost structure than other countries producing labor intensive products. The average wage of a production worker in WBG is about twice that of a Jordanian worker and almost three times an Egyptian's. If the Palestinian private sector is going to grow and provide jobs for the rapidly expanding population, Palestinian entrepreneurs will have to invest and move to high value goods that can compensate for the high costs of production.

viii. Since its inception the Palestinian Authority has attempted to provide a supportive environment for private investment. The financial sector is highly liquid and less than 15 percent of the survey sample is financially constrained. Most enterprises do not have a bank loan. But that is because they do not want one given the few profitable investment opportunities and not because the banks will not lend to them or the required collateral is too high. Corruption and government regulations do not appear to be a major constraint to investment. Most managers reported not having to pay any bribes and for those who did, they paid less on average than in most neighboring countries. The average time it took to obtain a business license was only 30 days, which is half the time reported in Turkey. Senior managers in WBG also reported spending on average less than 7 percent of their time dealing with government regulations, compared to over 8 and 12 percent in Turkey and Lebanon respectively. The Palestinian Authority is new and just beginning to develop its institutions, but they appear to be emerging in an efficient manner.

ix. Unfortunately, the growing settlements and movement restrictions imposed by Israeli authorities for security reasons overshadow all other elements of the investment climate. The restrictions close off markets, raise transaction costs and prevent producers from guaranteeing delivery dates. The closures also serve to keep firms small and prevent them from attaining minimum efficient scale. The percentage of West Bank and Gaza enterprises selling into the other territory has fallen by half since 2000. More importantly, markets in the West Bank appear to be shrinking because of movement restrictions imposed to protect Israeli settlements. In 2000, nearly 60 percent of firms made a significant share of their sales outside of their home city; by 2005, this had fallen to around 40 percent. The most difficult issue to overcome is the uncertainty caused by the movement restrictions. For example, the survey reveals that on average it takes around 22 days to clear imports for companies in the West Bank. But the longest time averages nearly 43 days. On time delivery is a requirement in the modern export market, but Palestinian producers can never be sure when their cargo will move. Consequently, to a large degree, they are frozen out of the high value export market.

B. Policy Recommendations

x. The ICA policy recommendations fall into three broad categories: Movement and Access, the Investment Climate and Enterprise Capabilities. For the Palestinian private sector to fulfill its potential and create the jobs required by the rapidly expanding population, all three of these areas must be addressed. However, re-establishing free movement and access, while maintaining Israeli security, is the *sine qua non* for a viable Palestinian economy. Without a concerted political effort to re-open markets and lower transaction costs the Palestinian private sector is bound to fail.

Movement and Access

xi. ***Improving access to third country markets.*** All open economies need to have alternative trade routes to directly access their customers and successfully compete in the global economy. World Bank analysis suggests that the Rafah trade corridor provides a viable alternative trade route for Gaza. While not a substitute for improved trade with and through Israel, the Rafah crossing can provide an essential additional route with potentially high returns for the Palestinian private sector. After Rafah was turned over to Palestinian control, it was efficiently and securely operated under EU supervision for eight months until the GoI closed it at the end of June 2006. The crossing should be reopened not only for passengers, but for the movement of goods so that Palestinian producers have the option of accessing Egypt's port at the entrance to the Suez Canal (SCCT) and Cairo International Airport. Initial analysis suggests that this route provides competitive trade logistics in terms of performance and at a cost equivalent to Israel's ports and airports. Even more importantly, it offers Palestinians direct access to Europe and the Gulf, which are potentially the most lucrative markets for Palestinian exports. Opening Rafah is complementary to and not a substitutive for ongoing efforts to improve the border crossings with Israel at Karni.

xii. The West Bank economy is larger than the Gaza economy and also needs direct access to the world market. An efficient and reliable crossing and trade corridor through Jordan would provide similar advantages of direct market access as Rafah. However, for such a corridor to be successful, it is crucial that Israel reverse the current policy of highly restricted access to the Jordan Valley for the Palestinian population. Likewise, progress on the Palestinian port and airport as provided for under the Agreement on Movement and Access should begin in order to provide other alternatives for reaching third country markets.

xiii. ***Rebuilding the domestic market***. It's necessary to rebuild the domestic market, which has been fragmented by the closures in the West Bank and the near total separation between Gaza and the West Bank since 2001. The closures increase uncertainty, raise transportation costs and shrink available markets, which prevents Palestinian firms from attaining economies of scale. An immediate first step is restarting the convoy system between the West Bank and Gaza as called for under the Agreement for Movement and Access (AMA) and in the longer term establishing a permanent territorial link between the territories. The current fragmentation of the West Bank resulting from an extensive system of permit restrictions, the Israeli separation barrier, settlements and physical impediments must also be reversed. The solution goes significantly beyond the removal or movement of some physical barriers to an examination of the entire system, including the provision of residency and travel permits, which has created enormous uncertainty in the normal economic and social functioning in the West Bank.

xiv. ***Support to key institutions that support trade.*** To ensure that the private sector has the support necessary to operate efficient border crossings and can take advantage of improved access to third country markets, certain critical institutions must be developed.

- The Department of Customs needs assistance with entering the World Customs Organization (WCO), continued help in expanding the ASYCUDA system which monitors and records trade and VAT transactions, and other assistance to implement a modern and secure customs regime.

- It is critical that the private sector, as the clients of the border crossings and trade corridors, be involved in the development and operation of the border terminals. As a first step, private sector involvement in border monitoring should continue in Gaza and expand to the West Bank border crossings, which are located along the green line. This would ensure that critical data on the movement of goods between the West Bank and Israel are recorded and available.

- One of the factors limiting the sale of Palestinian products in Israel and other countries is their failure to meet international standards. The Palestine Standards Institution (PSI) should be supported to quickly reform the national quality system and improve its capacity to establish and enforce standards. PSI also needs to create and build capacity for testing laboratories to support exports.

Improving the Investment Climate

xv. The key to the economic performance is the investment climate in which enterprises operate. The PA had been slowly but steadily establishing an enabling investment climate. But progress has almost stopped since the recent elections. The first step in improving the Investment Climate is to continuously measure it and track changes over time. An independent agency should regularly survey the private sector to measure the investment climate. The data should be analyzed and quickly made publicly available for use by policy makers and the private sector.

xvi. Private sector operations depend upon strong enabling institutions. The PA, with the support of the international community, should move quickly to improve the services and capabilities of the key institutions needed by the private sector. Among the critical institutions and issues are:

- *Land Administration*: Most land in the West Bank remains unregistered, making it difficult for businesses to purchase land and expand operations. Funding a full-scale project to improve land policy and register all land would provide a major boost to private sector activity.

- *Legal Reform and new legislation*: There are major gaps in the legislation required to facilitate private sector operations. Many existing laws are contradictory and those governing the West Bank and Gaza are not fully harmonized. The PA should press quickly to pass the most important legislation to provide a less uncertain legal environment. Among the most pressing laws are the Commercial law, Companies Law, Competition Law and a Secured Transaction Law. The system for drafting and passing legislation should also be addressed. The enforcement of existing laws is weak and strengthening judicial enforcement would enable businesses to more easily enter into contracts and expand their operations.

- *Competition Policy:* It is widely believed that the Palestinian economy is becoming less competitive and that monopolies and large businesses are using the current crisis to expand their market power. Given the importance of maintaining confidence in the economic system and trust of the population, the PA should renew efforts to develop a competition policy and establish necessary regulatory bodies in areas such as telecommunications.

- *PalTrade:* Palestinian producers have been effectively cut off from the world market and it is difficult for Palestinian businessmen to travel or for international buyers to visit WBG. Palestinian entrepreneurs need a reliable source of information on market requirements and opportunities as well as institutions to promote Palestinian products abroad. The Palestine Trade Center is the organization tasked with providing these services. However, it needs support to improve its capabilities to provide market information and promote Palestinian businesses in new markets.

- *Infrastructure*: Many firms in the survey noted the cost and reliability of power, particularly in Gaza, and this has undoubtedly gotten worse after the fighting in mid-2006. The fact that a large percentage of enterprises relies on self-generated power indicates the need to develop more reliable power sources. The lack of water is also a constraint. The use of water by Palestinians in the West Bank is severely constrained by Israeli authorities, which limits the types of activities Palestinians can undertake. Efforts must be made to increase the reliable provision of power and water supplies to the Palestinian private sector.

- *Private sector business membership organizations*: Business associations and private sector trade groups in WBG have played an important role in helping both the government and donors formulate good policy. In the past, most of these organizations have been supported by donor funds, yet their capability to provide services to members remains weak. Successful organizations must have the dedicated support of their members and cannot be run by donor organizations. But outside support for developing their capabilities to provide useful services to members would enhance growth.

Developing Enterprise Capacities

xvii. Even if market access is granted and an enabling investment climate provided, few Palestinian enterprises are currently capable of competing on the international market. They require significant investment to develop new products, increase productivity, improve quality and reduce costs. It is especially important to invest in marketing plans and developing contacts in new markets.

xviii. Improving enterprise capabilities is a difficult task. Palestinian businesses have been operating in isolation for years and are to a large extent cut off from the most important enterprise learning mechanisms. Few Palestinian firms export directly, conduct training, hire technical experts or have technology licenses. Their main contact with the rest of the world is through Israeli firms and these contacts are declining as Israel moves forward with its policy of separation. The movement and access restrictions make it expensive to develop new learning mechanisms to replace contacts with Israel.

xix. Managers are well aware of the need to increase their capabilities and most enterprises—at least the formal ones—can access the necessary finance. However, investing in the current situation is extremely risky. Attempting to enter a new market is risky in and of itself. Add the uncertainty about movement and access and most enterprises decide against significant investment. In this unstable situation, individual enterprises are highly risk averse and the level of investment is below what is socially optimal.

xx. Palestinian enterprises need support to help lower the cost of developing learning mechanisms and to offset some of the risk of investing in new capabilities. Successful investments by some entrepreneurs would serve as a demonstration effect to others encouraging more investment. Initial success in exporting will also help create a "made in Palestine" brand and will offset some of the negative perceptions about the ability of Palestinians to reliably supply goods.

xxi. A matching grant, challenge fund or some other type of program that directly supports individual Palestinian enterprises upgrade their internal capabilities could help jump start private investment. Such support must target specific market failure and should focus on helping find and adopt new technologies and opening new markets.

CHAPTER 1: BACKGROUND AND INTRODUCTION

A. Background

1.1. Though the ICA does not attempt to provide a full analysis of the legacy of occupation, to understand the economic situation in WBG today, it is necessary to understand how it evolved during nearly 40 years of occupation. What is most remarkable is how little the economic structure has actually changed. In 1967, WBG had all of the hallmarks of an underdeveloped economy. Agriculture was the dominant sector and industry provided less than 10 percent of GDP. Most industrial establishments were family owned micro enterprises using the lowest level of technology to produce for the local economy. Now, after 40 years of development—a time in which per capita incomes in WBG have risen dramatically and the industrial sectors in neighboring countries have grown significantly—the structure remains basically the same. In 2004, the size of the average industrial establishment in WBG was four workers, no larger than the average of such establishments in Palestine in 1927.[1] The share of agriculture in GDP has fallen to about 7 percent but industry's share remains only about 12-13 percent. In contrast, in Jordan, which until 1967 the West Bank was a part of, the share of agriculture has fallen to less than 3 percent and industry is approaching 30 percent of GDP. While the Palestinian productive sectors have stagnated; services, trade and construction, driven by the higher incomes have thrived leaving a heavily distorted economy in a state of arrested development.

Table 1.1: Share of GDP by Selected Activities: West Bank and Gaza

	2005	2000	1994
Agriculture and Fishing	7	10	13
Mining, manufacturing, electricity and water	13	16	21
Construction	3	6	11
Wholesale and retail trade	8	12	17
Transport	10	5	3.5
Other Services	25	24	22
Public Administration and Defense	18	13	10

Source: Published and unpublished PCBS data, World Bank

1.2. Israel's initial policies were to encourage income growth for the Palestinian population while restricting activities that directly competed with Israeli businesses and preventing development of sovereign institutions.[2] There were two main aspects to implementation of the policy. The first was "open bridges", where Israel maintained the bridge link with Jordan. It was hoped that Jordan would take Palestinian agriculture output that Israel did not want competing with its own agriculture sector. Israel also encouraged Palestinian industry to supply Arab markets via Jordan. Jordan did provide a market for significant amounts of Palestinian agriculture output, but exports of services and industrial products was extremely limited. Jordan enforced the Arab boycott of Israel against Palestinian products and also took measures to protect its own industry. Despite the open bridge idea, Palestinian imports were limited. Israel instituted its own barriers to protect domestic industry, which prevented Palestinian producers from accessing many inputs at world prices. In addition, Israeli security measures made it prohibitively expensive to import most goods.

1.3. The second aspect of the occupation policies was "integration", whereby Israel sought to remove all barriers between the Israeli and Palestinian economies. Palestinian income levels rose dramatically as thousands of workers found employment in Israel. However, integration did little to help Palestinian

[1] Roy 1999.
[2] See Arnon and Weinblatt (2001) for a discussion of Israeli government economic policies in WBG.

enterprises. In a fully integrated economy, capital would be expected to flow into the Palestinian territories to take advantage of the lower labor costs. But, almost no Israeli or foreign capital was forthcoming. In addition, there was relatively little local investment despite the liquidity provided by remittances from Palestinians working in the Arab gulf or Israel. Most remittances were sunk into real estate, housing and retail establishments instead of being invested in productive enterprises.

1.4. Palestinian enterprises benefited only marginally from the surge in demand created by the growing income levels. Local enterprises were severely constrained by the impediments to doing business and uncertainty imposed by the Israeli occupation. Thus, the small local businesses had difficulty competing and most of the increased demand was met by the larger and more modern Israeli producers. One of the biggest constraints to Palestinian investment was the lack of credit facilities. After 1967, Arab banks withdrew from the market and few Palestinians would deal with Israeli banks[3]. In the early years of occupation, formal credit facilities depended largely on a special Israeli government fund, but this was gradually reduced and then eliminated altogether in 1981.[4] In addition, Palestinian producers did not receive the wide variety of government supports, such as export subsidies and investment incentives that were available to Israeli firms. Taken together these factors explain why there was little domestic investment in the Palestinian territories despite the increased demand and labor cost differential with Israel.

1.5. Initially, Israel made an effort to support investment in the Palestinian territories. For example, in 1967 and 1968 the military government allowed the repatriation of over 100 high net worth individuals with the intent that they would spur investment. However, as policy evolved, the occupation imposed more and more significant barriers to development. All activities, including building, importing, manufacturing and shipping required permits from first the military government and then the Civil Administration. While Israeli policy is hard to divine since there was little public information, it was clear that permits for activities that competed with Israeli products were rarely forthcoming. When permits were granted, they could often take years to receive. There were a variety of other impediments to doing business under occupation including.[5]

- The most profound problem was the loss of natural resources. Using a variety of measures, Israeli authorities restricted the use or took control of land and water in the Palestinian territories. By the beginning of limited self rule under the Oslo Accords, it was estimated that Israel had confiscated nearly 68 percent of the total land in the West Bank and 40 percent in Gaza. In the West Bank, Palestinians were only using 15-20 percent of the water resources.[6]

- Israeli security measures made it difficult and expensive to import or export directly so Palestinian businessmen used Israeli middleman, which increased costs.

- Permits to import new capital equipment were difficult to obtain forcing Palestinians to rely on second hand equipment from Israel.

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[3] Palestinians were reluctant to deal with Israeli banks for a variety of reasons. Israeli banks charged high interest rates to compensate for high political risk. Palestinians were also unwilling to pledge land as collateral and risk losing Arab lands to Israelis and dealing with Israeli institutions was seen as a form of collaboration with the occupiers.
[4] Roy 1985, pp 72-73.
[5] There are a number of sources on impediments faced by Palestinian businesses. The majority of this section is drawn from World Bank 1993.
[6] UNCTAD 1994, p. 98.

- Tax administration by the Civil Administration imposed high costs on Palestinian firms. Income taxes were collected in advance on estimated earnings and Palestinians, unlike Israeli firms, were unable to defer Value Added Tax payments. The long wait for VAT refunds in one estimate added as much as 8 to 12 percent to the final cost of finished goods.

1.6. One area where Palestinian industry did see significant growth was in sub-contracting arrangements between Israeli and Palestinian enterprises. These were for labor intensive goods like garments and footwear and were often between an Israeli producer and a number of Palestinian micro-enterprises. Sub-contracting meant that Israelis did not need to set up facilities in Palestinian territories and Palestinians did not have to invest large amounts of capital. It also meant that Palestinian producers were supporting and not competing with Israeli businesses so they were allowed to freely operate.

1.7. By the eve of the Oslo Accords, the occupied Palestinian territories had become completely dependent upon Israel and had little economic relations with other countries. Nearly 60 percent of the West Bank's exports and more than 90 percent of imports were to and from Israel and the trade deficit was nearly 45 percent of GDP. The figures for Gaza were similar, but the trade deficit was even higher.[7] Palestinian enterprises were heavily reliant on Israelis for inputs and most production was sold either locally or through Israeli distributors. While neighboring countries had moved toward industrialization, the Palestinian territories were in a distorted state of development. The share of industry in GDP was low like a developing country, but the share of agriculture had also dropped and services and construction were higher than would be expected for a country at that level of development. The enterprises that did exist were dependent upon Israeli firms for inputs and almost all exports went to Israel or were exported through Israeli firms.

1.8. The Oslo Accords were expected to solve many of the problems facing the Palestinian private sector and provide an economic boost. Palestinian enterprises would no longer be subject to Israeli licensing, they would be allowed to import selected items at a tariff rate different from Israel's and they should have unrestricted access to the Israeli market. Unfortunately, this situation did not materialize and instead of improving, Palestinian business has suffered even more since the Oslo Accords. A deterioration of the political and security situation has brought ever increasing closures. The number of Palestinians working in Israel and on settlements has been significantly reduced and the inability to meet product standards, labeling requirements and a host of other barriers, in addition to security closures have effectively excluded most Palestinian goods from the Israeli market. Palestinian businesses remain almost completely dependent on Israel for inputs.

1.9. The most successful industrial sector, sub-contracting, has also suffered in the recent years. Closures have made it nearly impossible for Palestinian enterprises to meet delivery schedules and have dramatically raised costs, leading Israeli buyers to seek lower cost and more reliable arrangements in Jordan, Egypt and elsewhere. But the sub-contacting sector faces a more fundamental problem. Palestinian enterprises developed to provide low cost, labor intensive products such as garments, furniture and shoes for both the heavily protected domestic and Israeli markets. However, the Israeli economy is undergoing profound structural change. As incomes have risen, production costs have increased and Israel is moving toward higher value products and services. In exchange for obtaining access for its high technology products, it is opening its own markets to competition from low cost producers of manufactured goods in Asia, Turkey and elsewhere. The Israeli industries that the Palestinian producers have been supporting are declining and investment has shifted into higher value products. But unlike the Israeli producers, the Palestinians have not been able to adjust. The decline in subcontracting and in other Palestinian industries has been due not only to the closure regime but also the fundamental changes in the Israeli economy, which WBG are an integral part of.

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[7] Arnon and Wienblatt 2001.

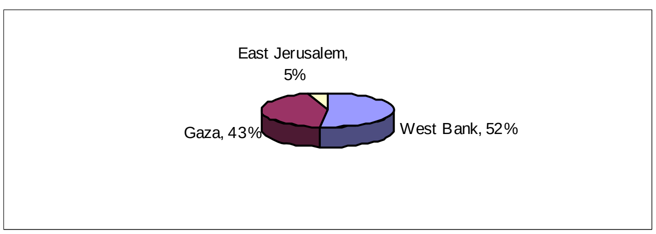
1.10. It is clear that while Israel will remain the largest trading partner for the time being, the Palestinian economy cannot rely on Israel indefinitely. The domestic economy is small so Palestinian producers must seek out new markets and enter them directly without relying on Israeli intermediaries. But to do this, they will have to increase productivity, reduce costs and improve marketing. Since the Palestinian economy is integrated into the Israeli economy it faces a related cost structure. Consequently, Palestinian producers must also attempt to move toward higher value goods and services. It is the purpose of this Investment Climate Assessment to look at what hinders the move to new markets and what can be done to encourage it.

B. The Survey and Sample

1.11. An Investment Climate Enterprise Survey underpins the Investment Climate Assessment. The survey collects data on the investment climate and enterprise performance at the establishment level. The survey is a standard World Bank product, which allows direct comparison with other countries in the region and around the world. But it also contains a few questions specific to the WBG experience. The Palestinian Central Bureau of Statistics (PCBS) conducted the WBG survey in face-to-face interviews after training by World Bank staff. The field work took place in the summer of 2006 and most of the data and answers relate to fiscal year 2005, before the tight closure of Gaza in January of 2006 and the cut off of foreign aid to the PA, which began in March 2006. Since then the economy has deteriorated, however, the survey still captures the essential nature and issues of the Palestinian private sector.

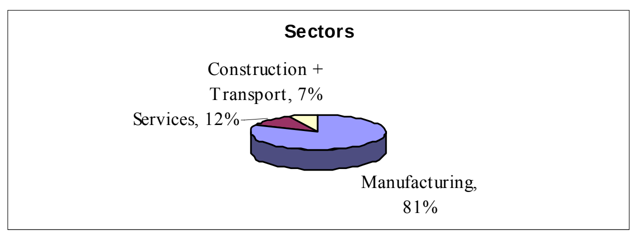
1.12. The sample consisted of 401 formal sector enterprises in East Jerusalem, the rest of the West Bank and Gaza (Figure 2.a). The sample frame was from the PCBS data base and consisted of enterprises in the manufacturing sector, construction, transport, and selected service sectors with more than five employees (Figure 2.b). Retail establishments, restaurants and informal firms were not covered. Agriculture was also not covered. Within the selected sectors, individual sectors were drawn in proportion to their representation in the frame (Table 1.2).

Figure 1.a: Sample by Regions



Source: 2006 World Bank/PCBS WBG Enterprise Survey.

Figure 1.b: Sample by Sectors



Source: 2006 World Bank/PCBS WBG Enterprise Survey.

1.13. Most Palestinian enterprises have less than five workers. Consequently, this survey cannot be considered representative of the Palestinian economy as a whole. However, no detailed survey can effectively cover every sector. This survey was aimed at understanding the issues related to formal enterprises in productive sectors that have the potential for growth and exports. While, agriculture, retail and informal enterprises are all important sectors of the economy, the survey instrument was not suitable for them. Thus, the survey results should be carefully interpreted. They provide comprehensive information but are representative only of the sectors covered. The data provides much richer and more detailed insights than can be presented in this short policy document. Only the most important results are discussed and

Table 1.2: Sample Size

	No. Workers
Mean	31
Median	12
Min	4
Max.	1628

Source: 2006 World Bank/PCBS WBG Enterprise Survey.

differences between size classes and regions are omitted unless central to the discussion. More detailed analysis awaits future work.

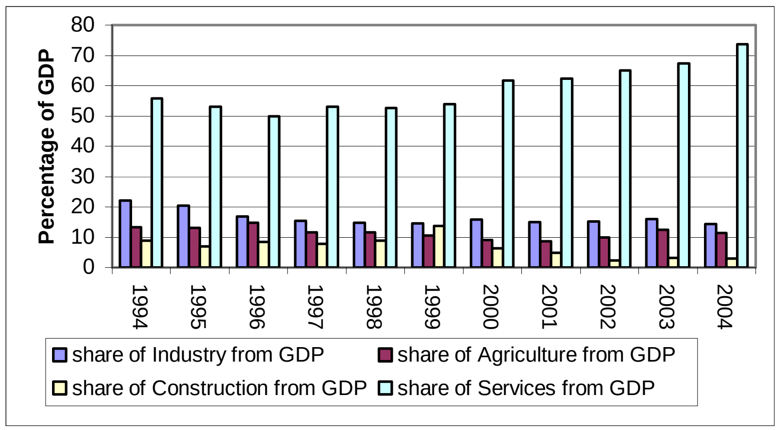
Table 1.3: Sample by Sub-Sector

Sector	Activities	Frame	Sample	Survey
Manufacturing	Food	314	65	73
	Garments	417	24	20
	Textiles	24	20	14
	Machinery & Equipment	18	13	16
	Chemicals	45	20	20
	Electronics	13	13	12
	Non-Metallic Minerals	882	124	125
	Other Manufacturing	268	44	45
Total	**Industry**	**1981**	**323**	**325**
Services	Hotels	45	12	14
	Information Technology	22	8	10
	Other services		15	18
Total	**Services**	**103**	**35**	**42**
Other	Construction & Transport	367	42	34
All Total		**2451**	**400**	**401**

CHAPTER 2: STRUCTURE AND PERFORMANCE OF THE INDUSTRIAL SECTOR

2.1. Limited self rule following the Oslo Accords was expected to unleash private investment in WBG. The industrial sector would grow rapidly and, free of the occupation constraints, it would assume the same importance it has in neighboring countries. Given the limited long term potential of agriculture in WBG and the difficulty of building a high wage service economy, a growing industrial sector is essential to provide jobs for a rapidly expanding population. Unfortunately, far from growing, the industrial sector's share of GDP fell from around 16 percent in 1996 to around 12 in 2005, while retail, construction and other services along with the public sector became even more dominant. As discussed above, the industrial sector is constrained by two factors. First, though the Palestinians received authority over areas of the West Bank and Gaza, settlement activity has expanded, the security situation has badly deteriorated and Palestinians are facing more and not fewer closures and restrictions. Second, changes in the international market have led to a sharp fall in WBG's relative competitiveness in the low value, labor intensive goods it relied on in the 1980s and 1990s. Both of these factors are important in explaining the poor performance of Palestinian industry and it is often difficult to separate the effects of market changes from the costs imposed by Israeli policies. However, the closures and restrictions are by far the most important. Not only do they impose high transaction costs, but the uncertainty they create prevents Palestinian entrepreneurs from making the investments needed to improve their competitiveness.

Figure 2.a: Contribution of Value Added by Economic Activity



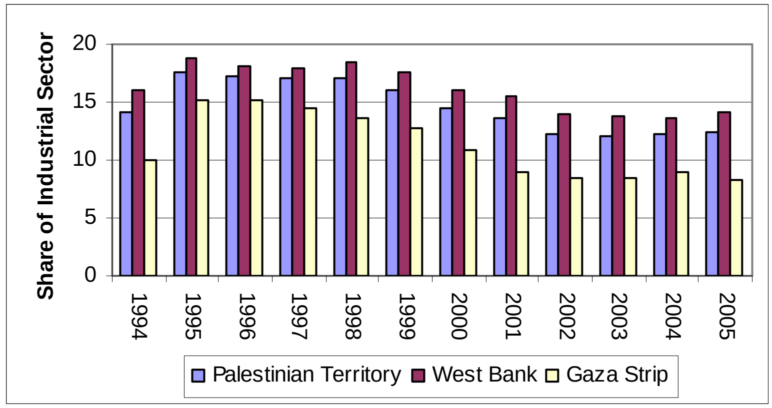
Source: PCBS, 2006, National Accounts, various issues. Taken form Makhool 2006.

A. Closures and a Changing Economy

2.2. Despite the ongoing peace process, Israeli settlements continued to expand in the 1990s and were accompanied by closures, land confiscation and other measures needed to secure them. The 1990s also witnessed an increase in Palestinian violence, which resulted in stricter Israeli security measures. The cycle of violence and security closures ultimately resulted in a second *Intifadah* in late 2000. In 2002, at the height of the *Intifadah,* the industrial sector's performance reflected the heightened level of violence. Growth in value added in the industrial sector was high during the relatively peaceful years between 1997 and 2000 (Figure 2.c). But 2001 saw the sector contract by nearly 11 percent. In the calmer year of 2003, annual growth rebounded to nearly 10 percent. However, this merely reflects recovery from a low base and not a healthy trend as 2004 again saw a high negative growth rate. Though 2004 was relatively peaceful, the closures and movement restrictions continued and the negative growth rate points to the severity of their impact on the private sector.

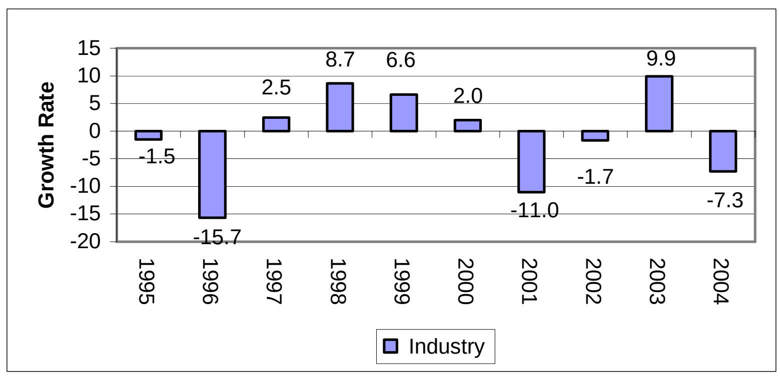
2.3. The failure of the Palestinian private sector, particularly the industrial sector to grow, can also be traced to fundamental changes in the economy. Palestinian industry developed to produce low value, labor intensive goods for the Palestinian and Israeli domestic markets. Often, this was done by collections of small Palestinian enterprises serving as sub-contractors for larger Israeli firms who designed and marketed the goods. For many years Israel was a heavily protected market, and Palestinian producers emerged in an environment where they did not have to compete directly with low cost international producers. This is no longer the situation and Israel has transitioned to become one of the most open economies in the world. Israel has joined WTO and reached trade agreements with a number of countries. In order to gain access for their high value exports such as IT, advanced electronics and services, Israel has opened its domestic market to imports of labor intensive goods. At the same time, productivity growth in Israel has led to increased wages and an overall higher cost economy. Since WBG is essentially a part of the Israeli economy, Palestinian producers face the similar high costs but have not seen the same productivity gains. Thus, Palestinian producers have been squeezed from two sides. They have lost the protected market they relied on and at the same time they face increasing labor and other costs while productivity has stagnated.

Figure 2.b: Contribution of the Industrial Sector in Local Employment by Geographical Distribution (1994-2004)



Source: PCBS, 2006, Labor Force Survey, unpublished data. From Makhool (2006).

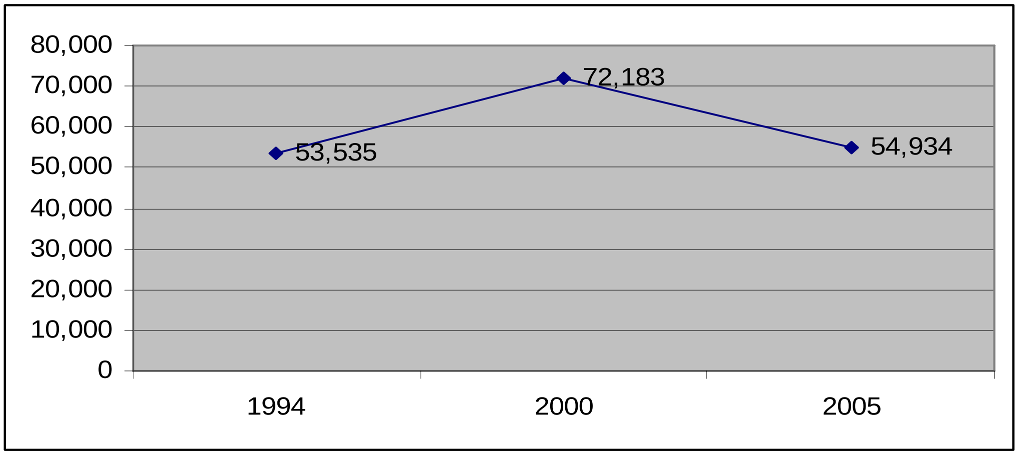
Figure 2.c: Average Growth of Value Added in the Industrial Sector (1994-2004)



Source: PCBS, 2006, National Accounts, various issues.

2.4. To understand the challenges facing the Palestinian productive sector, one need only look at employment patterns in the manufacturing sector. WBG has one of the highest rates of population growth in the world; well over 3 percent per annum. But manufacturing employment has stagnated and the sector has not made a significant contribution to job creation. Between 1994 and 2004 the industrial (mostly manufacturing) sector's share in total employment fell from an estimated 14.1 percent to 12.3 percent (Figure 2.b). Manufacturing employment grew steadily for the first part of the decade, rising from around 53,000 to over 73,000, but then dropped back to about 55,000 in 2004 (Figure 2.d). The hardest hit sectors were also some of the largest and most important sectors. In apparel—the largest employer—from 2000 to 2004 the number of people engaged in the sector declined by over 50 percent. Manufacture of non–metallic products (essentially stone and marble and other construction material) and leather (footwear) sectors declined by 9 and 5 percent respectively. The sharp fall in manufacturing employment in 2001 can be attributed to the violence and closures associated with the *Intifadah*, but the failure to recover, especially in the labor intensive sectors, reflects not only the continued occupation, but also the deeper problems of declining competitiveness.

Figure 2.d: Manufacturing Employment (2004-2005)



Source: PCBS Enterprise Census, 1994; Industrial Survey 2000, 2005.

Table 2.1: Employment by Selected Activities

	2005	2000	1994
Manufacturing Total	**54,934**	**72,183**	**53,535**
Manufacture of non-metallic products	11599	11,934	9,626
Manufacture of Wearing Apparel	11640	22,050	12,401
Manufacture of Food and Beverages	8,561	10,358	8,285
Manufacture of metal products	6,575	7,442	5,501
Manufacture of furniture	6,459	6,177	3,749
Tanning and Leather	2,027	3,846	3,210
Manufacture of Chemicals and its products	1622	2,010	1,381
Manufacturing of textiles	1099	1,530	1,796
Construction	**4600**	**Not Available**	**2,900**
Wholesale and retail repair	**118,256**	**Not Available**	**63,220**
Hotels and Restaurants	9425	Not Available	5,758

Source: PCBS Enterprise Census, 1994; Industrial Survey 2000, 2005.

B. Efficiency and Labor Productivity

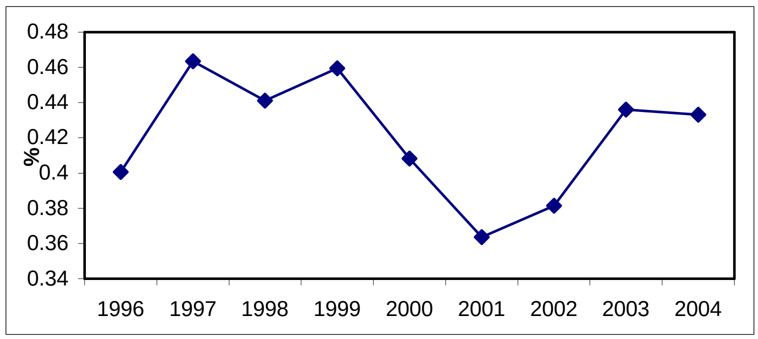
2.5. Efficiency in the West Bank, as measured by the ratio of value added to output in the industrial sector declined from around 40 in 1996 to close to 37 in 2001.[8] It then recovered a bit to reach 43.3 in 2004. However, to remain competitive in the world market, productivity should be constantly rising and not merely holding even. Average labor productivity in the industrial sector shows a similar pattern; it declined sharply after 2000 and did not begin to recover until 2003. By 2004, output per worker reached $12,110 per worker, a 44 percent increase over 1996. However, the rise in average labor productivity does not point to a recovering economy when set against the nearly 24 percent fall in manufacturing employment between 2000 and 2004. It suggests that instead of a general increase in productivity that the less efficient firms were driven from the market, but that the resources freed by this lay idle and were not directed to more efficient uses.

[8] Unless otherwise noted all figures in this section come from Makhool (2006) and are based on PCBS data.

2.6. The highest level of labor productivity is in the pharmaceutical industry, which is also the most capital intensive.[9] At the other end of the spectrum is the apparel industry, which consists mostly of small enterprises assembling pre-cut fabric as sub-contractors. In the West Bank, labor productivity averaged $4,561 over the period 1996-2004. There was a steady decline from 1997 through 2003. The jump in 2004 reflects the fact that the least productive enterprises had been forced out of the market by stiff competition from imports. Both employment and the number of enterprises in the apparel sector nearly halved after 2000 and by 2004 only those enterprises that could hold their own against imports from Asia, Turkey and other low cost producers survived. The same pattern holds for the other sectors in the West Bank.[10] The footwear, structural metal and stone and marble sectors also saw a contraction in employment along with an increase in labor productivity.

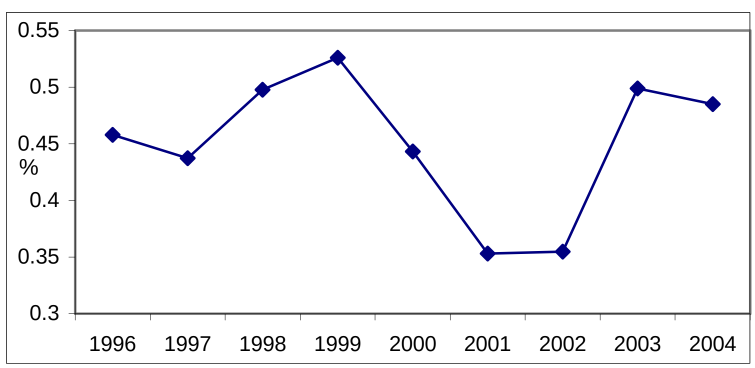
2.7. The story in Gaza is similar. Employment fell in the labor intensive sectors. Value added to output fell from nearly 46 percent in 1996 to 35 percent in 2000 and then recovered to 48.5 percent in 2004. Output per worker fell from $8,830 in 1996 to around $4,100 in 2002 before recovering to $10,000 in 2004. Wearing apparel, the largest industrial employer in Gaza, was particularly hard hit. Value added over output fell from a high of nearly 74 percent to less than 36 percent in 2004. In 1996, value added per worker was $7,890 and it fell steadily to $3,620. Employment fell in step with value added, declining from a high of over 10,000 in 2000 to only 5,000 in 2004. Other labor intensive sectors such as footwear also suffered.

Figure 2.e: Ratio of Value Added to Production in the West Bank (1996-2004)



Source: PCBS, 2006, Industrial Survey, unpublished data. Taken from Makhool (2006).

Figure 2.f: Ratio of Value Added to Production in the Gaza Strip (1996-2004)



Source: PCBS, 2006, Industrial Survey, unpublished data. Taken from Makhool (2006).

2.8. One of the important measures of competitiveness is the ratio of value added to wages. This is a proxy for unit labor costs and measures the value added obtained by one dollar in wages. Here, there is a similar pattern to labor productivity. In the West Bank there was a sharp decline in 2000-2002 followed by recovery in 2003 and 2004, though with lower overall employment. In Gaza, the recovery was smaller. Value added over wages

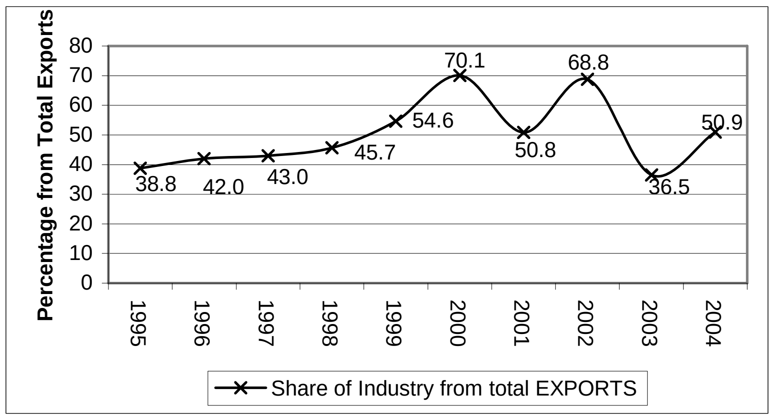
[9] See Appendix 1

[10] See Appendix 1 for productivity and employment in selected sectors.

clearly shows the lack of competitiveness of Palestinian goods, particularly in labor intensive products. Despite the recent recovery, average wage productivity in Palestinian industry is only 57 percent of Egypt's and 85 percent of Israel's.[11] At the industry level, the lack of competitiveness is even starker. Palestinian wage productivity in the food processing industry is only 66 percent Egypt's and 41 percent of Turkey's. In the wearing apparel sector, Jordan's wage productivity is triple that of WBG and Egypt and Turkey's productivity is nearly double. Given that wages account for nearly 50 percent of total costs in the Palestinian garments sector, this is an enormous obstacle to overcome. Wage productivity in the footwear sector is also much lower in WBG than in neighboring countries.

C. Exports

Figure 2.g: The Contribution of the Industrial Sector to Total Exports (1995-2004)



Source: PCBS, 2006, Statistics on Foreign Trade: goods and services 2004. From Makhool (2006).

2.9. Both the lack of competitiveness and the movement and access restrictions severely constrained Palestinian exports. Until the second *Intifadah,* industrial production accounted for a growing proportion of total exports. However, the collapse in industrial output in the first years of the decade dramatically reduced the share of industry in exports and it is only now recovering. In WBG, exports as a share of industrial production gradually increased after 1996 reaching 22 percent in 2000. But the advent of the *Intifadah* crushed exports and by 2005, they were only about 12 percent of industrial output. The majority of exports are low value added goods that require little processing. In 2005, over half of the value of exports was accounted for by stone and marble (non-metallic products) or other mining and quarrying. Other major exports were low value products such as footwear, garments, food and wood products. The composition of exports reflects WBG's very low and unsophisticated manufacturing base.[12] It also indicates the lack of participation in intra-industry or intra-product trade. The fall in the share of processed food and textile in exports and increase in the share of stone, marble and quarrying from 2000 to 2005 (Table 2.2) suggests that exports are becoming more resource based and embody even less processing than they did previously.

2.10. It is clear that low value industries such as apparel and footwear cannot provide the employment needed for the rapidly growing Palestinian economy. However, there are niches where Palestinian enterprises can be competitive. Despite shrinking in size, the percentage of output exported by the apparel sector has actually increased from 15 percent in 1996 to nearly 40 percent in 2004. This again reflects the fact that those firms that have been able to survive are relatively competitive. Since there is no longer a heavily protected local market, inefficient firms have been driven from the market and surviving firms have had to focus on product lines that are competitive. Consequently, we observe rising average productivity and increasing shares of exports. However, overall the industry is in rapid decline.

[11] Makhool (2006). Calculations based on PCBS data and UNIDO data from 2001. See Appendix 2.

[12] See the recent World Bank Country Economic Memorandum for a detailed discussion of the content of exports and imports and the implications for industrial development.

This pattern can be generalized for many sectors including footwear (tanning of leather) where employment has fallen but wage and labor efficiency have increased in the remaining enterprises.

2.11. In Gaza industrial exports generally declined after 1996. In 2000, exports surged as many small producers, especially in the apparel sector, began producing as subcontractors for Israel. However, by 2003 and 2004, Israeli closures had substantially reduced all types of exports. There is no data available for 2005 and 2006, but given the almost complete closure of Gaza in much of 2006, most industrial exports have undoubtedly ceased. In 2004, the only industrial products Gaza exported in any appreciable amount were furniture and it is unlikely that this continues today. In fact, it is reported that several Gaza entrepreneurs have shut down their Gaza operations and have shifted their investment to Egypt.

Table 2.2: Percentage of Total Exports for Remaining West Bank* and Gaza; by Selected Activity

	2000	2005
Manufacture of non-metallic products	25	46
Tanning of leather, manufacture of bags	3	11
Other mining and quarrying	1	7
Manufacture of rubber and plastics	5	7
Manufacture of furniture	7	5
Manufacture of Food and beverages	31	4
Manufacture of wood and its products	5	4
Manufacture of metal products	6	4
Manufacture of Wearing apparel	6	3
Manufacture of textiles	3	2

Source PCBS.

** Remaining West Bank and Gaza refers to data without East Jerusalem.*

D. Small Size and Lack of Learning Mechanisms

2.12. One of the most important explanations for the low productivity of Palestinian enterprises is that their extremely small size does not allow them to attain economies of scale. The average size of industrial establishments has not changed over the last decade. It is four workers in the West Bank and five in Gaza, which would be considered micro in any country. The 2004 enterprise census reported that there were only 21 industrial establishments in all of WBG with more than 100 workers. In addition to most establishments being micro, the recent World Bank enterprise survey found that the average level of capacity utilization was only about 57 percent in the West Bank and 47 percent in Gaza (Table 2.3). Micro enterprises operating at only half capacity cannot hope to be internationally competitive, especially in low value, labor intensive products.

Table 2.3: Capacity Utilization Training and Investment

	WB	GZ
Capacity Utilization (mean/median)	57/50	47/50
% of Firms Investing in 2005	50.0	25.3
% of Firms Conducting Formal Training	35	15

Source: 2006 World Bank/PCBS WBG Enterprise Survey.

2.13. In the current situation, Palestinian enterprises show little inclination to invest to increase their capabilities. The enterprise survey found that the average age of machinery in manufacturing was eleven years in the West Bank and about nine years in Gaza. Despite this, only 50 percent of the West Bank and 25 percent of the Gaza manufacturing sample invested any amount in 2005. Nor did Palestinian enterprises invest in human resources. Only 26 percent of enterprises did any employee training in the last year.

2.14. Palestinian firms do continue to innovate, though on a limited basis. Over half the sample claims to have introduced a new product in the last year (Table 2.4). However, the level of innovation is low: most of the new products were variations on what was already being produced and few enterprises introduced completely new product lines using new production techniques.

Table 2.4: Innovation Indicators for Manufacturing Enterprises

	WB	GZ	EJ
% introducing a new prod. in last year	63	49	68
% w/ foreign technology license	13	6	11
Age of Machinery (mean/median)	11/10	9.4/10	7.8/5

Source: 2006 World Bank/PCBS WBG Enterprise Survey.

2.15. Palestinian enterprises have been cut off from mechanisms for enterprise learning, which also helps explain their poor performance. A firm's performance depends upon its ability to acquire, adapt and implement new technologies. Often, new technologies are embodied in new equipment but in other cases it comes in the form of new production and management methods. Both research and experience have shown that among the most important learning mechanisms are firms' interactions with foreign customers, foreign direct investment, consultants, technology licenses and work experience with international companies; all of which are generally absent from the Palestinian market. There is effectively no foreign direct investment, except in the form of local Palestinians with foreign passports. Most exporters sell through Israeli middlemen so they do not get the benefit of close interaction with international firms. Travel for Palestinians is difficult, restricting the opportunity to work abroad. In addition, often international firms will not allow their consultants to travel to the WBG because of security concerns and insurance costs.

2.16. Many Palestinian entrepreneurs obtained their initial experience working in Israeli companies inside Israel and most skilled workers developed their skills in the same way. This is especially true in the furniture and garments industry. However, with the decline of Palestinians working in Israel, this last remaining source of enterprise learning is being cut off. The lack of effective learning mechanisms is getting worse, just at the time when Palestinian firms are under intense pressure to increase their capabilities to survive.

2.17. Palestinian industry has been buffeted by both the burden of the Israeli closure policies and the changing world economy. It originally developed to provide low value labor intensive or resource intensive goods to complement Israeli industry. However, they can no longer depend on a protected Israeli and domestic economy and must attempt to raise productivity and enter new markets. But attempts to do this are limited by their small size, the lack of enterprise learning mechanisms and most importantly by the lack of free movement and access to markets.

CHAPTER 3: MOVEMENT, ACCESS AND MARKETS

A. Movement and Access

3.1. The biggest challenge facing Palestinian businesses is the closure regime imposed on the WBG by the Government of Israel for security reasons.[13] The system of closures necessitated by Israeli's security requirements affects Palestinian businesses by significantly increasing costs, creating unpredictability in both international and domestic trade flows and shrinking available markets. The system of movement restrictions makes the transport of goods increasingly expensive, not only to markets in Israel and abroad but even to the domestic WBG market. Restrictions that bar Palestinians from major roadways and transit routes within the West Bank, non-transparent permit systems, the construction of the separation barrier, and formal and informal procedures which act as barriers to commerce between Gaza and the West Bank, have made domestic commerce, outside of a business' municipal area, unpredictable, expensive and inefficient. In terms of imports and exports, the difficulties faced by Palestinians in clearing their goods through Israeli ports and through Israeli controlled border crossings, and the requirement to use Israeli trucks to carry goods from WBG through Israel, force Palestinian businesses to rely on Israeli middlemen and shuts off direct access to third country markets. These complex, costly, and unreliable trade logistics prevent Palestinian firms from growing to an efficient scale and make Palestinian goods increasingly uncompetitive in the global trading system that demands on time and dependable delivery.

3.2. Most Palestinian enterprises currently find it difficult to compete on the world market because of their low productivity. Managers are well aware of their deficiencies and have access to the financial resources necessary to upgrade their capabilities. But, they are unwilling to make the investments required to raise productivity, lower costs and improve quality because they are not confident that they will be able to access markets. As long as this high level of uncertainty persists, there will be little new investment in productive enterprises and there will be little growth.

3.3. Since the Oslo Accords, both settlement activity and violence have been steadily increasing and Israeli authorities have responded with a policy of increased closures. This policy, which broadly consists of comprehensive restrictions on the movement of people and goods within the West Bank, highly constricted movement of goods across the border with Israel, and a near total separation of economic and social interaction between Gaza and the West Bank, has resulted in a highly fragmented Palestinian economy.

3.4. Major factors affecting businesses include:

- Loss of the East Jerusalem market for most Palestinian producers in the West Bank and Gaza. East Jerusalem has been an integral part of the Palestinian market and business community. With the creation of the separation barrier and a system of permits and travel restrictions, it has become increasingly separate from the WBG economy. Palestinians from WBG are heavily restricted from entering East Jerusalem and producers must have Israeli certifications. A number of

[13] The impact of movement restrictions on Palestinian economic prospects has been singled out repeatedly in World Bank reports: as the World Bank's December 2004 report states, "Economic recovery depends above all on a comprehensive Israeli approach to lifting closure"[13]. Since the beginning of the second *intifadah* physical and procedural movement restrictions have greatly intensified in the West Bank. After a period of relaxation in 2004-5, the system has been tightened again, as described in this report. The impact of these restrictions has been to compress the socio-economic space in the West Bank: as OCHA maps have illustrated, closure effectively partitions the West Bank into a northern, a central and a southern economic zone, bounded on three sides by the Separation Barrier and to the east by a Jordan Valley that is increasingly difficult for Palestinians to access..

Palestinian enterprises that previously had permission to sell in Jerusalem report that they no longer have access.

- Almost all cargo flows between Gaza and the rest of the world (including the West Bank and Israel) must be channeled through the Karni crossing point. Karni has been closed for the majority of 2006. While the Agreement on Movement and Access (AMA) calls for the number of daily export trucks from Gaza to have reached 150 a day by January 2006 and 400 a day by end 2006, on average some 20 trucks a day crossed in 2006. The average of 42 a day, which was reached in January 2007 was the highest reached in 12 months.

- The separation barrier has cut off nearly 10 percent of West Bank territory and has made informal sales to Israel increasingly difficult. The World Bank estimates that the separation barrier will cost the Palestinian economy two to three percentage points of GDP per annum.[14] Internal barriers and check points increasingly segment the West Bank, making it difficult for Palestinians to move between the North, Central and Southern areas of the West Bank. In many cases Palestinians need permits to move between cities in the West Bank. There are now over 500 checkpoints or obstacles to movement in the West Bank and Palestinians are partially or wholly restricted from nearly 1,200 kilometers of roads in the West Bank.[15]

- The loss of access to the Jordan Valley for most Palestinians. In early 2006, Israeli authorities issued regulations requiring Palestinians who are not residents of the Jordan Valley to obtain special access permits, which are rarely forthcoming, even for investors or Palestinians who own land in the Jordan Valley. This has effectively cutoff an important agricultural and tourist area from the rest of the West Bank.

- Israel does not issue residence permits to people without an Israeli ID card and has made it increasingly difficult for people of Palestinian descent to obtain tourist visas.[16] This has forced many of the most important investors out of the WBG and prevents Palestinian firms from obtaining needed technical expertise.

3.5. The Government of Israel has cited security concerns for the frequent closures of Karni. Without challenging this assertion, much of Karni's inadequacy derives from poor management. When it is open, it operates haphazardly with changeable opening hours, inefficient and unpredictable screening procedures, and disregard for internationally accepted procedures for the secure handling of goods. Since Karni is the only outlet for the passage of goods for a population of 1.5 million people of Gaza, it has unsurprisingly attracted large scale corruption, with payments on the Israeli side of the border running purportedly on the order of $2,000-$6,000 for the movement of a single truck. There is also corruption on the Palestinian side, as shippers pay to have their trucks moved up in the cue.[17] Israel has worked to keep the crossing open for the importation of foods and medicines for the Gazan population, which has been essential in avoiding a humanitarian crisis. However, this is not sufficient for any type of economic recovery. With the ability to guarantee delivery dates, a vital part of securing export markets, speed and reliability are mandatory, particularly for agricultural products. As it stands, today's regime is an overwhelming obstacle to investment and growth in Gaza.

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[14] IBID.

[15] OCHA, Implementation of the Agreement on Movement and Access, various reports. See OCHA website http://www.ochaopt.org/.

[16] The new visa policy has led to an official protest by the US government over discrimination against US citizens of Palestinian descent.

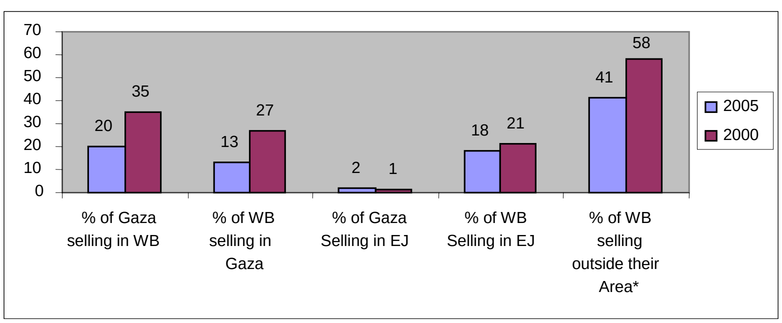
[17] World bank interviews with Palestinian shippers and the Palestinian Shippers Council.

3.6. It appears that border facilities are not the significant bottleneck for West Bank trade. Terminals on the West Bank, although relying on back-to-back facilities, function considerably better than at Karni. For the time being, most West Bank producers rely on trucks with Israeli license plates and other means to transport cargo that increases costs but allows them to avoid the terminals. However, as the separation barrier and settlements continue to close off the West Bank, Palestinians will be forced to use the terminals and it is probable that there will be problems similar to those at Karni. West Bank producers, however, face significant difficulties in reaching customers in Gaza, (where procedures at Karni discriminate against cargoes arriving from the West Bank although these cargoes are carried in Israeli trucks and can move without restriction in Israel) and in moving goods within the West Bank en route to the border.

3.7. There are two principle reasons for this—the confiscation of West Bank land for settlements and their related infrastructure, and the comprehensive system of internal movement restrictions, which are also closely related to preserving the security and access of settlers. Restrictions on the movement of people and goods within the West Bank were intensified during the *Intifadah* and the concomitant attacks on settlers in the West Bank and civilians in Israel. After a considerable reduction in numbers in 2004-5, there are now more than 540 checkpoints and fixed impediments compared to 376 in August 2005. The combined impact of these impediments, coupled with complex permit restrictions, has been a fragmentation of the socio-economic space in the West Bank into a northern, a central and a southern economic zone, bounded on three sides by the separation barrier and to the west by a Jordan Valley, a significant agricultural area, that is increasingly difficult for Palestinians to access.

3.8. The closures and movement restrictions have forced Palestinian enterprises into ever smaller markets. The survey reveals a large drop in the percentage of establishments in Gaza and the West Bank selling into the other region. It also shows a smaller, but important decline in the percentage of establishments in the West Bank making a significant amount of their sales in another region of the West Bank; for example the percentage of firms in the North selling to the south or the central area (Figure 3.a). This data reflects the experience of fiscal year 2005 and since settlements and movement restrictions have been steadily increasing, the rate of decline in out of region sales has probably intensified. Palestinian firms are already struggling to maintain full capacity utilization and reach the minimum efficient size.

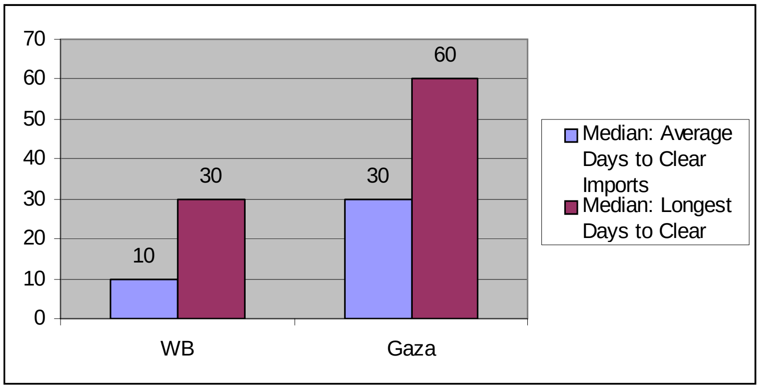
Figure 3.a: Percentage of Sample Selling Out of Their Region



*% of WB enterprises selling more than 25% out of their area
Source: 2006 World Bank/PCBS WBG Enterprise Survey.

3.9. Palestinian producers must produce high value products to compensate for their high costs, but theses markets demand quick turn around and just-in-time delivery. However, the current closure regime prevents Palestinian firms from adhering to delivery schedules and effectively excludes most of them from entering the export market or from moving into the production of high value added products. The uncertainty faced by the Palestinian producers is illustrated by the survey responses when managers were asked what the average was and the longest time it took to clear Israeli customs in the last year.[18] The median of the longest time is nearly triple the median of the average number of days for the West Bank and nearly double for Gaza. On average it took most firms in the West Bank about 10 days to clear customs, however, it could take as long as 30 days. Consequently, firms can never know how long it will take to import necessary raw materials or to clear exports. This uncertainty is reflected by the high stocks enterprises keep of imported inputs. Companies that rely on imported inputs keep on average nearly 73 days of inputs on hand while those that rely on local material for their key inputs keep less than 18 days. One major garments firm reports turning down a large and lucrative export contract simply because it could not guarantee delivery on a certain date. Thus it lost a rare chance to break into a new market.

Figure 3.b: Average and Longest Days to Clear Israeli Customs



Source 2006 World Bank/PCBS WBG Enterprise Survey

3.10. The closure regime directly increases the already high cost of doing business in WBG. For example, one olive oil exporter estimates that the cost of moving his product to the port accounts for nearly 20 percent of the total cost of shipping a container to Europe[19] and a food manufacturer in Nablus reports that the cost of sending a truck from Nablus to Ramallah has increased nearly fourfold since 2002. At times, the restrictions are so severe that it is less expensive to import goods from Israel than to try and ship them from within the West Bank. The security and movement restrictions dominate all aspects of doing business. They raise costs in a myriad of ways including:

- Israeli and many international technicians cannot come into WBG to service or test machines. Palestinian establishments must have duplicate machines or shut down while they send equipment to Israel for servicing.

- Palestinian businessmen must travel out through Jordan which adds to the cost and uncertainty of business travel.

- The cost of shipping a container through the Haifa port is about 18 percent higher for Palestinian than Israeli shippers.[20]

- Because of the difficulty and cost of importing, most Palestinian producers buy inputs from Israeli suppliers. Informal interviews with various Palestinian producers suggest that this adds anywhere any where from 15-25 percent to the world price, depending on the type of goods.

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[18] This is only Israeli customs and does not include security checks at the crossing points into Gaza or the West Bank.
[19] World Bank (2006b).
[20] World Bank Country Economic Memorandum

3.11. Israel maintains strict control over the population registry, which is used to determine residency. If a Palestinian wants to officially change residency he/she must receive permission from the Israeli authorities. While it is possible at times to move among West Bank cities, it is essentially impossible to move between West Bank and Gaza. Israel tightly restricts residency in Jerusalem and if the authorities decide a Palestinian has moved the center of his life away from Jerusalem they will strip him of his Jerusalem residency. Control of the population registry has serious consequences for education, work and investment. Palestinians cannot move to obtain a better job, pursue an education or invest in another area. Palestinians who leave and do not return regularly to renew their ID cards risk losing their residency status. Consequently, many Palestinians are reluctant to travel abroad to obtain education, training or work experience that would help Palestinian firms when they return.

Table 3.1: Days of Inventory of Most Important Input on Hand*

	West Bank	Gaza	East Jerusalem
Days of inventory on hand (mean/median)	40.3/30	39.3/30	30.3/4.5
Days of inventory on hand/use only domestic inputs (mean/median)	17.6/14	31/15	11/7
Days of inventory on hand/ use 3d country inputs (mean/median)	72.5/45	62.1/45	54.5/22

The question asks: Thinking about your current experience, at the time this establishment receives delivery of its most important input, how many days of stock, measured as days of production, is available.
Source: 2006 World Bank/PCBS WBG Enterprise Survey.

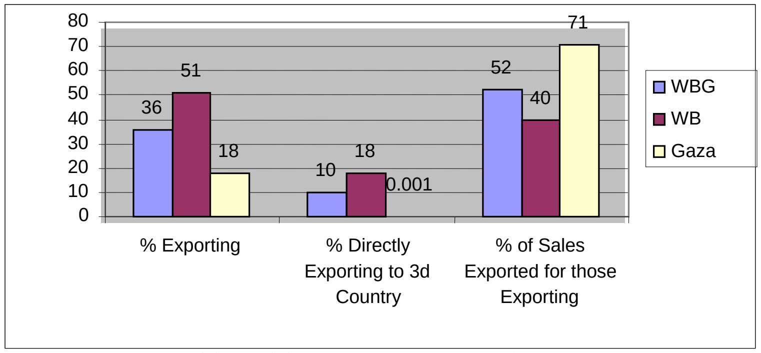
3.12. There is no database on foreign direct investment, but almost all foreign investment in WBG that the Investment Climate Assessment researchers could locate came from expatriate Palestinians. Israel does not allow residency for anyone who does not posses an Israeli Identity Card, however in the past many investors were let in on tourist visas that they had to renew every 90 days. Recently, Israel has declined to allow many foreign passport holders of Palestinian descent to renew their tourist visas, even if they are married and well established in WBG. This has forced many investors to leave the country and further discouraged new investment. Israeli authorities say these decisions are made on an individual basis and only those who are security threats are forced to leave. However, it appears to be arbitrarily enforced adding another dimension of uncertainty for potential investors. It is also difficult for residents of Arab countries—the most natural foreign investors or trading partners—to get visas to enter Israel. Most Arab countries forbid their citizens to travel to Israel and citizens from countries that do recognize Israel, often find it hard to get Israeli visas. The inability for foreign passport holders to enter the WBG is one of the leading constraints on investment and performance of Palestinian enterprises.

B. Market Access

The Israeli Market

3.13. In the medium term, expanding penetration of the Israeli market is the Palestinian private sectors' best chance for growth. Israel is a high income economy that dwarfs the Palestinian economy and as such offers an enormous potential market. The WBG is in a quasi-customs union with Israel and in theory should have open access to exploit its lower labor costs. However, relatively few Palestinian enterprises are able to directly access the Israeli market. In the survey sample, less than a third of the manufacturing sample exported to Israel and these were predominantly in the West Bank.[21]

Figure 3.c: Percentage of Sample Exporting to Israel and 3rd Countries



Source: 2006 World Bank/PCBS WBG Enterprise Survey.

3.14. Access to the Israeli market is restricted in a number of ways. The closures and movement restrictions are the main factors. They both reduce competitiveness of Palestinian products and physically prevent movement into Israel. But there are a number of other factors that act as non-tariff barriers. Palestinian exports must meet the same labeling, certification and standards as Israeli products, which is often extremely difficult. Few of the establishments in the survey had a Kosher certification or Teken, the Israeli Standards Bureau certification for quality and manufacturing. Though, the Paris Protocol calls for Israel to recognize certifications from the Palestinian Standards Institution, these sometimes do not match Israeli standards and consequently Israel does not accept PSI certifications. At the same time, for security reasons, Israel will not send personnel into the Palestinian areas to test and certify Palestinian products. Israel also will often not accept Palestinian products for testing in Israel. Hence, Palestinian products are kept out of the Israeli market for failure to adhere to Israeli standards. For example, Palestinian pharmaceuticals cannot be legally sold to Palestinian hospitals in East Jerusalem though they meet international standards and can be exported.

3.15. Industries that do not require health and safety certifications find it easier to enter the Israeli market. Products such as garments, wood furniture, stone and marble, metal frames for construction and leather have difficulty but are able to enter. Many of these firms began as subcontractors to Israeli firms and they are also industries where there are few Israeli producers to compete with. Food products, pharmaceuticals, IT and other industries, which compete with established Israeli producers, are almost completely shut off from direct access to the Israeli market.

Table 3.2: Percentage of Manufacturing Sample with Israeli Certifications

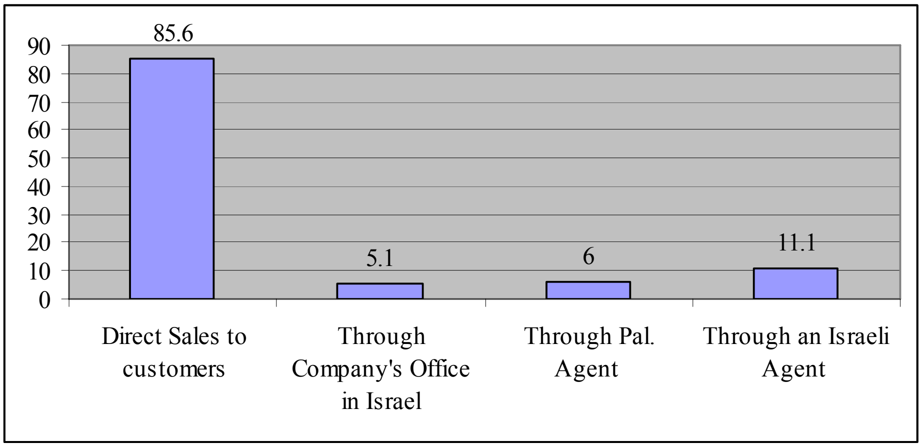
	West Bank	Gaza	East Jerusalem
% w/Teken Certificate	19	10	16
% w/Kosher	1	2	0

Source: 2006 World Bank/PCBS WBG Enterprise Survey.

3.16. Because Palestinians cannot enter Israel without a special permit they are dependent on Israeli buyers to come to them. Few Palestinian firms have marketing agents or offices in Israel to develop contacts and identify buyers. Most sales are made directly to individual Israeli buyers and usually Palestinian producers have only one or two contacts, making them highly vulnerable to the demands of their regular customers. Though it is right next door, the Israeli market is a mystery to most Palestinian firms, especially those in Gaza, where movement is even more restricted.

[21] This is proportion is out of establishments that could export. For example hotels, construction companies and some other services are not in the base.

Figure 3.d: Percentage of Palestinian Firms Saying That a Method is used to Sell in Israel



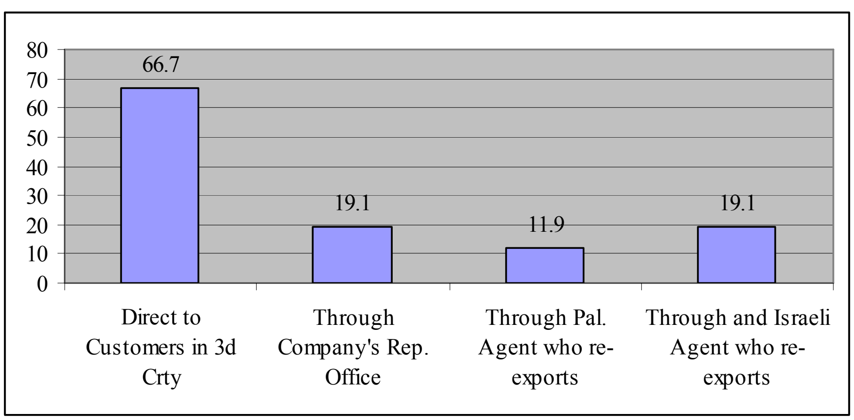
Source: 2006 World Bank/PCBS WBG Enterprise Survey.

The World Market

3.17. Less than 10 percent of the manufacturing and IT sample sells directly to the international market. Many more establishments sell indirectly, by supplying Israeli companies that then re-export the Palestinian goods. How many enterprises are in this situation is unclear because often Palestinian companies are not aware of the final destination of their goods. In developing an export market the Israeli closures and movement restrictions again play a pivotal role. The unpredictability of the closures means that Palestinian exporters cannot commit to delivery dates. Consequently, they rely on Israeli distributors, who are better able to get products out and will absorb the risk of not meeting scheduled delivery times. In addition, it is difficult and expensive for Palestinian businessmen to travel abroad to make market contacts.

3.18. Because Palestinians have been relying on Israelis to access the world market, they have not developed the required market contacts of knowledge. The distribution system is underdeveloped and most of those who do export directly do not use distributors but sell directly to foreign customers. Few Palestinian companies have offices abroad or work through Palestinian distributors. Less than 20 percent of exporters in the sample used Israeli distributors (Figure 3.e). But as noted above, many Palestinian producers have no idea of what happens to their products or where they end up once they are sold to an Israeli company. For example one Palestinian stone and marble company recounted discovering its

Figure 3.e: Percentage of Palestinian Firms Saying That a Method is used to Sell in 3rd Countries



Source: 2006 World Bank/PCBS WBG Enterprise Survey.

products being sold at a trade show in Europe under the label of an Israeli company. The producing company had no idea it was being re-exported or was being labeled as Israeli made.

3.19. It is essential that Palestinian producers begin to develop their own market contacts. As Israel moves more toward separation, Palestinians will have less access to the Israeli market and expertise. In addition, relying on Israeli middlemen and managers drives up the cost of Palestinian products, which are already at a cost disadvantage. In the garments industry producers estimate that experienced mid-level managers in Israel are paid more than three times similar Palestinian managers. This is enough to make the difference between being internationally competitive and not.

Table 3.3: Percentage of Manufacturing Sample with Internationally Recognized Quality Standard Certifications

West Bank	Gaza	East Jerusalem
18	19	5

Source: 2006 World Bank/PCBS WBG Enterprise Survey.

3.20. To expand their foothold in the international market, Palestinian exporters will have to move away from low cost labor intensive manufactured goods toward higher value added goods and services. They have to create a "made in Palestine" brand name with a reputation for consistent quality that will compensate for the higher costs. This requires investing in newer technology and better management practices. Firms report that most of the consultants and expertise they need to upgrade are available in WBG or can be easily obtained. For example, one food producer is pursuing ISO 2200 in hopes of exporting to third countries. But most enterprises do not see an opportunity to export under the current situation and thus see no reason to make the investment. The survey results verify this. Few exporters reported that meeting standards or specifications was a major or severe impediment to increasing exports (Table 3.4).

Table 3.4: Percentage of Exporting Establishments Reporting an Obstacle as Major or Severe

	WB	GZ
Movement and access for raw materials	51.6	83.3
Movement and access for export goods	50	80.6
Production capacity to meet order quantities and delivery dates	40.6	36.1
Difficulty attaining visa and entry issues	33	50
Lack of export financing	31.6	25
Import regulations and non-tariff barriers in the export markets	29.7	38.2
Information and contacts in external markets	23.9	31.4
Price competitiveness in export markets	14.6	13.9
Meeting export market packaging specifications and requirements	9.6	5.7
Meeting export market product specifications and requirements	8.2	8.3

Source: 2006 World Bank/PCBS WBG Enterprise Survey.

CHAPTER 4: THE INVESTMENT CLIMATE

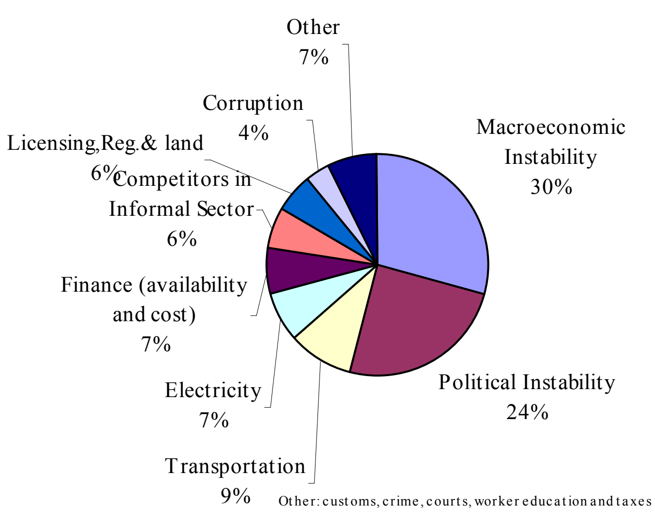
A. Major Constraints

4.1. A country's international competitiveness is directly related to its investment climate. Countries with business environments that enable investment and encourage innovation have the highest levels of productivity and as a result, the highest levels of income. Consequently, both government and the private sector must monitor the investment climate and continuously strive to make improvements that will help maintain competitiveness and increase growth.

4.2. Access to finance, infrastructure, corruption and government efficiency are all important aspects of the investment climate. But both experience and research has shown that the level of competitive pressure is the single most important factor in determining productivity. In highly competitive, open economies firms are under constant pressure to innovate and increase productivity or be driven from the market. In contrast, heavily protected economies—where low productivity firms are allowed to survive—display both low levels of overall productivity and per-capita incomes.[22]

4.3. The WBG economy is one of the world's most open. It is completely open to the much larger Israeli economy, which itself is one of the world's most open and most productive. The small family owned Palestinian enterprises must compete with imports from all over the world including from some of the most productive and lowest cost producers. The fact that they are able to survive and some even export indicates the potential for Palestinian enterprises to be competitive under the right conditions. As discussed below, by most measures, the Palestinian investment climate is relatively good and in many ways superior to other economies in the region. Yet, despite being in a highly competitive market with a relatively strong investment climate, Palestinian enterprises are struggling to survive and display low levels of productivity, which speaks to the special circumstances of the occupation.

Figure 4.a: Constraints to Doing Business (From Ranking of 3 Top Business Problems)



Source: 2006 World Bank/PCBS WBG Enterprise Survey.

[22] See Palmade (2005) for a good discussion of the importance of competition and other sources.

4.4. The Investment Climate Enterprise Survey revealed that the most important constraints to doing business in the Palestinian territories are the uncertainty linked to the political environment. The survey asked managers their three biggest problems and Figure 4.a shows the results for an index that was constructed by weighting the problems identified by managers.[23] The index is independent of sample size and rises in proportion to the percent of firms that report problems within a category. It can be interpreted as the intensity-weighted percent of firms that reported problems within each category.[24]

4.5. The results of the survey clearly show that managers perceive the unstable political environment and the resulting economic instability as the biggest constraints to doing business. Other issues pale in comparison. The options that managers were given are standard throughout the world and the special circumstances of WBG had to be fit into fixed categories. Consequently, movement, violence and other political issues were subsumed into the categories of political and economic instability. The next most important problems are transportation, electricity and finance. However, using this system of weighting they are relatively less important. Corruption, courts and unavailability of skilled labor almost do not appear among the three biggest problems. These results are similar to the Governance and Business Environment Survey conducted in the West Bank and Gaza in 2001, which also showed instability as the major constraint. Overall, except for the issues related to the closures and violence, the Palestinian investment climate is strong relative to other countries in the region, though many areas still need substantial improvement.

B. Finance

4.6. Access to finance does not appear to be a serious constraint to formal Palestinian businesses and most enterprises are able to obtain the financing they need for current operations. It must be noted that the survey covered only formal business and most of them are much larger than the average enterprise[25]. Around 37 percent of enterprises in the survey said that access to finance was a major or severe problem, which places it well behind other constraints such as political and economic uncertainty or electricity supply. The banking sector is relatively well developed. There are 22 private banks, 12 of which are foreign owned. They operate throughout the West Bank and Gaza and all but the very smallest enterprises in the survey had bank accounts. The banks are highly liquid and provide a number of products ranging from deposits to trade finance and mortgages.

4.7. Equity finance is negligible. There are only 27 companies listed on the Palestinian Securities Exchange based in Nablus and few of the surveyed firms funded new investment with equity. Other forms of finance such as leasing and factoring are only now emerging. There is no legislation that covers leasing. Consequently, only a few companies are issuing operating leases, but they provide a negligible amount of enterprises' financing requirements. The Capital Markets Authority, which is supposed to regulate non-bank sources of credit, has recently begun to design the regulatory framework for

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[23] $$index = \frac{100}{Samplesize} * \left[\frac{3}{6} * \frac{\#\ firms}{greatestproblem} + \frac{2}{6} * \frac{\#\ firms}{secondproblem} + \frac{1}{6} * \frac{\#\ firms}{thirdproblem} \right]$$

The overall rankings do not change when firm responses are not weighted.

[24] An index of 31.4 for finance can arise if 31.4 percent of the sampled firms identified government as their biggest problem, 31.4 percent firms identified finance as their second biggest problem and 31.4 percent identified finance as their third biggest problem. The same index could also result if 35 percent (an additional 3.6 percent) of firms indicated that finance is the biggest problem and 3.6 percent fewer firms indicated that finance is their second and third biggest problems.

[25] The sampling cutoff size was 6 workers though a few smaller firms did end up in the sample. The average size of enterprises in WBG is four and most are in the informal sector and in retail, neither of which were covered by the survey. A recent unpublished survey of all enterprises, including very small retailer, by the Palestinian Economic Research Institute MAS found that nearly 40 percent of the surveyed enterprises had been refused loans for lack of collateral.

developing different forms of finance, including leasing, mortgage finance and micro-finance institutions. Despite the lack of a regulatory framework, there are a number of micro-finance institutions making loans at the low end of the spectrum. But, with only around 30,000 active borrowers they only meet about 13 percent of estimated demand.[26] None of them are self sustaining and repayment rates are declining. Consequently, most micro-finance institutions are no longer recruiting new clients and are depleting their capital to cover operating costs.

Table4.1: Financial Indicators

% With a Bank Account	88
% With Loan or Over Draft	38
Avg. and Median Collateral as % of Loan	158/100
Median Term	2 years
Median Collateral Level	100%
% Using Movable Assets as Collateral	37

Source: 2006 World Bank/PCBS WBG Enterprise Survey.

4.8. Despite the liquid banking system, only about 18 percent of the survey sample reported having a loan and the majority of investment and working capital is financed through retained earnings. This pattern holds true for all classes of enterprises, both manufacturing and services, small and large and those in the WB and Gaza. Less than 15 percent of the sample can be considered financially constrained. Most enterprises do not have bank credit because they do not need it at the current interest rates or they do not borrow for religious reasons. Only a few firms were rejected for loans or said they did not apply because they feared rejection, collateral requirements were too high or the process was too difficult.

4.9. The median level of collateral for outstanding loans is 100 percent, not particularly high by standards in developing countries. In many countries, lenders only accept land and buildings as collateral. But in WBG, despite the fact that the secured transaction law has not yet been passed, some lenders appear willing to accept movable assets such as machinery and accounts receivable as collateral. In the survey, over a third of the loans were secured at least partially with movable assets. This signals that while they may not be the most efficient, the property registration and legal enforcement systems are functional.

4.10. It appears that most formal Palestinian businesses are able to access the financing they need. Establishing a credit bureau, strengthening property registries and introducing new forms of lending as suggested in previous studies would certainly help, but such measures are not likely to significantly increase borrowing and investment under present circumstances.[27] The fact that very few businesses have loans reflects not the lack of available funds or a weak financial system, but rather the lack of investment opportunities for Palestinian enterprises. Most are operating at low capacity and because of the closures are steadily losing markets. Thus, they have little need to invest and are able to fund their operations out of retained earnings.

Table 4.2: Sources of Funding for Fixed Assets: Average

a. Internal funds/Retained earnings	90.4%
b. Issued new equity shares	0.53%
c. Issued new debt (including commercial paper and debentures)	0%
d. Borrowed from private commercial banks	5.6%
e. Borrowed from state-owned banks and/or government agency	0%
f. Borrowed from family/friends	0.5%
g. Borrowed from non-bank financial institutions	0.56%
h. Purchases on credit from suppliers and advances from customers	1.7%
i. Borrowed from informal sources (e.g., moneylenders)	0.12%
j. Other	.62

Source: 2006 World Bank/PCBS WBG Enterprise Survey.

[26] Conversation with Palnet managers, March 2007.
[27] World Bank Country Economic Memorandum.

Table 4.3: Percentage of Firms Financially Constrained: By Size Category

Size Category	Total Sample	Less than 20	20-99	100 or More
Percent Constrained*	14.5	16.1	12	9.5

*Constrained firms are those that were rejected for a loan, did not apply because they feared rejection, thought collateral requirements were too high or the procedures we re too complex.
Source: 2006 World Bank/PCBS WBG Enterprise Survey.

Table 4.4: Main Reason for not Applying for a Loan

	% of Responses
No need for a loan - establishment has sufficient capital	68.5
Application procedures for loans or line of credit are complex	9.2
Interest rates are not favorable	6.5
Collateral requirements for loans or line of credit are unattainable	1.2
Size of loan and maturity are insufficient	0.3
Did not think it would be approved	1.8
Religious Reasons	12.5

Source: 2006 World Bank/PCBS WBG Enterprise Survey.

C. Corruption and Bureaucracy

4.11. Some observers have suggested that corruption, nepotism and political cronyism in the PA are the major cause of WBG's poor economic performance. A 2005 survey by Transparency International ranked Palestine 107th out of 159 countries on the perception of corruption and many newspaper articles and other sources suggest that the Hamas electoral victory was a backlash against corruption among the Fatah leadership. The main issues with corruption are intervention, or *Wasta*, and nepotism. A 2004 survey by the Coalition for Accountability and Integrity in Palestine found that 52 percent of citizens believe that *Wasta* is the most blatant form of corruption, while less than 8 percent believed personal use of public resources by government officials was a problem. Clearly, nepotism, favoritism and intervention remain a large problem for Palestinian society and affect economic performance. However, the ICA is not designed to measure corruption in society at large, but narrowly focuses on the effects on individual businesses.

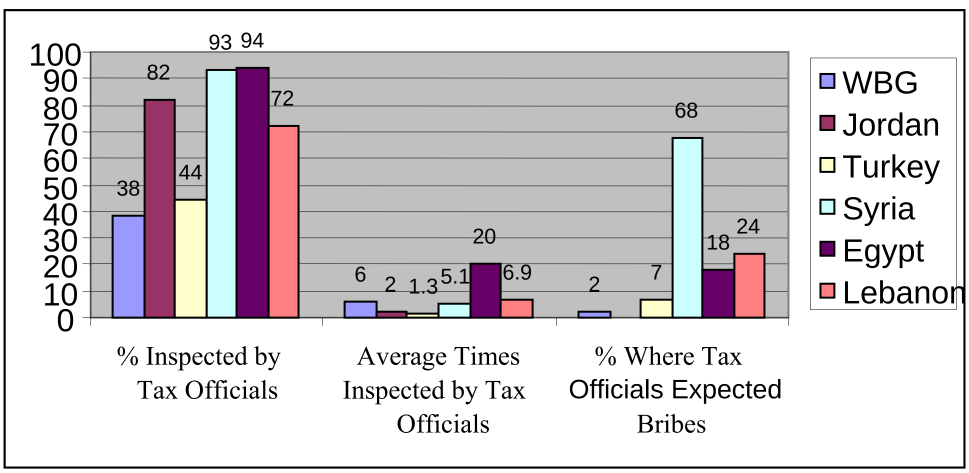
4.12. Both the survey and interviews with businessmen clearly indicate that corruption is not a major impediment to Palestinian enterprises. In the enterprise survey, it does not appear often among the managers' top three problems and few institutions or business associations list fighting corruption as an important part of their program. In addition, objective measures from the survey indicate that corruption levels are lower in Palestine than elsewhere in the region. The ICA cannot be a comprehensive review of corruption and only focuses on the enterprise level effects. But, the analysis here reveals, that while, there may be corruption at the highest levels, it does not seem to affect the average businessman. This is similar to the results reported in a 2001 survey and in the World Bank's 2004 Country Procurement Assessment Report, both of which found that there was little petty corruption and that corruption was not a major business constraint.

4.13. Unlike in many developing countries, public servants do not appear to use their offices for rent seeking purposes and seem dedicated to providing needed services. The survey reveals that they rarely demand bribes and do not impose unnecessary regulatory requirements on businesses. The PA is a new bureaucracy, with no legacy of central planning or state control and while there is corruption in any government, the PA appears to be developing relatively honest and transparent services. However, it is also reported that the recent cut-off in direct aid and resulting failure to pay government salaries, long running strike of public employees and break down in regular processes has led to an increase in bribery and petty corruption. The PA is in its formative stage and there is a real danger that these developments will undo the previous progress and lead to a dishonest system that could plague the private sector for years to come.

4.14. The main business concerns about corruption involve the PA's direct involvement in commercial activities (for example, fuel and previously cement, cigarettes), how government positions are filled and the close personal ties between large businesses and government officials. In addition, there is concern about the growth of unregulated monopolies; many observers fear the powerful business groups are using the current period of crisis to increase there power and squeeze out competition. For example, there are no longer any independent internet service providers and PalTel, the telecoms monopoly, is now bundling landline, cell phone, and internet service with hardware. There are no laws or regulations to prevent such a build-up of market power; neither is there any authority to oversee groups who obtain substantial market power. While a number of draft laws and regulations were passed prior to the 2006 election, they have not been implemented and work in this area appears to have stopped in the current crisis.[28]

4.15. The survey results show that compared to other countries in the region, Palestinian businessmen spend little time dealing with government regulations (Figure 4.d). They are not subject to excessive inspections and when they are inspected, they are rarely asked for bribes. Figure 4.b shows the results for inspections by tax officials but the results are similar for other government agencies. The survey also reveals that few businesses were asked for bribes to connect utilities.

Figure 4.b: Tax Inspections

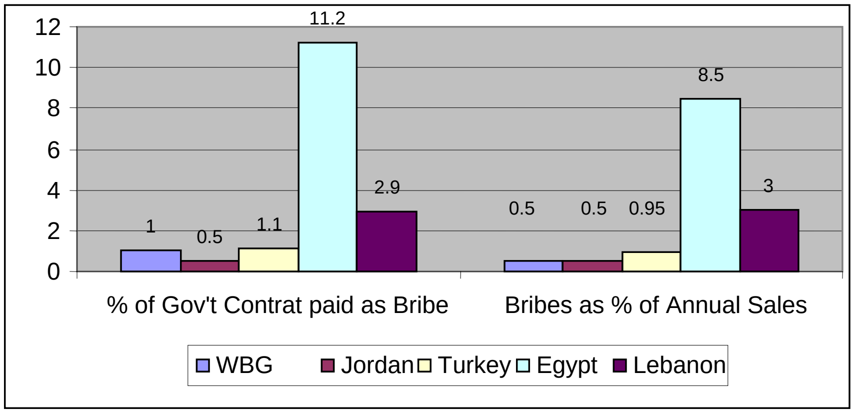


Source: World Bank Enterprise Survey Data.

[28] It is reported that the Ministry of National Economy is working on a new competition law and that there is ongoing work on telecoms regulation. However, the PLC is not passing legislation and if such efforts are taking place they are not widely known.

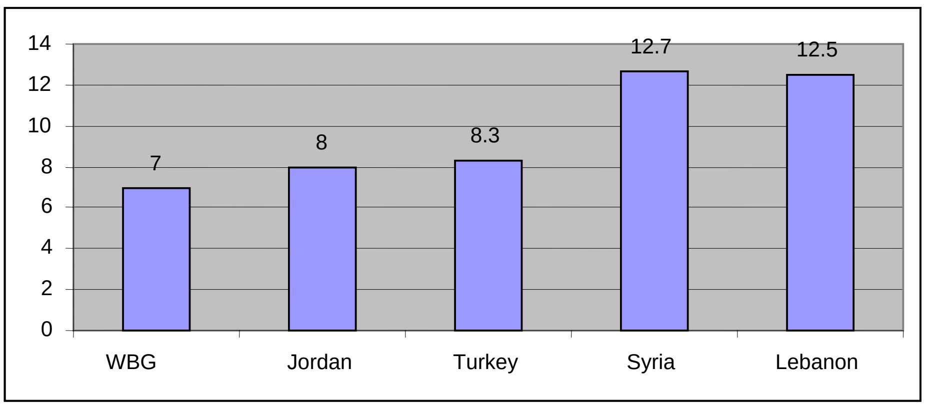
4.16. The average amount of sales spent on bribes is less than one percent; significantly lower than in neighboring countries (Figure 4.c). Likewise, the average bribe required to obtain government contracts is lower. Government agencies also seem to be fairly efficient as evidenced by the short period of time most firms wait to obtain operating licenses (Figure 4.e).

Figure 4.c: Bribes



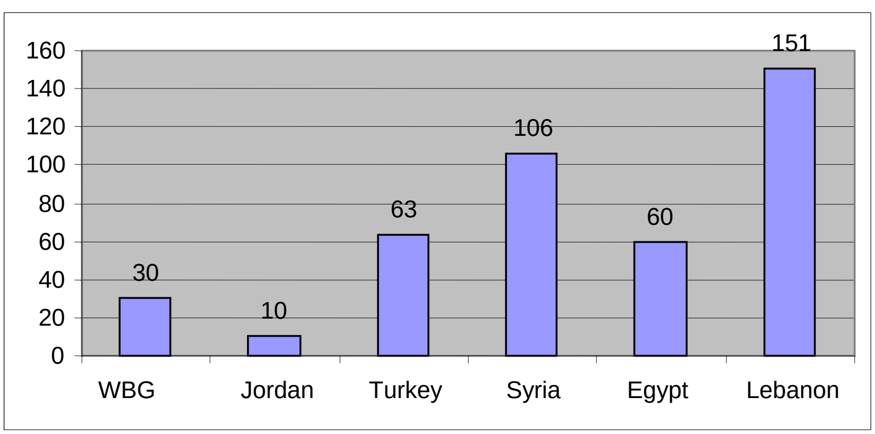
Source: World Bank Enterprise Survey Data.

Figure 4.d: Percentage of Senior Managers' Time Dealing with Government Regulations



Source: World Bank Enterprise Survey Data.

Figure 4.e: Average Days Waiting to Receive Operating License

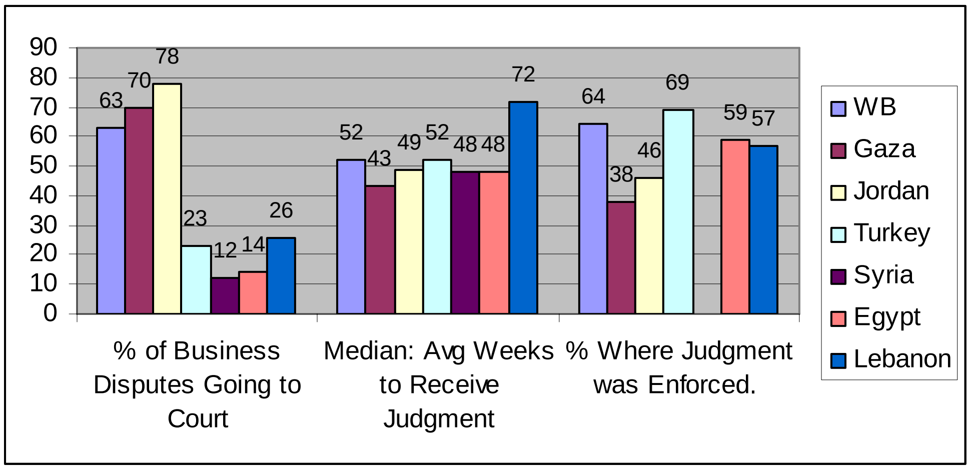


Source: World Bank Enterprise Survey Data.

D. Courts and Crime

4.17. Most businessmen in WBG have long established relationships and disputes are generally settled informally. Consequently, the survey does not find that the nascent judicial system is an impediment to the private sector. The survey suggests that the Palestinian judicial system functions as well or better than the regional norm. Most business disputes go to court and judgment is rendered in about the same time as in other countries in the region (Figure 4.f). This is contrary to expectations based upon anecdotal information and informal interviews with business associations and other local experts who argue that courts do not adequately enforce laws. The lack of enforcement of judicial rulings is constant complaint from many legal experts and big businessmen. The survey findings also seem at odds with the Doing Business indicators, where WBG is ranked 100 out of 175 economies on the enforcement of contracts. The survey does reveal that nearly 60 percent of the sample either strongly or moderately disagrees with the statement that courts are fair and impartial. This suggests that courts are not as efficient as the other survey questions indicate. But, no source suggests that courts, whether they are efficient or not, are currently a major impediment to businesses in the West Bank and Gaza. Effectiveness of the judicial system will become a more pressing issue if foreign investment ever becomes significant and new businessmen without local contacts enter the market. It will also become important if Palestinian businessmen are allowed direct access to the international market and must enter into agreements and contracts with foreign customers.

Figure 4.f: Courts

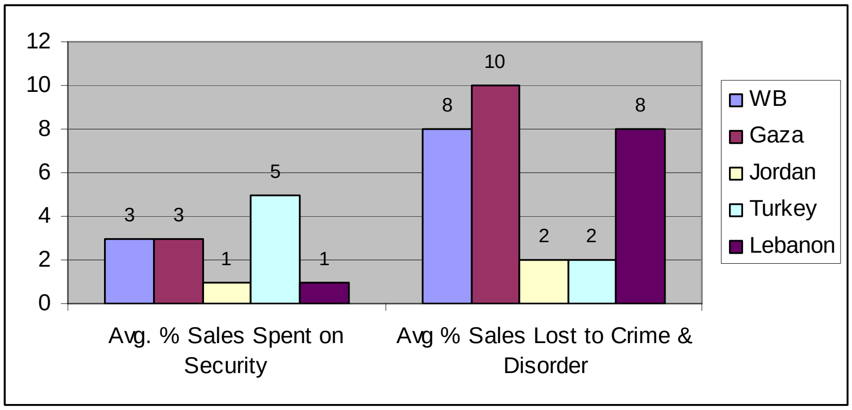


Source: 2006 World Ban Enterprise Survey Data.

4.18. Consequently, there is a need to continue commercial legal reforms that are currently stalled and complete the legal framework for private sector activities. There is a backlog of un-passed draft laws needed to conduct businesses efficiently and much remains to be done to sort out the overlapping laws left over from years of occupation by different powers.[29] The laws in Gaza and the West Bank need to be harmonized and many of the recently passed laws conflict with one another. Among the highest priority legislation needed are a Commercial Law, Companies Law, Competition Law, Leasing Law and an Insurance Law.[30] In addition to needing foundation economic legislation, the Palestinian legal system lacks the necessary secondary legislation to guide regulators' interpretation and enforcement of law.[31] But despite this, few entrepreneurs identified the nascent legal system as a binding constraint. They face much more pressing issues and have found ways to work around the hurdles imposed by the legal system.

[29] See the recent Country Economic Memorandum (World Bank 2006b) for a concise discussion of the legal issues.
[30] The EU report on Strengthening the Palestinian Economic Legislative and Private Sector Institutional Framework proposes a prioritized list of needed by the private sector.
[31] For a detailed discussion of the legal system, what laws need to be passed and the challenges to enacting legislation see "Developing a Palestinian Roadmap for Legislative Reform in the Business Sector" by the Al-Mustaqbal Foundation, September 2006.

Figure 4.g: Cost of Crime and Security

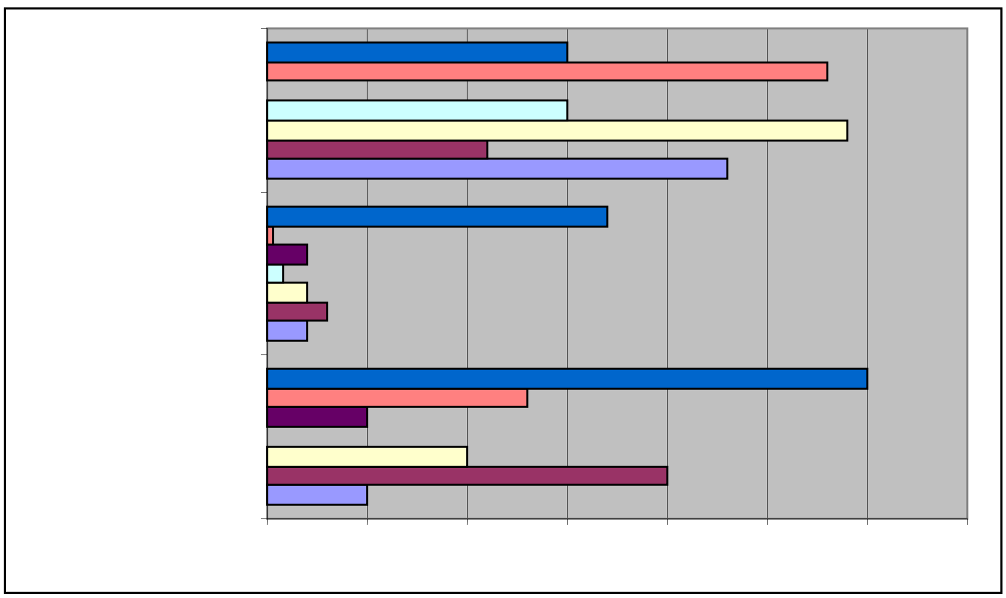


Source: 2006 World Ban Enterprise Survey Data.

4.19. Crime and disorder continue to impose a heavy burden on the Palestinian businesses. On average in the WB businesses lose nearly eight percent of sales on security equipment, barriers and personnel. In Gaza that rises to nearly 10 percent, about five times what the average small firm in Turkey spends (Figure 4.g). These losses do not reflect direct losses from Israeli incursions but rather losses due to crime and domestic disorder. It reflects the break down in overall security.

E. Infrastructure

Figure 4.h: Infrastructure Indicators



Source: 2006 World Ban Enterprise Survey Data.

4.20. The WBG depend upon Israel for most of their infrastructure needs. Consequently, the infrastructure is fairly well developed and poses relatively little difficulty to most enterprises. The main roads are generally good and when Palestinians are allowed to use them, pose little problem. However, in the West Bank, Israeli efforts to protect settlers and settlements are increasingly preventing Palestinians from using main roads, forcing them on to small, poorly maintained secondary roads. Telecommunications services are widely available and many firms have access to broad band internet service. At the same time, many respondents did cite issues with power and water. The survey found that in some areas, especially Gaza, there were localized shortages of both; however they generally did not stop operations and the level of reported shortages is less than found in neighboring countries. But the survey results reflect the period before the wide spread destruction of infrastructure facilities in mid-2006, so the problems are probably much larger now. The biggest complaint was about the cost of electricity. Producers felt that the tariff was too high and reduced their competitiveness. The cost of electricity from generators is almost always higher than from a power grid. Therefore the high percentage of self-generated power in Gaza (nearly 20 percent, see Figure 4.h) indicates that the cost of electricity is a significant burden for enterprises in Gaza.

F. Land Administration

4.21. The availability of serviced land is a major constraint to developing new businesses and expanding existing ones. It did not appear as a major problem in the survey, because the survey covered existing businesses, which for the most part are not planning to expand in the current situation. But industrial land is scarce as evidenced by its very high price. Land suitable for industrial development in Ramallah can cost anywhere from $100 to over $200 per square meter. This is not far from the cost of prime real-estate in major European cities.

4.22. Most businesses operate on land long owned by the family and business premises are often attached to the personal residence of the owner. A limited amount of land has been identified by local governments for industrial development, but that has seen more housing than industry erected. The lack of suitable industrial land has serious consequences for Palestinian businesses. It prevents them from expanding and establishing the most efficient layouts for factories, it creates severe problems for waste disposal and increases the cost of shipping because trucks have to negotiate small urban roads that were not designed for shipping goods.

4.23. In the West Bank, it is only possible to establish new businesses in the area administered by the PA.[32] Outside of this area, a business must have permission from Israeli authorities, which according to interviews with businessmen suggest is rarely forthcoming. The Palestinian areas are effectively ringed by Israeli controlled territory forcing development into an ever shrinking stock of undeveloped land. In Gaza, the Gaza Industrial Estate (GIE) showed that well serviced land could attract investors. However, without the ability to move goods in and out, most enterprises in the GIE have shut down. Consequently, the success of any industrial zones is tied to ensuring free movement.

4.24. The inefficient registration and titling system also constrains the availability of land. Much of the land remains unregistered—less than 30 percent of the land in the West bank is surveyed and registered—and land titling and administration are still covered by numerous overlapping laws and regulations dating from as far back as the Ottoman Empire. The scarcity of land makes the limited amount of available public land extremely valuable. The PA has not yet established a transparent way of allocating public land. Consequently, there is a wide spread perception that only politically well connected businesses can obtain it. The PA understands the importance of the land administration problem and has been taking steps to improve the land registration and administration system, including establishing the Palestinian Land Authority in 2003 and piloting new registration systems. But there remains much work to do, including computerization of records and surveying and registration of the remaining land, to make even the limited land in Area A fully available.

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[32] Area A, the area assigned to be fully controlled by the PA, is only about 17 percent of the West Bank. The PA is in charge of administration in Area B, while Israel retains security and planning control. Area C, where Israel retains full control is about 60 percent of the West Bank. Area C is the only fully contiguous area in the Occupied West Bank; it surrounds and divides Areas A and B.

CHAPTER 5: RECOMMENDATIONS

5.1. For the Palestinian private sector to grow and provide the jobs needed by an expanding population, producers will have to move toward higher value goods and services and establish new markets. Because the WBG is intimately tied to the Israeli economy, its cost structure is too high to allow Palestinians to effectively compete against developing countries in labor intensive, low value added products. Consequently, they will have to produce high value goods that can justify the cost of production. Palestinians will also have to establish new markets. In the immediate future, Israel will remain the largest potential market and it is critical to expand penetration. However, Palestinian businesses cannot depend solely on the Israeli market and must develop and directly access new markets in Europe, the Arab world and beyond.

5.2. Re-establishing free movement and access, while maintaining Israeli security, is the *sine qua non* for a viable Palestinian economy. Without a concerted political effort to re-open markets and lower transaction costs, the Palestinian private sector is bound to fail. But to take advantage of improved market access, Palestinian enterprises will have to dramatically improve their competitiveness. This will require continued improvement in the investment climate to reduce costs and provide a strong enabling environment for investment. It also requires that individual enterprises improve their internal capabilities.

5.3. It is difficult to sequence recommendations in this highly uncertain environment because they are all interdependent and success ultimately hinges upon political agreements. For example, without free movement, there will be little demand for a functioning customs and border management department. However, without efficient customs and border management, it is difficult to get agreement for opening borders. Many things need to happen together and success in anyone area depends upon actions in other areas. What follows is a list of the most urgent issues facing the private sector. They are generally listed in order of importance, with movement and access first followed by improvements in the business environment and risk sharing with private enterprises. Some recommendations like land registrations will take years to implement, while others such as drafting a competition law, can be done relatively quickly. However, for all of them, work can and should start immediately.

A. Movement and Access

Recommendations for improving movement and access fall into three categories.

5.4. ***(1) Improving access to third country markets:*** As is true in all open economies, the Palestinian private sector needs to have alternative trade routes to directly access its customers in order to successfully compete in the global economy. At the same time, Israel must have guaranteed security. The world market demands that producers guarantee on time delivery at a competitive price. Therefore, the uncertainty and costs generated by the movement and access restrictions effectively exclude most Palestinian producers from the global market.

5.5. World Bank analysis suggests that the Rafah trade corridor, initially for transit trade through Egyptian gateways, provides a viable alternative trade route for the Palestinian economy.[33] While not a substitute for improved trade with and through Israel, the Rafah crossing can provide an essential additional route with potentially high returns for the Palestinian private sector. Rafah was turned over to Palestinian control at the time of the disengagement and is operated with third party security provided by EU border monitors. The crossing was efficiently and securely operated for travelers for eight months

[33] Information in this section is drawn from Bank research presented to stakeholders in WBG in January 2007. Further details will be available with the finalization of the Bank policy note in March 2007.

until it was closed by GoI at the end of June 2006.[34] The crossing should be reopened and its operations expanded to allow the movement of goods so that Palestinian producers have the option of accessing Egypt's efficient and privatized port at the entrance to the Suez Canal (SCCT) and Cairo International Airport. Initial analysis by the World Bank suggests that this route provides competitive trade logistics in terms of performance and at a cost equivalent to Israel's ports and airports. Even more importantly, it offers Palestinians direct access to Europe and the Gulf, which are potentially the most lucrative markets for Palestinian exports. Given WBG's relatively high cost structure and the competitive nature of global trade, even if Israel becomes more accessible, the only way Palestinian producers can capture enough value-added to grow the economy is by accessing these markets directly and making full use of the generous trade agreements provided by Europe and the Arab League.

5.6. In the current political situation, the Rafah corridor has the best chance of success if its operations are expanded in phases, with the first being operation for transit trade. The Palestinian, GoI, and US approved "Agreement on Movement and Access" allows for immediate operation of Rafah for exports. In the first instance, these cargoes will need to be handled by "special arrangements" –that is with special attention by Palestinian and Egyptian officials to ensure that "red tape" does not impede the movement of cargo and perhaps with donors active in the region providing additional financing for the costs of shipment. Simultaneously, the Palestinian and Egyptian governments, along with the EUBAM, need to begin discussions as soon as possible on the processes at the Rafah border terminal and for goods in transit to regularize transit operations. A simple, secure transit movement using Egyptian trucks provides the most obvious solution. The World Bank and other donors are prepared to provide technical assistance in this regard. Construction of efficient cross-docking facilities and other infrastructure to support the movement of goods is not a lengthy process and begin once general procedures are agreed. In time, the Rafah trade corridor would also be able to handle imported goods.

5.7. These steps are complimentary to ongoing efforts to improve the border crossings with Israel, particularly at Karni. The West Bank economy is larger than the Gaza economy and producers there also need direct access to the world market. An efficient and reliable crossing and trade corridor through Jordan would provide similar advantages of direct market access. The World Bank has been requested to explore and analyze this trade corridor and provide recommendations. However, for such a corridor to be successful, it is crucial that Israel reverse the current policy of restricting access of the Palestinian population to the Jordan Valley since this would add significant uncertainty in reaching a Jordan transit corridor. Likewise, progress on the Palestinian port and airport as provided for under the Agreement on Movement and Access should begin in order to provide other alternatives for reaching third country markets.

5.8. ***(2) Rebuilding the domestic market:*** It is necessary to immediately implement all parts of the AMA and rebuild the domestic market which has been fragmented by closure policy in the West Bank and the near total separation of Gaza and the West Bank since 2001. This can be done in the immediate term by restarting the convoy system (provided for in the AMA) and then followed, in the longer term, by establishing a permanent territorial link. Analysis by the World Bank in 2005 provides a useful starting point for designing a plan for secure movement of goods by convoy. The current fragmentation of the West Bank resulting from an extensive system of permit restrictions, informal barriers to movement and investment, and physical impediments also need to be reversed. The solution goes significantly beyond the removal or movement of some physical barriers to an examination of the entire system, including the provision of residency and travel permits, which has created enormous uncertainty in the normal

[34] Although the crossing is operated by the PA with third party monitoring by the EU, Israel has kept the crossing virtually closed since the capture of one of its soldiers by militants at end June 2006. In a statement to a conference in Israel in January 2007, General Pistolesce, head of the EU monitoring force, confirmed that Rafah was not being used inappropriately or for the smuggling of arms, and urged Israel to reopen it.

economic and social functioning in the West Bank. In economic terms, a piecemeal approach will have little significant impact on reducing the unpredictability of this system. Two World Bank reports are expected in the coming months looking at the impact on transport costs and logistics and overall impact of the West Bank impediments.

5.9. ***(3) Support to key institutions that support trade:*** In addition to the support to Palestinian institutions mentioned below in section B, three institutions need particular attention to ensure that the private sector has the support necessary to operate efficient border crossings and can take advantage of improved access to third country markets:

- **Customs Department:** The Department of Customs, currently working under the President's Office as part of the Steering Group on Borders, needs assistance in terms of entering the World Customs Organization (WCO), continuation and expansion of the ASYCUDA system which monitors and records trade and VAT transactions, and other assistance to help the government develop and implement a modern and secure customs regime. The EC is expected to continue its financing and support of ASYCUDA. The World Bank has been asked to assist the Customs Department with the technicalities of joining the WCO as well as developing a program of other technical assistance necessary to support a modern customs administration. A well coordinated program of assistance from interested donors would help support this effort. Likewise, other segments of the borders services agency will need technical assistance and financing in order to fulfill their role in expanded border services.

- **Involvement of the private sector:** It is critical that the private sector, as the clients of the border crossings and trade corridors, be involved in the development and operation of the border terminals. As a first step, continued private sector involvement in border monitoring (currently provided by PalTrade through a World Bank grant) should continue in Gaza and expand to the West Bank border crossings which are located along the Green Line. This ensures that critical data on the movement of goods between the West Bank and Israel are recorded and available. The involvement of monitoring of truck flows at Karni, established in 2005, has provided an essential element in the ability of the international community and other stakeholders to receive on-time, independent information of status of the borders. Collecting relevant data on the West Bank has not been possible to date because of the absence of these private sector monitors.[35] The inclusion by Government of private sector representatives in the Palestinian borders steering committee is a welcome step. As explained in the World Bank's analysis of the Rafah crossing, a dispute resolution mechanism should be established for the new crossings. Security and efficiency will also be enhanced by implementing proven standards of a secure supply chain which seeks private sector involvement. Finally, non-regulatory activities at the border crossings, such as goods handling, should be competitively provided by the private sector.

- **Palestine Standards Institution (PSI):** One of the factors limiting the sale of Palestinian products in Israel and other countries is their failure to meet international standards. The PA, with donor assistance should move quickly to reform the national quality system and improve the capacity of the PSI to establish and enforce standards. PSI should develop and adopt internationally compatible standards and specifications, especially in areas such as electrical equipment and solar heaters and for industrial calibration. PSI needs to create and build capacity for testing laboratories to support exports. To help Palestinian firms enter the Israeli market, PSI

[35] Despite repeated requests by the World Bank, the GoI has not provided disaggregated data collected by the military or other operators of West Bank back to back crossing points. This has made it difficult to analyze the flow of goods and the extent to which the closure regime has constricted economic activity.

must renew efforts to harmonize standards with Israel and ensure that Palestinian products are suitable for sale in Israel

B. Improving the Investment Climate

5.10. The key to the economic performance is the investment climate in which enterprises operate. The PA is a nascent government and has had to create from scratch all the institutions needed by a modern economy. As detailed in the report, with the support of international donors, the PA had been making slow, though steady progress over the last 10 years in establishing an enabling investment climate. But progress has almost stopped since the parliamentary elections in January 2006. For Palestinian enterprises to become internationally competitive, it is essential that the investment climate continues to improve. Donors must support the PA to maintain the institutions that were built previously and to continue to develop efficient new institutions required by the private sector.

Measuring the Investment Climate

5.11. Both the government and the private sector must strive to continuously improve the investment climate. The first step in doing this is to measure its major aspects and track improvements and deterioration over time. Currently, there is little available information on the WBG investment climate to provide guidance for policy makers. The Palestinian Central Bureau of Statistics (PCBS) conducts an annual enterprise survey but it mostly collects data on firm performance and not the investment climate. PCBS and other groups do small, irregular surveys on business confidence and perceptions but there is no systematic collection on the investment climate and how it changes to guide policy makers. The World Bank's Doing Business indicators provide a yearly snap shot of the investment climate. But they are not able to keep up with the changing environment or provide the necessary level of detail for policy decisions. Given the perceived recent deterioration in the investment climate, particularly rising corruption, and the undoing of some of the progress made in the last 10 years, establishing a system to regularly measure important aspects of the investment climate is a high priority.

5.12. ***Recommendation:*** The PCBS conduct an annual or semi-annual survey of private sector businesses that collects information on the main issues of the investment climate including: corruption levels, main business constraints, infrastructure services, access to finance and the regulatory and legal environment. The data should be analyzed by an independent agency and rapidly made publicly available for use by policy makers and the private sector.

Strengthening Institutions

5.13. In a modern economy, private sector operations depend upon strong enabling institutions. Without efficient customs, courts, standards institutes, statistical services and other necessary institutions, the Palestinian private sector will not be competitive. The PA, with the support of the international community, must move quickly to stop the deterioration and improve the services and capabilities of the institutions most needed by the private sector. Among the important institutions and issues are:

- **Land Administration:** Most land in the West Bank remains unregistered, making it difficult for businesses to purchase land and expand operations. The lack of formal registrations also makes it difficult to use land for collateral, rendering many families' largest asset unproductive. The PA has recognized the importance of the land registration system and initiated steps to improve it. Currently, there is small pilot project piloting the development of new policies and the creation of a more capable infrastructure. Funding a full scale project to improve land policy and register all land would provide a major boost to the private sector activity.

- **Legal Reform and new legislation:** There are major gaps in the legislation required to facilitate private sector operations. For example, the Palestinian Legislative Council (PLC) has still not passed a Commercial law, Companies Law, Competition Law or a Secured Transaction Law. There are also no institutions to enforce new laws. There is no telecoms regulatory body or competition authority. Some of the required laws are in draft and only need to be passed by the PLC. Others need to be re-written before being submitted to the legislature. Many existing laws are contradictory and those governing the West Bank and Gaza are not fully harmonized. The PA should quickly move to pass the most important legislation to provide a less uncertain legal environment. The system for drafting and passing legislation should also be addressed. Recent studies by the EU, Al Mustaqbal Foundation and other organizations provide details on this complicated subject. The EU report on Strengthening the Palestinian Economic Legislative and Private Sector Institutional Framework contains a prioritized list of laws needed by the private sector. Enforcement of existing laws is weak and strengthening judicial enforcement would enable businesses to more easily enter into contracts and expand their operations. This will take on added importance if movement is restored and Palestinian firms are allowed to access the world market directly.

- **Competition Policy:** It is widely believed that the Palestinian economy is becoming less competitive and that monopolies and large businesses are using the current crisis to expand their market power. Given the importance of maintaining confidence in the economic system and trust of the population, the PA should renew efforts to develop a competition policy and establish necessary regulatory bodies.

- **Capital Markets Authority:** The Capital Markets Authority is responsible for regulating all non-bank financial institutions and businesses. While they are well managed and funded, they do not have the capacity to develop all of the new laws and regulations they need. Leasing, Mortgage finance and micro-finance all exist but there are no laws governing them. The Capital Markets Authority should be supported to develop the laws and secondary regulations required by the financial markets.

- **PalTrade:** Palestinian producers have been effectively cut off from the world market and have relied on Israeli middlemen for most exports and imports. It is difficult for Palestinian businessmen to travel and international buyers or dealers rarely visit WBG. To develop new markets, Palestinian entrepreneurs need a reliable source of information on market requirements and opportunities as well as institutions to promote Palestinian products abroad. The Palestine Trade Center is a private organization tasked with providing these services. PalTrade has offices in both the West Bank and Gaza. It has had some success in various activities, notably supporting trade shows. However, it needs support to improve its capabilities to provide market information and promote Palestinian businesses in new markets. It also needs to strengthen its capacity to provide advice to the PA when it negotiates the implementation of trade agreements with other Arab countries.

- **Infrastructure**: The survey found poor infrastructure to be a relatively minor constraint. Despite this, there are notable issues relating to infrastructure. The cost and reliability of power, particularly in Gaza, were noted by many firms and this has undoubtedly gotten worse after the fighting in mid-2006. The fact that a large percentage of enterprises rely on self generated power indicates the need to develop more reliable power sources. The lack of water is also a constraint. Most operating enterprises have found a way to deal with the shortage and expense of water. But the country has limited water resources and Israeli authorities restrict Palestinian use of water, which limits the types of activities Palestinians can undertake.

- **Private sector business membership organizations:** Business associations and private sector trade groups have experienced rapid growth in the past 10 years. Organizations such as the Palestinian Federation of Industries, the Wood Industry Union and the Textile Producers Union have been strong voices for their members and have played an important role in helping both the government and donors formulate policy. In the past, most of these organizations have been supported by donor funds, yet their capability to provide services to members remains weak. Business membership organizations are an important part of the process for creating and maintaining a supportive investment climate. To be successful, they must have the dedicated support of their members and cannot be created or run by donor organizations or other outside forces. However, for functioning organizations, outside support to develop their capabilities to provide useful member services would enhance growth.

C. Developing Enterprise Capacities

5.14. Even if market access is granted and an enabling investment climate provided, few Palestinian enterprises are currently capable of competing on the international market. Most firms are small, use old technology and are relatively inefficient. To become competitive they will require significant investment to develop new products, increase productivity, improve quality and reduce costs. It is especially important to invest in marketing plans and develop contacts in new markets.

5.15. Improving enterprise capabilities is a difficult task. Palestinian businesses have been operating in isolation for years and are to a large extent cut off from the most important enterprise learning mechanisms. Few Palestinian firms export directly, conduct training, hire technical experts or have technology licenses. Their main contact with the rest of the world is through Israeli firms and these contacts are declining as Israel moves forward with its policy of separation. The movement and access restrictions make it expensive to develop new learning mechanisms to replace contacts with Israel. It is difficult and expensive for Palestinians to travel, most citizens from other Arab countries cannot travel to WBG and consultants and businessmen from other parts of the world are reluctant to enter WBG because of the security situation. For the most part, Palestinian enterprises must rely on local Palestinian consultants whose own knowledge is limited.

5.16. Managers are well aware of the need to increase their capabilities and most enterprises—at least the formal ones—can access the necessary finance. However, investing in the current situation is extremely risky. Managers are unable to predict the political environment and can never be certain of their ability to travel or ship goods. Investing to enter a new market is risky in and of itself. Add the uncertainty about movement and access and most enterprises decide against significant investment. In this unstable situation, individual enterprises are highly risk averse and the level of investment is below what is socially optimal.

5.17. Palestinian enterprises need support to help lower the cost of developing learning mechanisms and to offset some of the risk of investing in new capabilities. Successful investments by some entrepreneurs would serve as a demonstration effect to others, encouraging more investment. Initial success in exporting would also help create a “made in Palestine” brand and would offset some of the negative perceptions about the ability of Palestinians to reliably supply goods. There have been a number of previous efforts, notably a USAID program, to support certain industrial clusters. But these programs have not been enough.[36] Additional programs are needed to address the unique market failures resulting form the political situation and directly help Palestinian enterprises upgrade their capabilities and enter new markets.

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[36] USAID work on industrial clusters has mostly stopped as USAID has redirected its resources to humanitarian assistance.

5.18. In addition to adopting enhanced technologies and developing new products, Palestinian enterprises must improve their marketing ability. They need to increase their knowledge of potential markets and identify new customers. For example, several garments producers argued that for selected products, they are even now cost competitive with North African producers in the European market. However, they need to cut out Israeli middlemen that add significantly to the cost. But without the Israeli middlemen they have no market contacts. One firm that managed to export a small order was able to do so because of a personal relationship. The producers have discussed trying to develop more contacts but the cost of travel and the difficulty of committing to on-time delivery have discouraged them. Thus, they remain tied to producing for their Israeli clients, which is a risky strategy since most are dependent on a single buyer, and Israeli apparel companies have been reducing the amount they buy from Palestinian firms. Producers in other sectors, including stone and marble, pharmaceuticals, wood furniture and food processing have also had limited success in the export market, which indicates that Palestinian enterprises can be price competitive in selected markets. But they are also discouraged from pursuing and expanding opportunities because of the difficulty of travel and uncertain access. Providing assistance in marketing could help expand Palestinian industry and even provide a boost to the declining labor intensive industries.

5.19. ***Recommendation*****:** Establish a matching grant, challenge fund or some other type of program that directly supports individual Palestinian enterprises upgrade their internal capabilities. Assistance should be targeted at specific market failures and should focus on helping find and adopt new technologies and open new markets.

APPENDIX 1: KEY INDICATORS OF PALESTINIAN MANUFACTURING SECTOR `

West Bank									
	Production & preserving of meat products								
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Workers	489	333	332	295	1176	1242	455	298	396
VA/Wages $	1.02	2.56	2.84	1.62	2.33	2.11	2.82	12.43	1.95
VA per Labor (1000$)	5.8	10.69	14.21	97	58	7.24	12.22	77.08	9.36
Exports/Sales	0.24	0.07	0.16	0.10	0.51	0.16	0.48	0.36	0.13
	Spinning of textile fibbers								
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Workers	1237	673	958	1361	1118	1131	942	1289	977
VA/Wages $	3.42	2.76	3.78	3.36	1.61	-0.09	1.88	2.52	1.62
VA per Labor (1000$)	12.10	9.12	15.92	18.35	6.67	-0.34	5.24	12.30	5.41
Exports/Sales	0.12	0.45	0.29	0.22	0.25	0.18	0.40	0.42	0.42
	Manufacture of wearing apparel								
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Workers	8521	12368	9533	11610	11521	8948	6488	6684	5341
VA/Wages $	1.56	1.67	1.45	1.19	1.27	1.32	1.52	0.99	2.34
VA per Labor (1000$)	5.10	5.53	4.59	3.98	3.90	3.76	3.53	3.07	7.69
Exports/Sales	0.15	0.59	0.28	0.41	0.42	0.15	0.30	0.15	0.38
	Manufacture of footwear								
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Workers	2230	3730	3501	3132	3816	4480	5275	3166	2254
VA/Wages $	2.10	1.71	1.39	1.46	1.84	1.61	1.05	1.32	1.42
VA per Labor (1000$)	8.10	5.67	5.14	6.91	7.72	7.01	4.21	3.88	5.65
Exports/Sales	0.14	0.38	0.31	0.14	0.14	0.35	0.42	0.14	0.09
	Pharmaceuticals								
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Workers	734	673	631	723	819	1037	763	889	790
VA/Wages $	2.96	3.12	4.80	2.63	2.35	1.54	3.31	4.71	1.91
VA per Labor (1000$)	20.50	17.99	28.91	23.52	19.04	16.88	24.52	24.63	26.64
Exports/Sales	0.02	0.03	0.03	0.04	0.06	0.00	0.00	0.00	0.00
	Cutting, shaping & finishing of stone								
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Workers	2166	5691	5989	8083	5444	5394	8117	5656	6585
VA/Wages $	1.80	1.94	2.70	2.09	1.63	1.76	1.87	1.56	2.66
VA per Labor (1000$)	10.40	10.41	14.99	13.66	9.67	7.77	6.97	7.88	12.89
Exports/Sales	0.37	0.43	0.35	0.50	0.52	0.29	0.32	0.24	0.25
	Manufacture of structural metal products								
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Workers	2067	4144	3067	4233	4264	4670	3872	3828	4452
VA/Wages $	1.13	2.18	1.47	1.69	0.88	1.08	1.43	1.35	2.62
VA per Labor (1000$)	5.40	9.38	5.74	7.91	4.58	3.40	4.30	5.89	11.27
Exports/Sales	0.01	0.13	0.02	0.05	0.17	0.25	0.03	0.02	0.15

	Manufacture of furniture								
	1996	1997	1998	1999	2000	2001	2002	2003	2004
Workers	2085	3583	4157	4395	4066	3229	3732	3551	4100
VA/Wages $	1.49	-0.03	1.93	0.70	1.39	0.75	1.78	1.61	1.80
VA per Labor (1000$)	6.10	-0.09	9.18	3.68	6.79	3.94	4.92	5.53	6.89
Exports/Sales	0.05	0.22	0.12	0.20	0.24	0.05	0.05	0.05	0.18

	Gaza Strip								
	Quarrying of sand & clay								
	1996	1997	1998	1999	2000	2001	2002	2003	2004
Workers	2857	1396	1387	1654	1860	1751	1824	1709	1958
VA/Wages $	1.4	4.5	5.1	4.4	3.9	1.8	1.9	2.9	3.9
VA per Labor (1000$)	9.13	12.40	15.30	15.37	15.99	5.36	5.68	6.62	12.31
Exports/Sales	0.04	0.04	0.00	0.02	0.00	0.13	0.03	0.00	0.00
	Manufacture of made-up textile articles								
	1996	1997	1998	1999	2000	2001	2002	2003	2004
Workers	81	44	149	78	46	77	51	49	143
VA/Wages $	4.0	2.5	7.8	0.1	2.8	2.0	1.4	3.8	2.0
VA per Labor (1000$)	13.79	9.39	28.35	0.18	7.67	6.31	4.33	10.02	7.73
Exports/Sales	0.03	0.33	0.45	0.00	0.02	0.00	0.10	0.00	0.00
	Manufacture of wearing apparel								
	1996	1997	1998	1999	2000	2001	2002	2003	2004
Workers	4451	7919	7766	8343	10673	7984	7393	8320	5022
VA/Wages $	2.3	1.5	1.6	1.4	1.4	1.3	1.2	1.6	1.3
VA per Labor (1000$)	7.89	4.76	5.29	5.51	3.96	3.37	2.72	3.79	3.62
Exports/Sales	0.22	0.05	0.04	0.12	0.33	0.48	0.01	0.26	0.14
	Manufacture of footwear								
	1996	1997	1998	1999	2000	2001	2002	2003	2004
Workers	1548	803	595	789	892	1019	840	928	796
VA/Wages $	1.3	1.5	2.2	1.8	1.7	1.0	1.5	2.2	1.4
VA per Labor (1000$)	5.52	4.45	6.64	5.53	4.36	6.19	4.10	4.99	4.88
Exports/Sales	0.38	0.06	0.00	0.00	0.05	0.20	0.00	0.04	0.00
	Cutting, shaping & finishing of stone								
	1996	1997	1998	1999	2000	2001	2002	2003	2004
Workers	1941	687	563	715	542	456	485	391	592
VA/Wages $	3.9	1.8	4.4	2.4	3.7	1.8	1.2	1.7	2.0
VA per Labor (1000$)	21.56	6.49	16.44	7.09	13.05	5.58	4.06	4.68	7.55
Exports/Sales	0.42	0.02	0.01	0.00	0.01	0.00	0.00	0.00	0.00
	Manufacture of structural metal products								
	1996	1997	1998	1999	2000	2001	2002	2003	2004
Workers	1244	1138	1240	1548	1724	1698	1790	1214	1745
VA/Wages $	1.3	2.2	2.4	1.7	1.9	1.5	2.5	1.2	2.0
VA per Labor (1000$)	5.21	4.61	7.35	5.58	6.14	4.41	6.99	2.96	4.58
Exports/Sales	0.04	0.05	0.00	0.00	0.09	0.02	0.05	0.05	0.05

	Manufacture of furniture								
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Workers	1129	1638	1454	1826	1898	1928	1762	2357	2125
VA/Wages $	1.7	2.5	2.4	2.1	2.7	1.5	1.3	6.3	1.8
VA per Labor (1000$)	6.05	8.8	6.84	6.95	8.22	3.94	3.92	16.05	5.08
Exports/Sales	0.04	0.04	0.09	0.05	0.19	0.09	0.24	0.09	0.18

Source: Makhool (2006). Calculations from PCBS data.

APPENDIX 2: LABOR AND WAGE PRODUCTIVITY CALCULATIONS

Wage and labor calculations from Makhool 2006. Palestine data taken from PCBS. Other country data was taken from UNIDO sources.

Labor , Wage Productivity, Other Countries						
Jordan 2003	**Egypt 2002**	**Israel 2001**	**Turkey 2000**	**Sector**	**ISIC**	
16390	6787	33592	30307	Processed meat, fish, fruit, vegetables, fats	151	
8303	3144	20801	12842	Wearing apparel, except fur apparel	1810	
5634	4080	26804	13237	Footwear	1920	
20370	22370	69613	79774	Other chemicals	242	
17134	7494		33247	Non-metallic mineral products n.e.c.	269	
3954	1188	28683	27830	Struct. metal products; tanks; steam generators	2811	
4710	3779	28704	18588	Furniture	3610	**Labor Productivity**
4.6	4.2	1.4	5.6	Processed meat, fish, fruit, vegetables, fats	151	
4.2	3.5	1.3	3.5	Wearing apparel, except fur apparel	1810	
2.6	4.6	1.4	2.9	Footwear	1920	
3.7	3.7	2	5.6	Other chemicals	242	
5.6			5.3	Non-metallic mineral products n.e.c.	269	
3.5	2.6	1.7	4.4	Struct. metal products; tanks; steam generators	281	
3	6.7	1.4	4.4	Furniture	3610	**Wage Productivity**

Various Industrial Sectors in Palestinian Territories						
2003	**2002**	**2001**	**2000**	**Sector**	**ISIC**	
75345	11083	6926	11448	Processed meat, fish, fruit, vegetables, fats	151	Labor Productivity
3004	3204	3599	3766	Wearing apparel, except fur apparel	1810	
3796	3822	6710	7454	Footwear	1920	
24071	22242	16147	18389	Other chemicals	242	
			11609	Non-metallic mineral products n.e.c.	269	
5755	3902	3256	4422	Struct., metal products; tanks; steam generators	2811	
5408	4465	3773	6563	Furniture	3610	
12.4	2.8	2.1	2.3	Processed meat, fish, fruit, vegetables, fats	151	Wage Productivity
1	1.5	1.3	1.3	Wearing apparel, except fur apparel	1810	
1.3	1.1	1.6	1.8	Footwear	1920	
4.7	3.3	1.5	2.4	Other chemicals	242	
			1.7	Non-metallic mineral products n.e.c.	269	
1.4	1.4	1.1	0.9	Struct.metal products;tanks;steam generators	281	
1.6	1.8	0.8	1.4	Furniture	3610	

Industrial Sector, Palestinian Territories								
2003		**2004**		**2001**		**2000**		
Palestinian Territories	**Jordan**	**Palestinian Territories**	**Egypt**	**Palestinian Territories**	**Israel**	**Palestinian Territories**	**Turkey**	
8035	13589	5601	6883	6601	48138	8696	46014	**Labor Productivity**
2.23	4.4	1.80	3.13	1.76	1.5	2.04	5.9	**Wage Productivity**

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