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West Bank and Gaza Investment Climate Assessment
Fragmentation and Uncertainty

INTRODUCTION

This Investment Climate Assessment (ICA) seeks to evaluate the conditions under which the Palestinian private sector currently operates in the West Bank (including East Jerusalem) and the Gaza Strip. The context in which this Assessment is made is one of a complex and fragmented political and geographic environment embodied in the continuation of the Israeli military presence in the West Bank since 1967, the stalled implementation of the 1993 Oslo Accords,[1] the relative isolation of East Jerusalem from the remainder of the West Bank, the construction of the Separation Barrier since 2009, and the de facto split in Palestinian governance between the West Bank and the Gaza Strip since 2007. This context has manifested itself in relative economic instability and stagnation over the past decade, punctuated by some spurts of recovery and other rapid periods of decline, both related for the most part to political events and security developments occurring at the time. Although this Assessment cannot fully analyze the legacy of these political realities, where necessary and beneficial, it will reflect on the events and developments in the broader socio-politico-economic context which, in turn, relate to key characteristics of or constraints on the Palestinian private sector and the investment climate in which it operates.

This Assessment is both an update and expansion on a similar assessment undertaken by the World Bank in 2006. As such, it provides both a snapshot of the investment climate in 2013, as well as a longitudinal view of what has changed in the intervening seven years and, just as importantly, what has not. Where relevant, it also compares indicators of the Palestinian investment climate with those of other countries in the region and beyond.

The objective of this Assessment is to provide the Palestinian business community, the Palestinian Authority (PA), and the international development community with an empirical analysis of the investment climate under which Palestinian businesses operate. The report describes the key constraints on business and investment and identifies reform priorities for those aspects of the investment climate and constraints which are within the PA's control, as well as some policy recommendations for areas outside of the PA's control, but within the domain of development partner assistance agendas and/or Israeli policies. This analysis is intended to inform Palestinian policy-maker actions to improve the business environment. It can also help inform the actions of other concerned parties, including the international development community, regional actors, and the Government of Israel regarding policies that affect Palestinian economic growth and sustainability.

EXECUTIVE SUMMARY

- Political instability, the result of the unresolved conflict and the restrictions on movement and access[1], remains the binding constraint in the Palestinian investment climate, resulting in uncertainty, risk, increased costs for businesses and investors, and the fragmentation of Palestinian economic space and markets.
- While there are positive aspects in the investment climate, such as a stable financial sector and low incidence of petty bribery, and firm performance indicates potentially competitive productivity levels, a sustainable economy is still out of reach due primarily to the business constraints and conditions created by political instability.
- As a result, private investment in the Palestinian territories remains far from sufficient to fuel adequate rates of economic growth to create enough jobs and reduce unemployment.
- Thus, actions are needed by the Palestinian Authority (PA), the Government of Israel (GoI), and international community to improve access to resources and markets, mitigate political risk, reduce uncertainty for businesses and investors, reverse the effects of internal fragmentation and isolation, and promote investment in technology, skills and innovation

MAIN FINDINGS

The 2006 Investment Climate Assessment (ICA) found that shrinking market access and a lack of free movement of people and goods were the main constraints to growth for Palestinian enterprises. It concluded that despite positive aspects of the investment climate — including low petty corruption, a relatively efficient bureaucracy, and a developed financial market — Palestinian enterprises were not investing enough to maintain their international competitiveness as a result of those binding constraints. Thus, the Palestinian exporting sector has been in relative decline since Oslo. In 2013, this trend continues due primarily to continued political uncertainty and an increasingly fragmented economy.

This ICA empirically confirms that while the positive factors identified in the 2006 investment climate assessment remain largely true today, political instability, the result of the unresolved conflict and the restrictions on movement and access to resources and markets, remains the key obstacle to economic growth. When asked about the obstacles to doing business, the majority of Palestinian businesses surveyed, both formal and informal — regardless of their location — cite political instability as the top obstacle to their business operations. Few other aspects of the investment climate appear to be as binding in light of this overwhelming constraint[2]. Decades of military presence, violence, restrictions on the movement of people and goods, restricted access to economic space and resources, governmental crises, internal Palestinian political division, and relative isolation from the global economy have increased the cost of doing business, leading to an uncertain environment in which it is difficult to predict future risks and returns.

As a consequence of these risks and restrictions, the Palestinian private sector is largely confined to small-sized firms in low productivity sub-sectors, exhibiting wide variability in performance and alternating between episodes of growth and decline. The lack of a political horizon has in turn led to the lack of an investment horizon, dampening growth and investment and undermining productivity. The political context, in some sense, also represents a barrier to entry, largely limiting competition to those firms capable of maneuvering through the myriad ever-changing regulations and restrictions, as well as to firms that stay small enough to avoid them. The proportion of formal firms with more than 20 workers is just 11 percent, compared to 35 percent in comparable lower-middle income countries.[3] Although reliable estimates are difficult to confirm, informal firms and labor appear to be a relatively significant factor in the competitive environment.

Within this uncertain and fragmented economic environment, most Palestinian firms do not appear to be investing or planning to invest in future growth. Palestinian firms have relatively low capital intensity, and panel data from firms surveyed in 2006 and then again in 2013 shows no significant growth in capital investment or annual employment among studied firms (with wide variability among firms). Existing firms are generally not constrained by access to finance. Indeed, over 77 percent indicate that they have not applied for a loan because they do not need one — rather than due to expectations of their inability to access credit— a remarkably high number compared to other economies. Lack of access to land, water, and other natural resources constrains economic growth at the macro level. Surveyed firms generally do not consider access to land as an obstacle to their current operations, although land is more likely to be reported as an obstacle by East Jerusalem firms. The restrictions on the use of these resources, particularly in Area C which represents over 61 percent of the land in the West Bank (excluding East Jerusalem), suggest that individual firms have sized and shaped their businesses within these existing constraints.

These depressed levels of investment are not surprising given that the cost of doing business and conducting trade for Palestinian enterprises is often prohibitively high and the movement of goods into and out of the West Bank has been subject to new impediments in recent years; at the same time, the movement of people and goods through Gaza has become even more severely restricted. The Enterprise Survey has confirmed the costs and risks associated with obtaining electricity, trading across borders, and even movement of goods within the Palestinian territories. Power shortages in Gaza exceed eight hours a day, as reported by firms. While there has been a reduction in the number of checkpoints in parts of the West Bank, passage through the crossing points with Israel established in recent years increases both import and export times, and subsequently costs. In the case of Gaza, some imports and practically all exports are prohibited. In both the West Bank and Gaza a drastic drop is observed in the trade between the two areas, which is to be expected given the Israeli restriction on any goods being exported from Gaza to the West Bank. The costs and uncertainty associated with following special procedures for obtaining movement permits, entry for goods on the dual use goods lists, and visas for investors, technical experts, or workers add another layer of complexity.

As a result of these restrictions and the years of political divide between the West Bank and Gaza, the Palestinian internal market and regulatory environment has become increasingly fragmented into disconnected "micro-climates". Firms are experiencing significantly different conditions and constraints depending on their location within the Palestinian territories. The de jure legal and regulatory environment and de facto administrative practices and competitive environment for Palestinian firms differ between the Gaza Strip, parts of the West Bank under PA security and administrative control (Areas A and B), and West Bank areas where security and administration of land and resources are under full Israeli control (Area C and East Jerusalem)[4]. Each of the various authorities that control these areas (the de facto Hamas government, the PA, and Israeli military, respectively) governs according to its own set of rules. This complex and often changing set of rules govern business activities including investment, trade, access to resources, and even the ability of a businessperson, investor, or worker to travel from one area to another – adding time, cost, and uncertainty to economic transactions. Having the information and capacity needed to navigate the changes and intricacies of the rules and restrictions of the different authorities is perhaps the most valuable competitive advantage any given Palestinian firm can have.

Thus, wide disparities in productivity remain between firms in different locations and sub-sectors, likely reflecting low competitive forces due to the fragmentation of the economic space and market. There are wide disparities in productivity between East Jerusalem, West Bank, and Gaza firms that may be a result of different firm concentration among sub-sectors, different business climates, and different factor conditions. For example, East Jerusalem firms have more than three times the value added per worker, and more than 16 times the capital intensity of firms in Gaza. There is also a wide gap in labor productivity among firms in the same sub-sectors, indicating inefficiencies within sub-sectors that may be explained in part by weak competitive forces. This may be due to a lack of direct competition between the most and least productive firms in different regions (between East Jerusalem, West Bank, and Gaza firms), since access to each other's markets is restricted and unpredictable.

Few other aspects of the investment climate appear to be as binding as the overwhelming constraint of unresolved political status and its consequent effects of fragmentation and uncertainty. These are discussed briefly below with differentiation between the West Bank (including East Jerusalem) firms and Gaza firms. The differentiation is due to the significant variation in their experience of the investment climate. Most of these differences are related in some manner to ongoing political instability and lack of a political resolution, whereas others are simply characteristic of a developing country context.

1. Gaza firms are increasingly constrained by a lack of a reliable supply of electricity. Access to electricity has emerged as one of the top constraints to business in Gaza. Although availability of reliable power supply has, over the years, continued to be a strategic constraint on medium-long term development in the Palestinian territories, the power crisis in Gaza is now an immediate binding constraint on current business operations. Gaza firms report an estimated 22 percent of sales in losses because of 232 hours of power outages that occur on average each month. In the West Bank, water supply rather than electricity emerges as the greater infrastructure constraint. By comparison, firms in the West Bank experience more frequent and longer water shortages, an average of nearly four per month, than those in Gaza.

2. Although restrictions on the movement of people and goods continue to impede trade and investment in the Palestinian territories, the nature of the restrictions has changed, with significant improvements in some areas and significant deterioration in others. With Gaza's direct access to the sea effectively blocked by Israel's naval blockade, the Palestinian territories are, in effect, a land-locked country that has no control over its borders. The blockade on trade and most movement of people into and out of Gaza has decimated its businesses and trade. It has severed most economic ties between the West Bank and Gaza, further reducing economies of scale. Further, it has limited access to markets for both Gaza and West Bank firms. In the West Bank, as well as in East Jerusalem, firms that do business with the West Bank experience difficulties in navigation through movement and access restrictions within and around the West Bank (checkpoints, the Separation Barrier, and the crossing points into Israel). Such restrictions continue to affect the cost of trade, although these costs have shifted from internal trade to trade between the West Bank and markets beyond. Since the last ICA in 2006, there has been a removal of key checkpoints and an easing of other mobility restrictions in the West Bank, particularly around Nablus.[5] The improvements in mobility restrictions within the West Bank have had positive effects, but these have been insufficient to shift the overall economic trend toward sustained growth.

3. Restrictions on the economic use of land in the West Bank limit the availability of infrastructure and serviced land and impede new opportunities for growth. These restrictions affect the delivery of telecommunications services, power, transport, waste and wastewater management, and the availability of serviced industrial zones — constraints that affect the entry of new investments and attendant strategic growth. Most economic activities on private land in Area C are restricted due to the difficulty in obtaining building permits. In addition, ownership of land in Area C is typically not accepted as collateral in Palestinian banks. A recent World Bank report found that the removal of constraints on the use of land and resources in Area C for agriculture, mining and quarrying, construction, tourism, and telecommunications and the indirect effects of inter-linkages among these sectors would generate the equivalent of 35 percent of 2011 GdP.[6] In addition, land administration in Areas A and B is also lacking, with most of the land still unregistered, a proliferation of land disputes, and systematic registration proceeding at a slow pace.

4. The legal and regulatory environments in the West Bank and Gaza have become increasingly disconnected due to the political and administrative separation since 2007. Since the split between Hamas and the PA in July 2007, a number of new laws affecting economic activities have been passed by Presidential Decree in the West Bank and at least two laws (including the Companies Law) passed by legislators in Gaza. This combined with restrictions on the trade of goods and movement of people between the two territories, have made navigating business and trade between the two territories increasingly difficult and costly. Nearly all facets of business regulation are affected by this split — including business registration, licensing and permits, banking, taxation, investment incentives, courts, enforcement of contracts, and competition with only a small number of Palestinian firms attempting to navigate business in both territories as regulated by the PA and the de facto Hamas government in Gaza.

5. Informality is a significant feature of the business climate. Formal small enterprises — and even formal medium and large enterprises — cite competition from the informal sector as a severe obstacle to business at significant rates. Although it is difficult to verify estimates of the size of the informal sector, an estimated 140,000 workers are employed in informal sector units in the West Bank (excluding East Jerusalem) and Gaza. Given that the vast majority of informal firms are extremely small (1-2 workers), there are likely something on the order of 100,000 informal sector units. These appear to be competing directly with a similar number of small formal firms (there are an estimated 108,000 sole proprietor enterprises in operation in 2012) in the same sub-sectors and markets. The majority of informal and small formal firms report that their market is limited to their locality. The informal firms are, however, unburdened by regulations and taxation, but have more restricted access to finance, export markets, and government contracts— the latter seemingly not a great disadvantage. As a result, more than half of small firms report competition from the informal sector as a major or severe obstacle to business.

6. Engagement in innovative and business-upgrading activities has dropped among Palestinian firms in recent years, driven primarily by diminished levels of activity among Gaza firms. The percentage of firms providing formal training, investing in product and process development, and maintaining International Organization for Standardization (ISO) quality system certifications have all dropped. The most significant drop has been among Gaza firms, which can be interpreted as a response to the effects of the economic blockade on firms. However, these behaviors have also decreased or stagnated among West Bank firms as well, including East Jerusalem. Given the known associations between investing in innovative and business upgrading behaviors with high growth in small and medium enterprises (SmEs), this is a negative trend that should be a focus of policy reforms.

On the other hand, this 2013 update on the investment climate finds that the positive factors identified in the 2006 investment climate largely remain true today – the incidence of petty corruption remains relatively low, the financial sector continues to be stable and liquid, and despite the political division between the West Bank and Gaza, most aspects of the bureaucracy are still functional. In terms of movement and access restrictions, the major impediment identified in 2006, there have been significant improvements on physical restrictions such as checkpoints within the West Bank, but new restrictions on trade into and out of the West Bank, as well as severe restrictions on Gaza movement and trade. The analysis also finds that labor productivity and unit labor costs of Palestinian firms are moderately competitive among the comparator economies in the region, but that the capital intensity of firms is low.

These and other positive findings and potential opportunities are elaborated upon below.

1. Although perception of corruption remains high, few Palestinian firms experience petty corruption in the form of informal payments to officials in their business operations. The difference is likely due to a perception of corruption occurring beyond their own experience and forms of corruption beyond petty bribery, particularly the use of connections or "wasta" which has been found to be the most cited form of corruption in the Palestinian territories.[7] However, the low experience of corruption is a significant departure from other comparator countries in the region where informal payments are cited much more frequently. The evidence points to remarkably low levels of informal payments related to business dealings in the Palestinian territories, with only 7 percent of firms reporting having experienced a request from an official for a bribe. The services for which payments were reportedly most likely expected varied by location – electricity connections in Gaza, import licenses in East Jerusalem, and construction permits in the rest of the West Bank.

2. What is impressive under the circumstances is that labor productivity of Palestinian firms is on par with comparator countries, while unit labor costs seem to be competitive within the region. At about USD 10,000 value added per worker annually, the labor productivity of Palestinian firms appears to be on par or nearly so with countries at a similar GDP rate. Indeed, labor productivity is higher than in Yemen, Egypt, and Tunisia in recent years. However, it is less than the best-performing comparator countries in the region, including Lebanon and Jordan. This moderate labor productivity performance seems to be the result of firms with relatively low capital investments in low productivity sub-sectors at a relatively high technical efficiency. While low capital intensity may be attributed to the uncertainty in the investment climate, the relatively high technical efficiency is more challenging to interpret. It may be the result of the quality of management, workforce, and transfer of know-how and practices through supply chain relationships, or from Palestinians gaining experience from abroad. Therefore, there is a potential opportunity to bring labor productivity up to more competitive levels if Palestinian firms are willing to invest more in their firms, and if resources shifted towards higher productivity sub-sectors in manufacturing and services. Unit labor costs (as a percent of value added) are estimated at about 23 percent, lower than all the comparator countries in the region which are all above 25 percent.

3. Access to finance does not appear to be a binding constraint in the Palestinian territories overall, but small and informal firms in the West Bank are relatively more constrained than others by lack of access to finance. The Palestinian financial sector is well developed in terms of regulation and financial service provision in the market, and it is liquid. The banking sector is stable and conservative, making most of its lending in the form of personal loans backed up to a significant extent by PA salaries, rather than for small business loans. However, most firms (77 percent) do not want a loan. This is likely due to a dearth of opportunities for growth and investment. However, small firms appear to be the most constrained in obtaining credit when they need it. Large firms do not appear to be constrained with regard to access to finance. Indeed, 100 percent have a bank account and 40 percent have a loan or access to a line of credit. Only 4 percent of small firms have loans or lines of credit, and report 15 percent of loan applications being rejected and collateral requirements set for them at 200 percent of loan value. This is somewhat surprising given the existence of loan guarantees specifically aimed at small and medium enterprises. It may indicate the need for further initiatives to facilitate access to finance for SMEs. Although the data are limited, informal firms appear to be more likely to borrow from money-lenders than from microfinance institutions, seemingly due to the complexity of the procedures.

4. Despite overall poor export performance, there have been limited but important gains in export market and product diversification. Export performance has deteriorated over the years since Oslo, tumbling from 12.2 percent to just 7.6 percent of current GDP in 2012, with spurts of growth throughout that period insufficient to recover from repeated political and military shocks.[8] Israel remains the destination for 82 percent of Palestinian goods exports, but this percentage has been dropping. The gains in market diversification, while small, are important since they represent potential opportunities to diversify not only markets but also market channels, thereby gaining direct exposure to advanced buyers and markets. Nearly half of all exports are in limestone and agricultural produce, mostly with limited processing and low value added. Although export diversification has been limited in value, the emergence and continued growth of some high-value sectors, such as pharmaceuticals, furniture, agribusiness products, information technology (IT) services, and call centers, points to the future potential in services and some high value added industry.

5. The emergence of the nucleus of a technology-based entrepreneurship ecosystem is an encouraging development. Although nascent, it shows potential for growth, especially as it links up and gains support from broader regional initiatives. The emergence of a venture capital fund and a few private equity funds aimed at growing startups and SMEs represent important steps toward the development of equity financing in the Palestinian territories. Along with recent developments in the equity market, this demonstrates a spirit of entrepreneurship and private sector responsiveness to opportunities, including a willingness to take on some risk.

6. A number of equity investors, including private equity funds and conglomerates, have attracted foreign direct investment (FdI) and launched new investments— a trend that has accelerated in recent years. These success stories tend to have a few common characteristics. Some funds or investors have a specific mandate to invest in the Palestinian territories or in developing countries more broadly. They tend to be large scale and have high visibility, investing in public and government relations. They often have a foreign partner, either as an investor or as a financer/ facilitator (such as bilateral or other international development agencies). In some cases, these agencies facilitated movement of goods from projects in which they have an investment or interest. Domestic and foreign investments in housing, agri-business, and other sectors appear to be on the rise in comparison to

previous years. This may continue to be a trend. Further, this trend may be aided by increased attention to investment by international and domestic actors, such as the launching of the Initiative for the Palestinian Economy (IPE) developed by the Office of the Quartet Representative, and the "Beyond Aid" initiative put forward by the Palestinian private sector through the Portland Trust. Although differing in timeframe (the "Beyond Aid" initiative has a longer-term perspective) and provenance, they share much of the same structural focus. Investment areas include: agriculture, tourism, construction, energy, information technology and digital entrepreneurship. Both initiatives aim to increase foreign and domestic private and public investment and employment.

RECOMMENDATIONS

Key directions for the medium-long Term

Policy directions in the medium-long term can only be formulated assuming the conclusion of a final peace agreement. The current political, economic and fiscal trends are unsustainable. Given that the final form of such an agreement is unknown, policy recommendations can be made here only in the broadest of terms.9 It is clear that after a negotiated settlement, the government of a Palestinian state will need to focus on investing in physical and institutional infrastructure and education as the basic building blocks for long-term economic growth. It will need to devise a trade policy, regime, and infrastructure that will enable rapid and sustained growth from diversified and higher value-added trade. Land assets will need to be unlocked for economic use, which will require reforms in land regulations and administration. Closing the progressively widening socio-economic gap between the West Bank and Gaza will require proactive measures for employment and income opportunities, as will the integration of any returning Palestinian refugees. Progressive reforms in the business climate that create incentives and facilitate investment will be needed to attract both domestic and foreign investment. Indeed, investment will need to occur at sufficient levels to overcome decades of underinvestment. In this context, the Palestinian government should strive for an investment climate that is among the best in the world — not merely on par with its neighbors. Finally, structural reforms that improve fiscal sustainability will be crucial, including improving the efficiency and effectiveness of public expenditures to create the fiscal space for priority infrastructure investments.

Concrete Short-Term Priorities

In the short-term, policy makers must recognize that the overwhelming constraint to investment and business in the Palestinian territories is political instability. Short-term recommendations should be formulated to mitigate the effects of political instability or to work to improve aspects of the investment and business climate that can be improved, even if marginally, under the current constraints. The set of recommendations below do not represent a comprehensive list of all that can and should be done to improve the investment and business climate in the short term. Rather, it contains a set of key priorities that have been identified as a result of the analysis. The recommendations are grouped under five primary areas and are summarized below (see Chapter 4 for the full set of recommendations).

many of the recommendations require a combination of political will, coordination, and capacity development by several parties, including the PA, the Government of Israel, the international community, and others. Indeed, it is those actions that require the cooperation of all parties, particularly those that would improve access to resources and markets and reverse the trends of fragmentation and isolation that would have the greatest impact in making a qualitative, positive shift in the investment climate. The other recommendation areas — on mitigating political risk, improving business regulations and enhancing the role of the private sector, and investing in skills, technology, entrepreneurship, and innovation — can work to create opportunities and improve outcomes marginally, but are insufficient to overcome the overall constraint of the unresolved political uncertainty and associated constraints.

The interim Oslo accords provide for coordination between the government of Israel and the PA on various aspects pertaining to civic and business affairs. Therefore, those recommendations that require a high level of cooperation and coordination between the PA, GoI, and other parties could potentially be acted upon in the context of the current political agreements. History has demonstrated that this is an ambitious goal. However, to the extent that the current period represents a window of opportunity, it is one certainly worth reaching for.

Endnotes

1. If sales rather than value-added is used, intermediate inputs are included on the right-hand side. As Caves and Barton (1990) found, measures of technical efficiency based upon revenues (gross output) were far more sensitive to small changes in functional form with respect to calculating efficiency than measures based on value added. As discussed below, because the value of output is used rather than a physical measure of output, 'sales generating' function might be a better description.
2. It is possible to make other assumptions about the functional form of the production function (for example, to assume a trans-log production function), although this does not appear to have a significant impact on results in most cases. See for example the analysis from the Investment Climate Assessment for Turkey (World Bank 2007a).
3. For the LAD regressions, the coefficients are better thought of as median levels of productivity rather than average levels.
4. There is a large literature on whether exporting improves performance (learning-by-exporting hypothesis), or whether only productive firms can export (self-selectivity hypothesis). The large literature on this topic is summarized in Tybout (2003), and Bernard and others (2007).
5. Gatti and Love (2008) do this, allowing access to credit to be endogenous in the second step.
6. This is due to omitted variable bias. It is discussed in more detail in Chapter 7 in Kumbhakar and Lovell (2000), and in Escribano and Guasch (2005).
7. Due to concerns about outliers, LAD estimators are often used when estimating production functions. See, for example, Greene (2000, pp. 449-450).
8. See, for example, the discussion in Pakes (2008).