

WEST BANK AND GAZA INVESTMENT CLIMATE ASSESSMENT

Fragmentation and Uncertainty





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WORLD BANK GROUP



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ACRONYMS AND ABBREVIATIONS

| | |
|-------|--|
| COGAT | Coordination of Government Activities in the Territories |
| CVET | Continuing vocational education and training |
| EU | European Union |
| FDI | Foreign Direct Investment |
| GCC | Gulf Cooperation Council |
| GoI | Government of Israel |
| GDP | Gross domestic product |
| ICA | Investment Climate Assessment |
| ICT | Information and communications technologies |
| IFC | International Finance Corporation |
| IMF | International Monetary Fund |
| ILO | International Labor Organization |
| IPE | Initiative for the Palestinian Economy |
| ISO | International Organization for Standardization |
| IT | Information technology |
| LAD | Least absolute deviations |
| MENA | Middle East and North Africa |
| MFI | Microfinance institution |
| MIGA | Multilateral Investment Guarantee Agency |
| MOPIC | Ministry of Planning and International Cooperation |
| MSME | Micro, small and medium-sized enterprises |
| NIS | New Israeli Shekels |
| OCHA | United Nations Office for the Coordination of Humanitarian Affairs |
| OECD | Organisation for Economic Co-operation and Development |
| OLS | Ordinary least squares |
| OPIC | Overseas Private Investment Corporation |
| PA | Palestinian Authority |



| | |
|--------|---|
| PADICO | Palestine Development and Investment Company Ltd. |
| PCBS | Palestinian Central Bureau of Statistics |
| PE | Private equity |
| PICTI | Palestine Information and Communications Technology Incubator |
| PIF | Palestine Investment Fund |
| PIPA | Palestine Investment Promotion Agency |
| PMA | Palestine Monetary Authority |
| PPP | Purchasing power parity |
| PSI | Palestine Standards Institution |
| SII | Standards Institution of Israel |
| SME | Small and medium enterprises |
| TE | Technical efficiency |
| TFP | Total Factor Productivity |
| TVET | Technical Vocation Education and Training |
| UNRWA | United Nations Relief Works Agency |
| US\$ | United States Dollars |
| VAT | Value-added tax |

Currency Equivalents

(As of April, 2014)

Currency Unit US\$ 1 = 3.453 New Israeli Shekels (NIS)

Weights and Measures

The metric system is used throughout this report.

1 dunum = 1000 m² = 0.247 acre

Fiscal Year

July 1–June 30

| | |
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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-political-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

Key Messages

- Political instability, the result of the unresolved conflict and the restrictions on movement and access¹, 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 (Gol), 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

constraint². 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 pe-

riod 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 financier/ 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, Gol, 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.

| Recommendation area | Key recommendations |
|--|--|
| Improve access to resources and markets | <ul style="list-style-type: none"> • Enable PA access to land and resources needed for economic growth within Area C of the West Bank, including land, water, and the telecommunications spectrum. • Improve access to land in Areas A and B – making access to land a national priority. Support and improve PA capacity for land management and registration in Areas A and B. • Improve reliability and supply of electricity and fuel to Gaza. • Enable Palestinian role in facilitation of Palestinian trade including customs clearance by Palestinian Customs and control of testing for standards and mandatory requirements by the Palestine Standards Institution (PSI). |
| Reverse the trends of fragmentation and isolation | <ul style="list-style-type: none"> • Improve movement and access for trade and people within, between and through the West Bank and Gaza. • Support business, academic and civil society initiatives that promote trade and economic relationships between the West Bank and Gaza. • Diversify trade and investment ties with the Arab region and the rest of the world by tackling non-tariff barriers to trade, promoting regional and global investment and trade, and facilitating trade along the borders with immediate neighboring countries. |
| Mitigate political risk | <ul style="list-style-type: none"> • Fund political risk insurance instruments. • Use international investment facilitation to encourage first movers. • Institutionalize and support investment facilitation by the Palestine Investment Promotion Agency, and link to international facilitation. |
| Improve business regulation and enhance the role of the private sector | <ul style="list-style-type: none"> • Renew economic legislative reform plan in light of the possibility of a new parliament. • Reconcile and rationalize legislation in the West Bank and Gaza to overcome legislative gaps that have developed since the Gaza – West Bank political rift. • Take on the secondary business regulation agenda, particularly in areas that simplify business regulation, based on priorities identified. • Promote public-private-civil society dialogue, especially in conjunction with a new parliament. • Provide incentives for informal firms to formalize. |
| Invest in skills, technology, entrepreneurship, and innovation | <ul style="list-style-type: none"> • Invest in workforce skills development, with an emphasis on industry-led continuing education supported by a technical and vocational training institution and fund. • Invest in firm-level capacity, technology acquisition, and entrepreneurship—including industrial modernization, growth in tradable services, and technology-based entrepreneurship. • Support access to finance for micro and small enterprises. |

Palestinian Territories—Investment Climate At-A-Glance

| Indicators of microeconomic environment | 2006 survey | 2013 survey (manufacturing and services firms only) | 2013 survey |
|--|-------------|--|-------------|
| <i>Inputs</i> | | | |
| Average number of permanent, full time workers | 13 | 12 | 11 |
| Average number of temporary workers (total) | 3 | 1* | 1 |
| Share of material inputs and supplies of domestic origin | 51.3% | 44.3% | 44.4% |
| Days inventory of main input | 38.7 | 43 | 42.9 |
| <i>Ownership</i> | | | |
| Share of firms with private domestic ownership | 98.2% | 96.1% | 97.1% |
| Share of firms with female ownership | 18.4% | 13.7%* | 12.6% |
| <i>Infrastructure, transportation, and logistics</i> | | | |
| Share of firms that experienced power outages during the last fiscal year | 64.7% | 73.7% | — |
| Number of electrical outages in a typical month | 92 | 9.1* | 8.7 |
| Value lost due to electrical outages (% of sales) | 2.6% | 6.7%* | 6.4% |
| Number of water insufficiencies in a typical month | 1.3 | 2.9 | 2.9 |
| Duration of insufficient water supplies (hours) | 2.2 | 3.1 | 3.1 |
| Share of firms identifying transportation as a major constraint | 51.7% | 33.6%* | 34.1% |
| Average number of days for imported goods to clear customs in last fiscal year | 20.2 | 17 | 17 |
| Average number of days to clear direct exports through customs | 7.89 | 2.5* | 2.5 |
| Share of senior managers' time spent dealing with requirements of government regulations | 4.7% | 4.7% | 4.3% |
| Share of firms using the Web in interaction with clients/suppliers | — | — | 31% |
| <i>Finance</i> | | | |
| Share of firms with bank loans/lines of credit | 14.6% | 5%* | 6% |
| Share of firms with a checking or savings account | 84.8% | 70.5%* | 71% |
| Share of firms that declare that they do not need a loan | 55% | 74.9%* | 72.7% |
| Share of financing through working capital | 13% | 30.3%* | 30.3% |
| <i>Governance</i> | | | |
| Share of firms believing the court system is fair, impartial and uncorrupted | 35.1% | 61.1%* | 58.1% |
| Share of firms identifying corruption as major constraint | 65.2% | 49.9%* | 49.4% |
| Share of firms expected to pay informal payment (to get things done) | 14.5% | 7.3% | 7.3% |
| Share of firms identifying crime, theft and disorder as major constraint | 50.9% | 31.4%* | 32.4% |
| Average number of meetings with tax officials | 1.4 | 1.3 | 1.3 |
| Share of firms with annual financial statement reviewed by external auditor | 83.2% | 58.7%* | 59.1% |

Source: World Bank Enterprise Surveys, 2006 and 2013.

Note: M&S includes only manufacturing and services firms; retail firms were excluded to make these results comparable to the 2006 survey results, which also only included manufacturing and some services.* Note: these differences are significant at 10 percent level.

Notes

1. It is the view of the Government of Israel that these restrictions are implemented to protect the security of Israel and Israeli citizens.
2. With the possible exception of the trade blockade and power shortages in Gaza and the movement and access restrictions in the West Bank and East Jerusalem, which are arguably inextricable from political instability.
3. Source: Enterprise Survey data 2013. This includes only formal firms with five or more workers, which represents only about 11 percent of all formal firms (the remaining 89 percent have less than 5 workers).
4. East Jerusalem is a part of the West Bank that was annexed by Israel in 1967, so the investment climate of East Jerusalem is distinct from the remainder of the West Bank. Although Palestinians living in East Jerusalem are not Israeli citizens, they and their businesses are subject to Israeli laws and regulations.
5. "The Merits of Market Access: Mobility Restrictions and Economic Development in the West Bank," Roy van der Weide, Bob Rijkers, and Brian Blankespoor, The World Bank, December 2013.
6. *Area C and the Future of the Palestinian Economy*, The World Bank, 2013.
7. West Bank and Gaza: Improving Governance and Reducing Corruption, the World Bank, 2011. The high perception of corruption also indicates an important agenda for the Palestinian Authority in terms of equal treatment in business transactions, transparency, communications, and outreach to the public and the private sector.
8. The Declaration of Principles was signed in 1993, followed by the Gaza-Jericho Agreement and Paris Protocol in 1994, and the Interim Agreement in 1995. The Hebron Protocol was signed in 1997. This document will consider 1995 as the effective beginning of the implementation of the Oslo Accords, and the establishment of the Palestinian Authority in the West Bank and Gaza.
9. A World Bank publication, *Towards Economic Sustainability of a Future Palestinian State: Promoting Private Sector-Led Growth*, published in 2012 provides a more thorough treatment of policy recommendations in the scenario of a future Palestinian state.

OVERVIEW

Investment Climate Assessments at the World Bank

Investment Climate Assessments (ICAs) are critical instruments developed by the World Bank to: (i) quantify features of the investment climate that matter most for productivity and income growth, especially for the poor; (ii) track changes in the investment climate within a country; and (iii) compare performance within regions or countries.

ICAs focus on microeconomic and structural dimensions of a country's business environment, viewed in an international perspective. To this end, ICAs look in detail at factors constraining the effective functioning of product markets, financial and non-financial factor markets, and infrastructure services which include weaknesses in the legal, regulatory and institutional framework.

ICAs also provide the tools and analytical framework to identify reform priorities in a country's investment climate by linking constraints to firm-level costs and productivity.

Methodology

This ICA is underpinned by two surveys: an Enterprise Survey and an Informal Sector Survey. The first and primary source of data is from an Enterprise Survey, which is a standard World Bank product that allows for comparison of investment climate characteristics with other countries in the region and the world, as well as within countries across time. The Survey undertaken in the Palestinian territories in 2013 is part of a regional survey effort that includes a number of countries in the Middle East and North Africa (MENA) region, which in turn is part of a global Enterprise Survey project.

The Enterprise Survey is based on a sample of 434 formal sector enterprises having five or more workers from among Palestinian businesses in East Jerusalem, the rest of the West Bank, and the Gaza Strip. The sample frame was obtained from the establishment census conducted by the Palestinian Central Bureau of Statistics (PCBS). It includes enterprises from both the manufacturing and service sectors, including transport, retail, and restaurants. Informal formal establishments with less than five workers

were not included. Agriculture is also not covered. More survey details are available in Annex 1. The full survey data is available at www.enterprisesurveys.org.

The second survey is an Informal Sector Survey undertaken for the specific purpose of this ICA. The Informal Sector Survey was included in this analysis due to the perceived importance of its role in the domestic economy, more so in terms of its contribution to household incomes and employment rather than to its contribution to GDP. It surveys informal enterprises, defined as enterprises that do not pay value-added tax (VAT), and that demonstrate one of two features, that is, they: (i) operate on premises outside of the home; or (ii) employ at least one paid worker (other than the owner). This excludes a vast number of informal enterprises which are household-based and are owned and operated by a sole proprietor working for their own account. Therefore, it is not representative of the informal sector in its entirety, but rather of a subset that is more comparable to the formal enterprises in the Enterprise Survey at the smaller-scale of the spectrum. The sample of 427 enterprises was pulled from a sample frame combined from the Labor Force Survey and Establishment Survey conducted by the PCBS. More details are available in Annex 2.

This Assessment also draws on data from surveys and censuses conducted by the PCBS, in particular the Establishment Census of 2012, the Labor Force Survey series, and the National Accounts, as well as other analytical work undertaken by the World Bank and other international and Palestinian agencies.

Structure of this Report

This report is structured into three substantive chapters. Chapter 2 provides the descriptive analysis of the structure and performance of the Palestinian private sector relying on the data from both the Enterprise Survey and the Informal Survey, and including also data from other sources, primarily the PCBS. Together, these provide insight into the structure and contribution of the private sector to the Palestinian economy. Annex 3 provides the detailed technical analysis of firm productivity that underpins much of the analysis of this chapter.

Chapter 3 represents the heart of this ICA and describes the key constraints faced by the private sector, with all due attention to the differences in the investment climates as experienced in different parts of the Palestinian territories and by different types of enterprises (by size, formality, or certain sectors). This chapter highlights the most pertinent constraints on investment and business.

Finally, Chapter 4 draws together the conclusions and recommendations of this analysis. It begins with a brief description of recommendations for the medium-long term. It then concludes with more detailed recommendations for the immediate and short-term.

THE PALESTINIAN PRIVATE SECTOR

2.1 Structure of the Private Sector

The Palestinian economy is characterized by firms with moderate productivity, low investment, and limited competition, most of which are operating in retail and wholesale trade activities. (See Table 2.1.) There is a significant level of informality and a predominance of formal enterprises at the micro or small end of the firm size spectrum. Enterprises are highly dependent on Israel for either inputs or as a market. They operate in relative isolation from the rest of the global marketplace. The Palestinian economy has one of the lowest female participation rates in the world, either as business owners or workers. At the same time, firms show a high level of agility and adaptability; informal businesses in particular display entrepreneurship, but with little effect on the overall economy.

Table 2.1: Characteristics of the Formal Palestinian Private Sector
Operating Manufacturing, Services, and Retail Establishments

| Region | | Manufacturing, Mining & Quarrying, Construction, Electricity, and Water | Wholesale and Retail Trade | Services (exclud- ing Trade) | All Sectors |
|---|-------------------------|--|----------------------------------|------------------------------------|----------------|
| West Bank (including East Jerusalem) | Micro and small (1–19) | 13,124 | 49,071 | 23,909 | 86,104 |
| | Medium (20–99) | 360 | 118 | 375 | 853 |
| | Large (100+) | 28 | 5 | 47 | 80 |
| Regional total | | 13,512 | 49,194 | 24,331 | 87,037 |
| Gaza | Micro and small (1–19) | 5,105 | 24,262 | 11,318 | 40,685 |
| | Medium (20–99) | 88 | 49 | 123 | 260 |
| | Large (100+) | 13 | - | 5 | 18 |
| Regional Total | | 5,206 | 24,311 | 11,446 | 40,963 |
| Palestinian territories | | 18,718 | 73,505 | 35,777 | 128,000 |
| % West Bank | | 72% | 67% | 68% | 68% |
| % Gaza strip | | 28% | 33% | 32% | 32% |

Source: PCBS Establishment Census 2012.

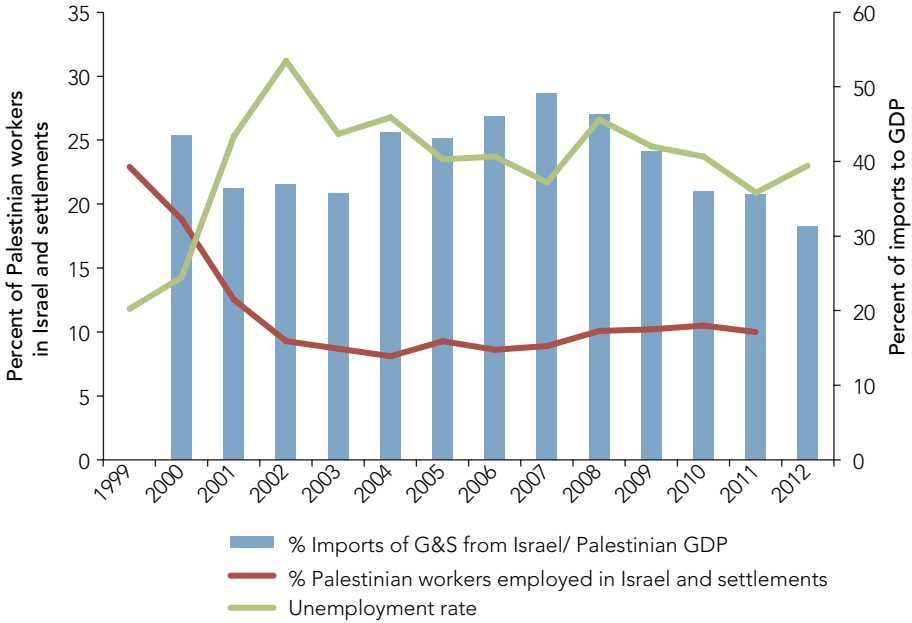
The structure of the private sector in the Palestinian territories has not evolved significantly since before the Oslo Accords. It has been limited and shaped in various ways by the multilayered restrictions on movement and access implemented by the Government of Israel. Since the Israeli presence began in the West Bank and Gaza in 1967, the Palestinian economy operated as an auxiliary to the Israeli economy, supplying cheap labor to the Israeli economy and importing most of its goods from Israel. Some low technology and low value-added goods were produced by Palestinian firms, primarily for the small domestic Palestinian market. Much of this is still true today. However, Palestinian labor exports to Israel are now severely restricted. Between 1995 until the year 2000 when the government of Israel began to implement its policy to reduce Palestinian labor in Israel, an average of 18.4 percent of Palestinian labor was working in Israel or in Israeli settlements. Since 2002, this has dropped to about 10 percent. Imports of goods and services from Israel, which historically comprise over 70 percent of all Palestinian imports, have represented at least 30 percent of Palestinian gross domestic product (GDP) throughout recent years. It continues to rise in absolute terms.

Despite the Palestinian Authority's limited control over the economy as delineated in the limited self-rule arrangements under the Oslo Accords—and largely because of the constraints on access to resources and on the movement and access of people and goods—the structure of the private sector has not shifted significantly.¹ In the simplest terms, the economic relationship between Israel and the Palestinian territories has been one of an exchange of labor for goods. (See Figure 2.1.) However, in recent years it has become more constrained, with increasing restrictions on Palestinian labor exports to Israel and on Israeli trade with Gaza. The necessary and long-awaited private investment and growth in the industrial and high value-added service sectors that would create jobs and GDP growth never materialized.

Despite some growth in private sector employment, whose share of total employment is estimated to have increased by 9 percent between 2000 and 2011, most of the jobs have been in retail and non-tradable services.² The industrial and high value-added service sectors have not been able to compensate for the Palestinian workers shed by the Israeli economy since 2000. The result has been a spike in unemployment, as high as 31 percent in 2002, from which the Palestinian labor market has yet to recover. The Palestinian public sector, which employs almost a quarter of the Palestinian workforce, has helped to offset some of the low labor demand in the private sector. However, this trend is fiscally unsustainable and cannot be expected to be a direct contributor to employment growth in the future.

In the meantime, rather than becoming a driver of the Palestinian economy, the contribution of manufacturing to GDP and employment has been in decline, with the contribution of manufacturing to GDP declining 26 percent in the last decade. The contribution of manufacturing (including quarrying) to employment dropped 13 percent between 2001 and 2011. Despite having yet to recover to 2001 levels,

Figure 2.1: Relationship between the Palestinian and Israeli Economies—
Labor for Goods



Source: World Bank calculations from PCBS National Accounts, Foreign Trade data, Labor Force Series, for multiple years.

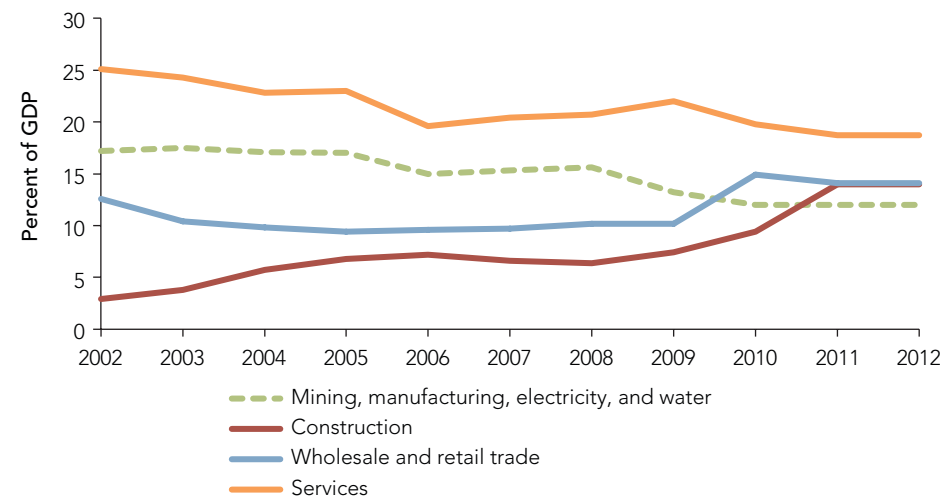
Note: G&S=goods and services; GDP=gross domestic product.

the contribution of services to employment has shown a modestly positive trend in the past few years. However, there is little evidence that high value-added services have contributed much to this growth. (See Figure 2.2.)

Palestinian firms are skewed toward a micro/small size and demonstrate weak employment growth. The distribution of establishments by size remains skewed to very small sized firms, with only 1 percent of establishments having 20 or more workers (in 2013). This represents relatively low levels of employment in what are typically higher productivity firms.³ The small scale of Palestinian enterprises is remarkable even for lower-middle income countries, as illustrated in Figure 2.5. Even if the large number of establishments with less than five employees is removed from the picture, and only establishments with five or more workers are examined more closely, the degree to which Palestinian enterprises are skewed toward the small end of the scale is notable when compared to other lower-middle income countries. Further, it is indicative of constrained growth among Palestinian small and medium enterprises (SMEs).

A panel analysis of 59 firms surveyed in both 2006 and 2013 reveals that employment growth was limited during this time period, averaging only 4 percent. Where-

Figure 2.2: Contribution of Manufacturing and Service Sectors to GDP Declining; Trade and Construction Rising

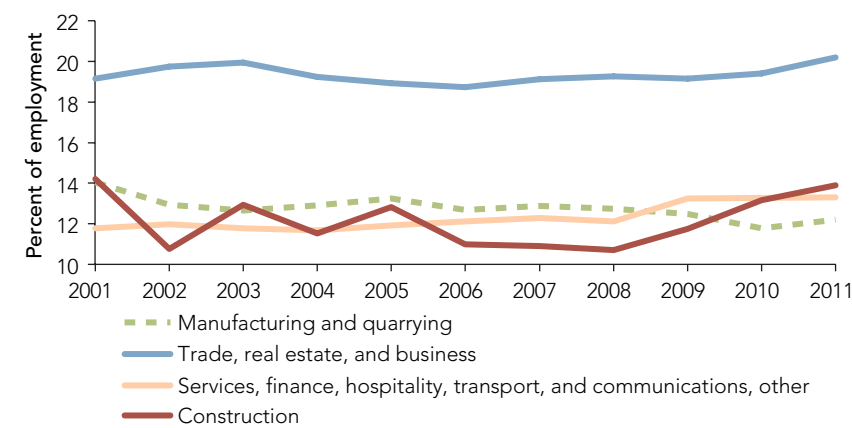


Source: World Bank staff calculations from PCBS national accounts data.

Note: GDP=gross domestic product.

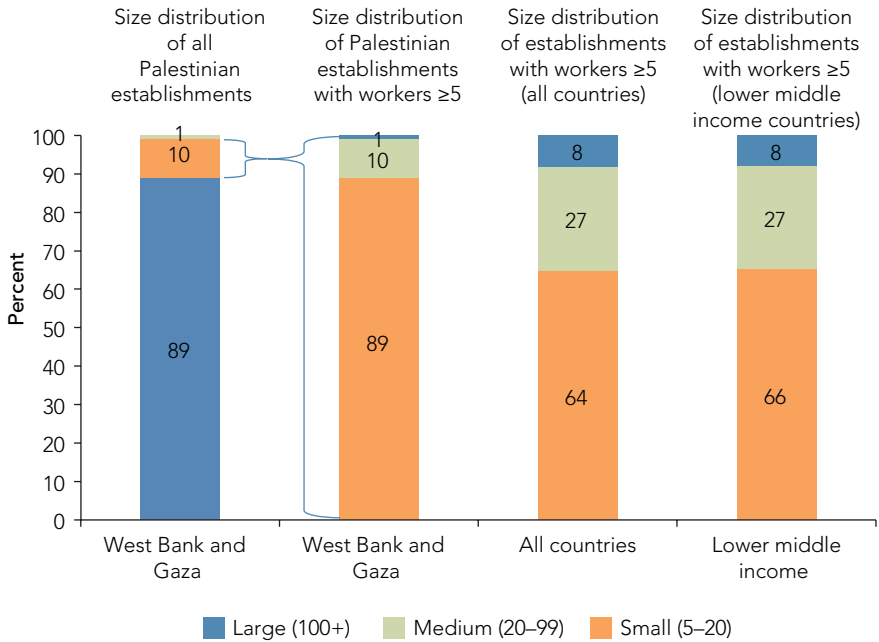
as a higher number of firms experienced employment growth than those that did not, the firms that experienced drops in employment did so more acutely than those that grew. With the Palestinian population growing at an annual rate of 2.9 percent and with an already structurally high unemployment rate, this growth rate is unremarkable, particularly when considering that this sample represents a select group of firms that survived during this time period.

Figure 2.3: Private Sector Employment Dominated by Trade; Percent Employment in Manufacturing in Decline



Source: World Bank staff calculations from PCBS data.

Figure 2.4: Very Small-Scale Palestinian Establishments



Source: World Bank calculations from PCBS Establishment Census 2012 and Enterprise Analysis Unit, West Bank and Gaza. Data includes all establishments (including public sector and non-governmental) and excludes agricultural establishments.

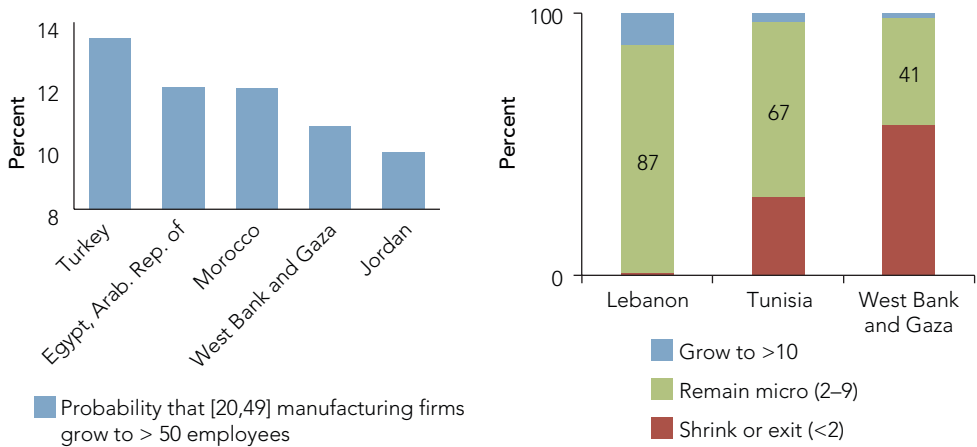
This analysis is further supported by firm dynamics analysis using establishment census data. Currently ongoing analysis of census data from 2007 and 2013 reveals limited growth among establishments of all sizes including microenterprises (which are largely informal), SMEs, and large firms, as well as high exit rates.⁴ (See Table 2.2.) Exit rates are highest for microenterprises at 44 percent, and are notably higher than other comparator countries. Growth is also notably lower than other comparator countries; for example, growth of firms with 20–49 workers is just 10.6 percent, among the lowest in the region. (See Figure 2.5.)

Table 2.2: Palestinian Firm Dynamics by Firm Size Growth and Exit Rates (2007–2012)

| Percent of firms (number of employees) | Percent of firms that exited (%) | Percent of firms that grew (%) |
|---|----------------------------------|--------------------------------|
| Percent of all firms | 44 | 15 |
| Percent of micro firms (1–9) | 44 | 15 |
| Percent of SME firms (10–99) | 28 | 12 |
| Percent of large firms (100+) | 17 | 17 |

Source: World Bank, *Jobs or Privileges: Releasing (Potential) Prosperity in MENA*. World Bank.2014. Forthcoming.

Figure 2.5: Palestinian Firm Dynamics by Regional Comparison



Source: World Bank. *Jobs or Privileges: Releasing (Potential) Prosperity in MENA*. World Bank. 2014. Forthcoming.

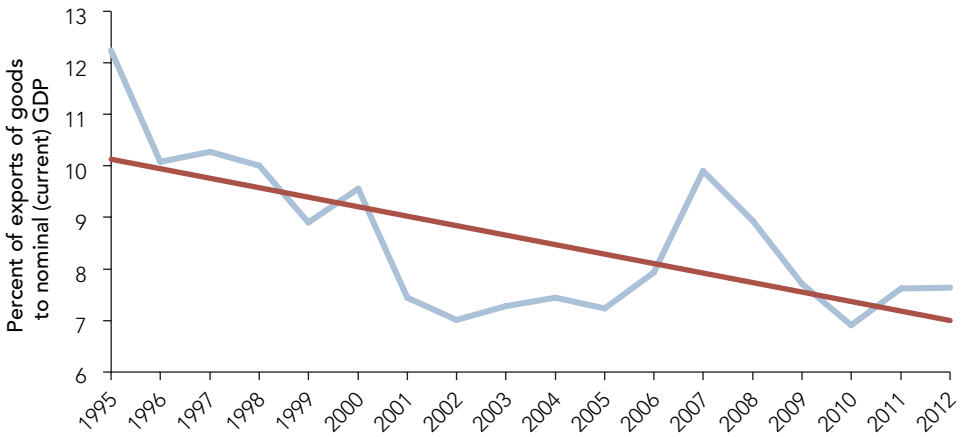
Female participation in the private sector is low in terms of ownership, management and labor. Only 12.6 percent of firms surveyed in 2013 reported having any female ownership, with the percentage significantly lower in Gaza than in West Bank firms (including East Jerusalem). This may have dropped since 2006, when 18 percent female ownership was reported, but this difference does not appear to be statistically significant. Female management of Palestinian firms is even rarer, with only 1 percent of firms having a female as a top manager. Similarly, only 12.1 percent of the informal businesses surveyed have a female among the principal owners of the enterprise. However, 10.2 percent of the informal businesses reported that the main decision maker is female. Female labor participation is also low. The latest labor force surveys show female labor force participation rates at only 17 percent compared with the MENA average of 26 percent. Female labor participation is highest in the public sector. In the 2013 survey of private sector firms, only 5.8 percent of full-time female workers were reported.

2.2 Performance of the Private Sector

Export Performance

The underperformance of the manufacturing and service sectors is further demonstrated by their export operations. Exports of goods relative to GDP has been declining since Oslo tumbling from 12.2 percent of current GDP in 1995 to 7.6 percent in 2012. While there were some signs of recovery beginning in 2006 (after the second Intifada of 2001), this was followed by another period of deterioration beginning in 2008. This is not surprising given the prolonged effects of the unrest and restrictions during that period, as well as the severe restrictions on exports from Gaza since 2007. (See Figure 2.6.)

Figure 2.6: Deterioration in Contribution of Exports of Goods to Current GDP



Source: World Bank staff calculations from PCBS trade data.

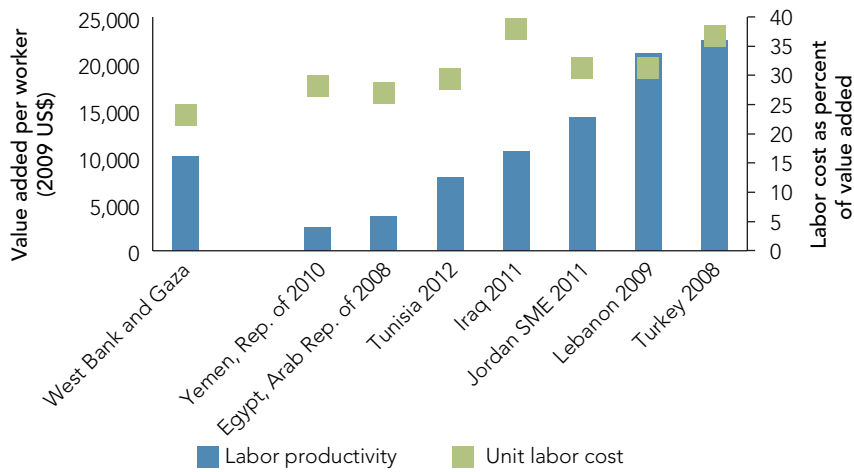
Note: GDP=gross domestic product.

A closer examination of export composition reveals modest improvement in the diversification of export markets and products. Some diversification from the dominant Israeli market was achieved, with the percentage of exports to countries other than Israel rising from 8 percent to 18 percent of exports between 2000 and 2012. Exports of good are still dominated by agricultural produce, limestone, and scrap metal, most with limited value added. However, some higher value-added products, including furniture, footwear, processed food, and pharmaceuticals, also represent significant exports.

Labor Productivity and Costs

A comparison of the labor productivity of Palestinian firms with those in neighboring and other countries in the region shows labor productivity to be comparable to some other countries in the mid-range of the productivity spectrum, such as Iraq—but with unit labor costs slightly below some of those countries (when measured per added value). (See Figure 2.7.) The median manufacturing firm in the West Bank and Gaza produced about \$10,000 of output (value-added) per worker; this is considerably higher than in Egypt or Yemen, but lower than in the better-performing comparator countries, including Lebanon and Jordan. Labor productivity is about 40 percent higher in Jordan and is over twice as high in Turkey. When labor productivity for a number of countries is plotted against GDP, the labor productivity of firms in the West Bank and Gaza lies close to the predicted value relative to its income level.⁵ This suggests that labor productivity is close to what we would expect given the level of development of the Palestinian territories. It should also be noted that unit labor costs for Palestinian firms are lower than those of comparator countries and lower than the average for countries at similar levels of per capita income, with little variation by firm size. (See Annex 3 for detailed productivity analysis).

Figure 2.7: Labor Productivity is Lower in the West Bank and Gaza than in the Best-Performing Comparator Countries, with Labor Costs Lower than in Comparator Countries



Source: Authors calculations based on data from World Bank Enterprise Surveys.

Note: Partial productivity measures are measured in 2009 USD (adjusted using GDP deflators). See Annex 4 for details. All data points are for the median firm on each measure of performance.

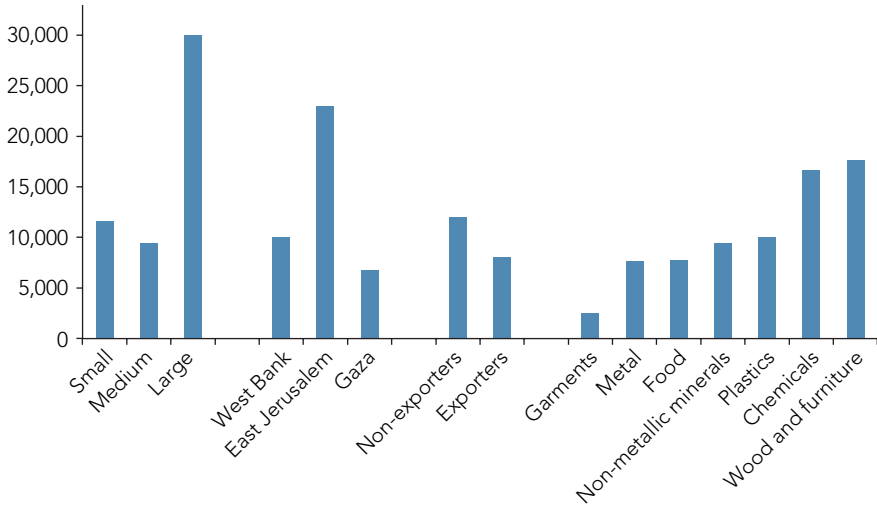
It is also possible to compare labor productivity for firms within the West Bank and Gaza. Because the sample is relatively small—only about 129 manufacturing firms provided enough data to calculate labor productivity—these comparisons should be treated with care. Indeed, some differences might be due to sampling variation. With this caveat in mind, Figure 2.8 shows labor productivity across regions within the West Bank and Gaza, for firms of different sizes, and by other firm characteristics.

As might be expected, large firms are considerably more productive than small and medium-sized firms. Labor productivity is about \$30,000 for the median large firm in the West Bank and Gaza, compared to about \$10,000 for the median small and medium-sized firms. Large firms are more productive in most countries, often because they are more capital intensive, have better access to technology, and can more easily achieve economies of scale.

Firms in East Jerusalem are far more productive than firms in the West Bank and Gaza. The median firm in East Jerusalem produces about \$23,000 of output per worker as compared with about \$10,000 for the median firms in the West Bank, and about \$6,800 for the median firms in Gaza. This can be explained by the higher capital intensity of East Jerusalem firms, as shown below, and by a higher concentration in higher productivity sub-sectors, as well as better investment conditions (for example, fewer effects of power outages, less restrictions on trade, and other factors).

In contrast to most countries, non-exporters are no less—and possibly more—productive than exporters in Gaza and the West Bank. This is unusual and may be explained

Figure 2.8: Labor Productivity is Higher in the West Bank and East Jerusalem than in Gaza



Source: Authors calculation based on data from World Bank Enterprise Surveys.

Note: Partial productivity measures are measured in 2009 US\$. See Annex 4 for details. All data points are for the median firm on each measure of performance.

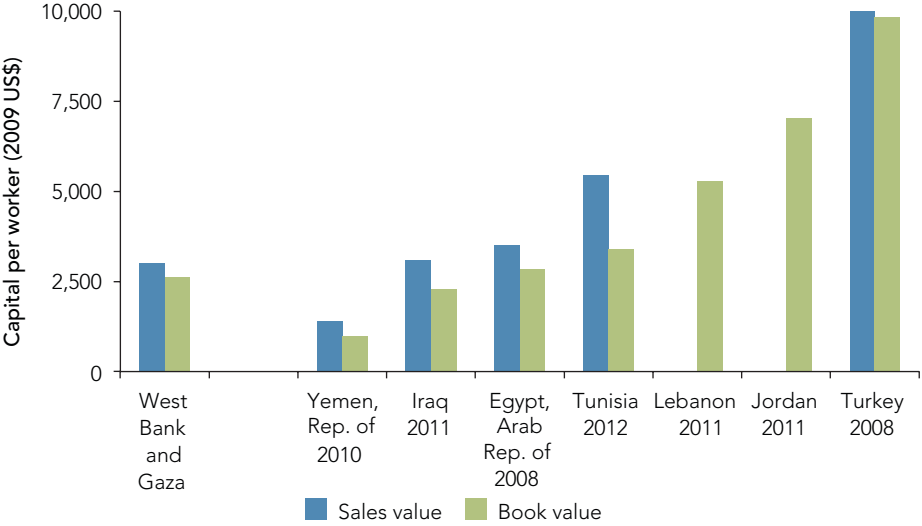
in part by the nature of Palestinian exports being concentrated in lower productivity sub-sectors, such as non-metallic minerals (limestone). Because firms need to be productive to enter export markets (self-selectivity) and because firms in export markets have easier access to new technologies in export markets, exporters are usually more productive than non-exporters. There are also notable differences across sectors with plastics, chemicals, and wood and furniture firms being the most productive.

Capital Intensity

One plausible reason why labor productivity might be lower in the West Bank and Gaza relative to the best-performing comparator countries might be that manufacturing firms are less capital intensive than firms in similar countries. As noted, labor productivity does not take capital use into account. As a result, capital-intensive firms (that is, firms that have a lot of capital for each worker) might appear to be more productive because they have substituted capital for labor.

Firms in the West Bank and Gaza are not as capital intensive as firms in most other countries in the region—whether the sales value or book value of capital is used to compare countries. (See Figure 2.9.) Although the median firm in the West Bank and Gaza has more capital per worker than the median firm in Yemen, the median firms in other countries are generally more capital intensive than the median firm in the West Bank and Gaza. For example, although labor productivity is lower in Egypt and Tunisia than in the West Bank and Gaza, firms in these two countries are more capital

Figure 2.9: Firms in the West Bank and Gaza are Less Capital Intensive than Firms in Regional Comparator Countries



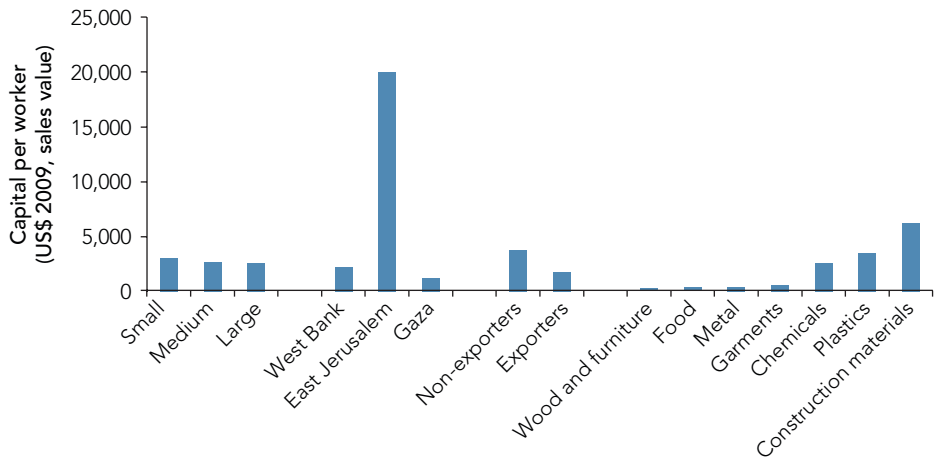
Source: Authors calculation based on data from World Bank Enterprise Surveys.

Note: Partial productivity measures are measured in 2009 US\$. See Annex 4 for details. All data points are for the median firm on each measure of performance. Sales value of capital was not available for Jordan in 2001 or for Lebanon in 2011.

intensive. When capital intensity for a larger group of countries is plotted against GDP levels, capital intensity in the West Bank and Gaza is also found to be significantly lower than would be predicted for its level of development, which would be consistent with the behavior of firms in an uncertain investment climate (see Annex 3). This lower capital intensity seems to be mitigated somewhat by higher technical efficiency (or total factor productivity) of firms in the West Bank and Gaza as compared to countries in the region (see Annex 3). Although estimation of technical efficiency is fraught with problems in estimation and interpretation, particularly for cross-country comparisons, these results are compelling. The higher technical efficiency warrants closer study, but may be explained by the quality of management, workforce, and transfer of know-how and practices through supply chain relationships, or from Palestinians gaining experience from abroad.

There are, however, large differences in capital intensity and technical efficiency among Palestinian firms by region, and among firms in the same sub-sector. (See Figure 2.10.) Most notably, firms in East Jerusalem are, on average, far more capital intensive than firms in the West Bank and Gaza. The median firm in East Jerusalem has over ten times as much capital per worker as the median firm in Gaza, and has almost ten times as much capital as the average firm in the West Bank. This might partly account for the large differences in labor productivity between the different areas in the West Bank and Gaza.

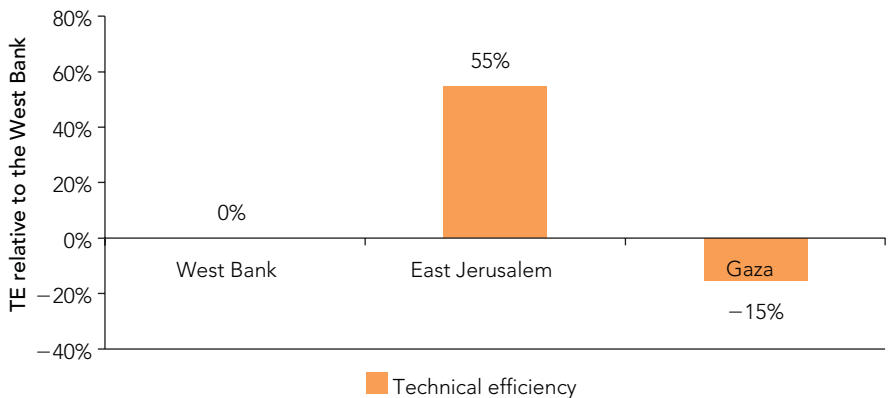
Figure 2.10: Firms in East Jerusalem are Far More Capital Intensive than Firms in the Rest of the West Bank and Gaza



Source: Authors calculation based on data from World Bank Enterprise Surveys.

A similar pattern can be observed for total factor productivity (TFP), or technical efficiency. Technical efficiency for the median firm in East Jerusalem is about 55 percent higher than for the median firm in the West Bank. Similarly, technical efficiency for the median firm in the West Bank is about 15 percent higher than for the median firm in Gaza. (See Figure 2.11.) The smaller differences in technical efficiency compared to capital intensity suggest that differences in labor productivity between the three regions are partly due to differences in capital intensity or the particular sub-sectors dominant in each region.

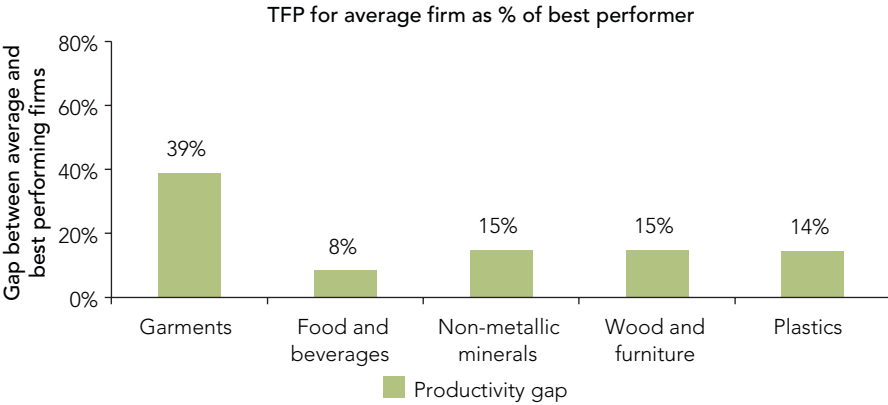
Figure 2.11: Differences in Total Factor Productivity, by Region



Source: Authors calculation based on data from World Bank Enterprise Surveys.

Note: The coefficients are from the least absolute deviation (LAD) regressions (see Annex 5 for description). The numbers can be interpreted as the difference in productivity between each region and the West Bank.

Figure 2.12: Differences between Average and Best Performers



Source: Authors calculation based on data from World Bank Enterprise Surveys.

Note: The residuals are from the least absolute deviation (LAD) regressions. The numbers can be interpreted as the productivity of the average firm in each sector relative to the most productive firms. Only sub-sectors with at least ten firms with usable data are included in table.

Productivity gap between the best and average firms. Another notable feature of the data is that there is a large gap between the best-performing firms in the West Bank and Gaza and the average firm in terms of total factor productivity. In the garment sector, for example, the average firm is only about 40 percent as productive as the most productive firms. The gap in other sectors, however, is even larger (see Figure 2.12). In this comparison, the average firm is only about 15 percent as productive as the best-performing firm.

Overall, the large differences between the best performers and the average performers suggest that there is considerable inefficiency in most sectors, and that competitive forces might not be as strong as would be desired. (See Figure 2.12.) Indeed, if competition was more intensive, less productive firms would be forced to become more productive. This lack of competition may be explained in part by the large regional differences in productivity, with firms in East Jerusalem being far more productive than firms in Gaza—and to a lesser extent than firms in the West Bank, and by the fact that firms in these areas are, by and large, not in direct competition with one another due to restrictions on trade and market access between the three areas.

Performance of Key Sectors

Two sub-sectors have outperformed others over the past decade: stone and marble, as a major export, and food production for domestic consumption. Marble and stone exports, with quality competitiveness in export markets, account for around 20 percent of total industrial exports. The bulk of stone and marble exports are in the form of unprocessed blocks, limiting the potential contribution to GDP and the job market.

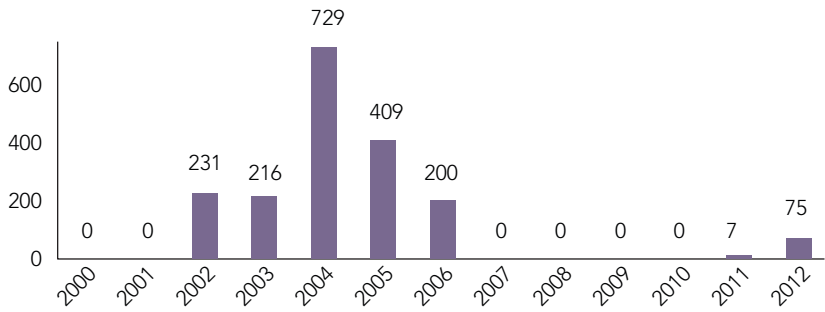
In terms of total investments, after stone and marble, food production is the second largest sector. The sector has generally been unable to compete on the international market (with the exception of select date and olive oil exports). Therefore, food producers target domestic markets, where, on average 42 percent of the Palestinian household consumption basket is spent on food products. The main subsectors in food production include: dairy products, meat processing, canned products, flour mills, beverage, and chips. Whereas Israeli food products are abundant in Palestinian markets, Palestinian food products largely do not have access to Israeli markets due to standards and certification requirements.

Agriculture and agribusiness products, equally significant drivers of manufacturing to the Palestinian economy, have also experienced a gradual decline over the past decade. Despite the Palestinian territories enjoying a climate conducive to the production of high-value crops, the share of agriculture in the economy dropped from 13 percent to 6 percent, and the sector’s productivity (as measured by output per worker) halved between 1995 and 2011.⁶

The key constraint driving down agricultural development is restricted access to arable land within the West Bank, and limited access to water. Currently, only 12 percent of cultivated land in the West Bank is irrigated, compared to 78 percent in Gaza. The introduction of new water technologies, especially in desalination, irrigation and wastewater treatment, could help raise the area under cultivation.⁷ The recent positive expansion in the agribusiness sector includes the growth of high-value fresh herb exports, developed with investment and trade facilitation support from international development agencies.

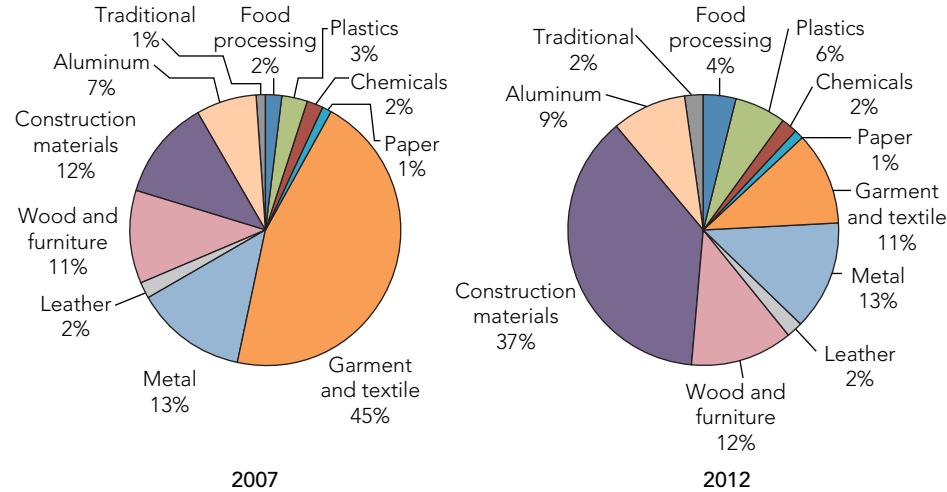
In light of the various constraints facing the Palestinian manufacturing and agriculture sectors, the conditions of the Palestinian economy may prove to be more compatible with tradable services. Sectors such as tourism, information and communications technologies (ICT), and business services (for example, business process outsourcing), rely primarily on skilled labor, while requiring less capital, energy, and natural resources. Although recent trends point to steadily growing tradable

Figure 2.13: Exports of Cherry Tomatoes from Gaza 2000 – 2012 (tons)



Source: The Palestinian Agricultural Relief Committee and Paltrade.

Figure 2.14: Distribution of Gaza Manufacturing Establishments by Type of Activity (% of establishments)



Source: Palestinian Federation of Industries.

services, with the exception of tourism, these sectors are largely considered nascent rather than key drivers of the economy. In this context, some manufacturing sub-sectors, including stone, furniture, footwear, and pharmaceuticals have shown sustained growth in exports in recent years. (See Figure 2.14.)

Performance indicators of the private sector in Gaza reflect the turbulent political events of recent years. Macroeconomic indicators, labor market outcomes, and sector performance were negatively impacted by a systematic embargo, a series of military actions by Israel which intensified during 2002, 2006, 2007, and 2012, and the internal Palestinian political crises.

Most economic sectors could not recover from the blockade on exports and imports placed on Gaza starting in 2007. Over 50 percent of enterprises across the industrial, furniture, garment, textile and agriculture sectors closed due to a combination of physical damage and deteriorating market conditions. Electricity blackouts due to local production constraints and intermittent supply from Israel levied an uneven burden on economic sectors operating in Gaza. The combination of the external forces and market distortions halted Gaza’s export potential, virtually ending the operations of key export sectors including furniture, agriculture, and textile and garment production. Cherry tomatoes and high-value fresh produce, once a mainstay of Gaza exports to European and other markets, have virtually ceased. (See Figure 2.13.) Limited exports occurred only in 2012, with the facilitation of international development agencies.

Equity Investment Performance

A number of large Palestinian investors have successfully attracted foreign direct investment (FDI) and launched new private investments. This trend 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, such as the Palestinian Development and Investment Company Ltd. (PADICO), the Palestine Investment Fund (PIF), and some investors in private equity (PE) funds. 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 (such as some Gulf Cooperation Council [GCC] sovereign wealth funds), or as a financier/ facilitator (such as the United States Agency for International Development (USAID), or the Government of the Netherlands). Such foreign partners have provided equity in the form of grants or loans for capital investments and, in some cases, facilitated movement of goods from projects in which they have an investment or interest. The launching of the Initiative for the Palestinian Economy (IPE) by the Office of the Quartet Representative, and the Beyond Aid Initiative by the Palestinian private sector, represent recent high-level, high-visibility initiatives. Such initiatives aim to bring a qualitative shift in domestic and foreign investment, and may similarly benefit from high-level facilitation and scale.

There are three private equity funds and one venture capital fund operating in the Palestinian territories at this time. All of these funds were established since 2011 and have a total committed capital exceeding US\$ 206 million, with estimated investments of at least US\$ 45 million. (See Table 2.3.) In 2006, at the time of the last investment climate assessment, there were no such funds.

Although they are relatively new investments and have had no reported exits to date, the funds are in a growth mode and are reportedly actively seeking investments. However, some have reported a small pipeline, with a dearth of viable companies and a relatively low flow of deals. Nonetheless, domestic and foreign investments in housing, agribusiness, and other sectors appear to be on the rise in comparison to previous years. This may continue to be a trend. In this context, the pipeline should benefit from a recently launched seed fund, Arabreneur (funded by USAID), that will provide financing in the US\$ 50,000 – US\$ 150,000 range, which had been identified as a financing gap for Palestinian start-up companies.

There is little evidence of any broadening of the role of diaspora finance as a source of investment in the Palestinian territories. Inward remittance flows were estimated to be more than US\$ 1.3 billion in 2010, slightly more than total donor assistance channeled through the PA budget totaling \$US 1.275 billion⁸ in the same year. Remittances are generally considered to be important in contributing to household expenditures and, to some degree, private construction. However, they are not a significant source of business investments.

Table 2.3: Private Equity and Venture Capital Funds in the Palestinian Territories

| Fund Name | General Partner/ Manager | Limited Partners | Fund Inception Date | Fund Term | Committed Capital (US\$) | # of Deals Closed | Total Invested Capital (US\$) |
|----------------------------------|--------------------------|---|---------------------|-----------|--------------------------|-------------------|-------------------------------|
| Sharakat | PIF | PIF | 2012 | 10 years | 50 million | 7 | 10.22 million |
| Siraj | Massar | Massar, Soros Development Fund, OPIC, and others | 2011 | 10 years | 90 million | 11 | 31 million |
| Palestine Growth Capital Fund | Riyada | PIF, EIB, CISCO, Bank of Palestine, IFC, Abraaj through SPV/ Riyada Managers Ltd. | 2011 | 10 years | 36 million | 2 | 3.5 million |
| Middle East Venture Capital Fund | Sadara Ventures | Not disclosed | 2011 | 10 years | 30 million | 3 | Not disclosed |
| TOTAL | | | | | 206 million | 22 | Over 45 million |

Source: As reported by fund management staff as of April 2014. The PGCF expects additional 5 pipeline deals to close in 2014 for an additional US\$ 15 investment.

Note: EIB= European Investment Bank; IFC= International Finance Corporation; OPIC= Overseas Private Investment Corporation; PIF= Palestine Investment Fund; PCGF= Palestine Growth Capital Fund.

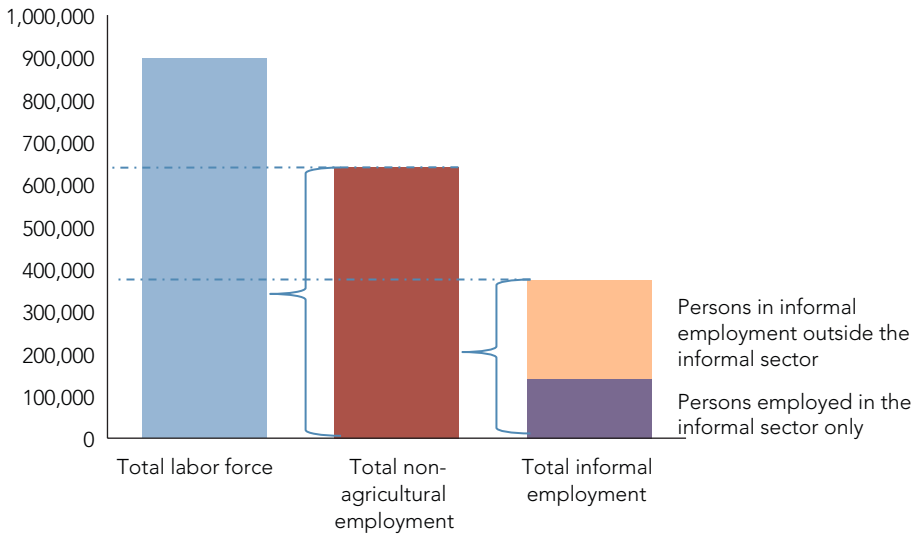
2.3 Informal Sector

Informal activities are a significant part of the economy in the West Bank and Gaza, both in terms of contribution to overall economic activity and the workforce. Total informal employment reaches nearly 60 percent of the non-agricultural workforce, meaning that nearly three out of five people in the Palestinian workforce hold an informal job, either within informal or formal enterprises.⁹ Of this share, about one in five people (23 percent) work directly in the informal sector for informal firms. Thus, informality runs high in the Palestinian economy – within both the formal and informal sectors. (See Figure 2.15.)

While no data are available on the contribution of the informal sector to GDP in the West Bank and Gaza, informal sectors in developing economies are generally estimated to contribute 35 to 40 percent of official GDP, and may average closer to 20 to 25 percent of GDP for countries in the Middle East and North Africa (MENA) region. The informal sectors in Israel and Jordan are both estimated to contribute around 20 percent of GDP.¹⁰

The informal sector in the West Bank and Gaza is comprised of enterprises that display characteristics of entrepreneurship, but have little overall impact on the econo-

Figure 2.15: Significant Share of Informal Activity: Nearly 60 Percent of Total Non-Agricultural Employment



Source: World Development Indicators; International Labour Organization (ILO) Department of Statistics, 2012 “Statistical update on employment in the informal economy.”

my. These informal enterprises are primarily young, small, owned mostly by men, and focused on the domestic market. Firms are mostly involved in the sale of various services (27 percent), construction and home repair (23 percent), food and grocery sales (16 percent), and the repair of motor vehicles and motorcycles (5 percent). As would be expected, education levels and wages are lower in informal firms than in formal firms.

Female ownership appears to be comparable between the formal and informal firms surveyed, that is, with about 12 percent of both groups having at least one female owner.¹¹ Whereas nearly half of formal business owners have a university degree or higher, only about a quarter of informal business owners have some form of tertiary education. Average monthly wages are similarly lower in informal firms (US\$326) than in formal firms (US\$652) and the public sector (US\$732).

Most informal business owners in the Palestinian territories are subsistence entrepreneurs, functioning within an isolated market. Nearly 90 percent of informal business owners indicate that their enterprise is their sole income-generating activity, and a similar share suggests that they have not searched for other jobs in the previous two years. Of the small share of informal entrepreneurs who do hold other employment, about 60 percent work for the Palestinian Authority and 15 percent for private businesses in Israel.

Similar to the formal sector, Palestinian informal enterprises serve primarily the domestic market with over 90 percent of sales taking place within the West Bank

and Gaza, and the majority of those sales occurring within the locality where the enterprise is located. Of the small share of sales to foreign markets, about 8 percent are direct exports to Israel. Only 0.3 percent are direct exports to the rest of the world, and 0.5 percent are indirect exports through a third party. The firms exporting directly to foreign markets, including Israel, are uniquely located in the West Bank. Domestic customers are mainly individuals and households, which also act as the primary suppliers of inputs to informal enterprises. It can be surmised that because informal firms rely mainly on local networks for sales and inputs, only one of five firms sampled uses the Internet for its operations.

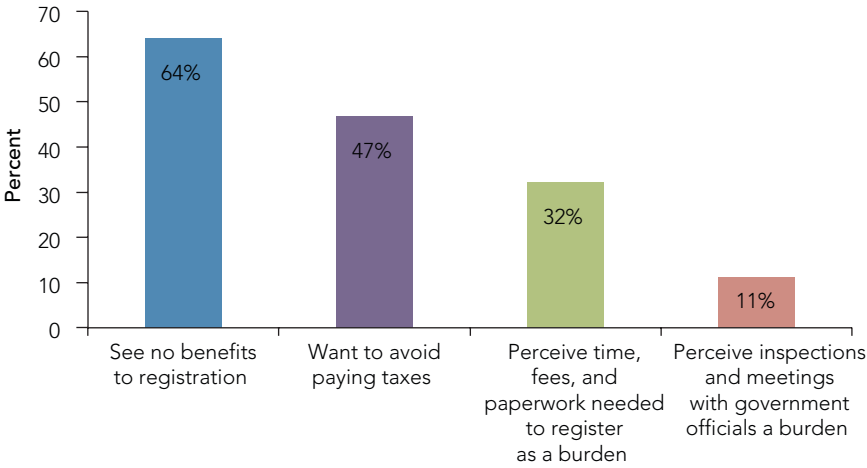
Investment and growth are limited and often stagnant for informal enterprises. On average, firms have two paid employees and one unpaid employee. Furthermore, over three-quarters of firms in the West Bank and Gaza indicated that in the three years previous to the survey, their number of employees, machinery used, and space occupied had not increased.

Despite challenging circumstances, firms in the informal sector display an entrepreneurial spirit, resilience and potential to grow. Nearly 90 percent of informal firms surveyed started the business on their own or with partners. About 44 percent indicate that they have purchased some type of new or used machinery, equipment, or vehicles in the three years prior to the survey. Analysis of census data shows that microenterprises, most of which tend to be informal, tend to stay at the micro level, with no more than one percent growing beyond 9 workers between 2006 and 2012.¹² Furthermore, nearly half of formal firms suggest that informal firms are competitors, indicating that the products offered by the informal sector are relatively competitive with presumably larger and more formalized enterprises.

Since start up, more than 98 percent of informal Palestinian businesses are not registered and have not been registered in the past with the Ministry of National Economy. An estimated 67.8 percent of informal entrepreneurs surveyed declared that they do not want their business or activity to be registered with the Palestinian Authority/Ministry of National Economy, versus about a third that would like to be registered.

For the most part, informal businesses perceive little benefit to registration and wish to avoid lost income from tax payments. They also cite as a disincentive the bureaucratic hurdles necessary for registration – such as time, fees, and paperwork. (See Figure 2.16.) Some feel dissuaded by the idea that registration would bring with it unwanted inspections and meetings with government officials. When asked how long it would take to register, on average informal businesses expected that it would take 52 days to register a business which is fairly close to, but higher than, the 45 actual days reported in the 2014 *Doing Business* Report (the MENA average is 19.8 days). Considering that most perceive little benefit to registration, including lost income from tax payments, this is certainly a strong disincentive.

Figure 2.16: Reasons for Non-Registration among Informal Firms (2013)



Source: PCBS Informal Sector Survey.

Notes

1. World Bank, *Towards Economic Sustainability of a Future Palestinian State: Promoting Private Sector-Led Growth*. April 2012.

2. PCBS *Labor Force Survey* statistics.

3. Although the census data from which this figure is derived includes public sector and non-governmental firms, a closer examination of the data reveals that this has no significant effect on the conclusion—which also held true for the data from the 2007 establishment census. Thus, this size distribution has persisted for many years.

4. Data in this paragraph are derived from *Jobs or Privileges: Releasing (potential) Prosperity in MENA*, World Bank. 2014. Forthcoming.

5. This analysis is affected by the fact that the GDP of the Palestinian territories is represented in terms of real GDP, whereas for all other countries purchasing power parity (PPP) GDP is used.

6. The World Bank: *Economic Monitoring Report to the Ad Hoc Liaison Committee*. March 2013.

7. The Portland Trust. *Beyond Aid, A Palestinian Private Sector Initiative for Investment, Growth and Employment*. November 2013.

8. This figure does not capture donor aid for projects implemented outside of the PA's budget. According to the Ministry of Planning and Administrative Development, from 2010 to 2012 donors gave US\$393 million through projects implemented through local and international non-governmental organizations (NGOs). (Source: Staff Report Prepared for the September 2013 Meeting of the Ad Hoc Liaison Committee, IMF, 2013.)

9. A job is informal when it lacks basic legal or social protections or employment benefits or is not subject to national labor legislation and income taxation. An informal job may be found in the formal sector, informal sector, or households (and in these figures may include informal employment in Israel or the settlements). See the following for a further definition: http://laborsta.ilo.org/applv8/data/INFORMAL_ECONOMY/2012-06-Statistical%20update%20-%20v2.pdf

10. *Shadow Economies All over the World, New Estimates for 162 Countries from 1999 to 2007*. Policy Research Working Paper 5356. Authors: Schneider, Friedrich, Andreas Buehn and Claudio E. Montenegro. 2010. World Bank, Washington, D.C. http://www.econ.jku.at/members/Schneider/files/publications/LatestResearch2010/SHADOWECONOMIES_June8_2010_FinalVersion.pdf

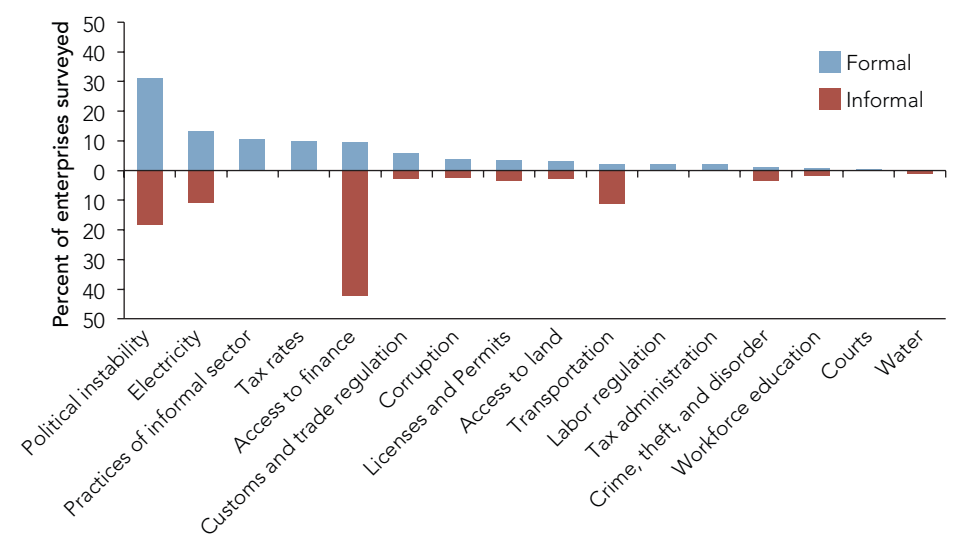
11. Since the informal enterprises surveyed excluded single-owner, household-based microenterprises, it is possible that female ownership in informal enterprises overall is underreported here.
12. World Bank, *Jobs or Privileges: Releasing (potential) prosperity in MENA*, 2014. World Bank Forthcoming.

THE INVESTMENT CLIMATE AS EXPERIENCED AND PERCEIVED BY THE PALESTINIAN PRIVATE SECTOR

Political instability looms large over the Palestinian business and investment climate. It ranks first among business obstacles for the formal sector, and is second only to access to finance among the informal sector enterprises surveyed. This result is consistent among formal firms of different locations and sizes. Among informal enterprises surveyed, the results vary between the West Bank and Gaza; in the latter, electricity and political instability are the top-ranked constraints, whereas the results for the West Bank mirror those of the overall sample with access to finance as the top-ranked constraint followed by political instability. (See Figure 3.1.)

This section will examine the effects of political instability and other identified constraints more closely, disaggregating the differences in the severity of the constraints by firm size, formality, and location— and delving deeper into the makeup

Figure 3.1: Largest Obstacles to Business as Perceived by Enterprises



Source: The 2013 Enterprise Survey and the Informal Enterprises Survey by the Palestinian Central Bureau of Statistics. Tax rates, tax administration, and labor regulation were not included as options in the Informal Survey. Water was not included as an option in the Formal Survey. The Formal Enterprise Survey data are weighted to be representative of the population; the informal survey was designed to be self-weighting.

and nature of these constraints as experienced by the private sector firms. The dynamics of the constraints will also be analyzed through a comparison of the results of the 2013 and 2006 Enterprise Surveys.

3.1 Political Instability and the Absence of an Investment Horizon

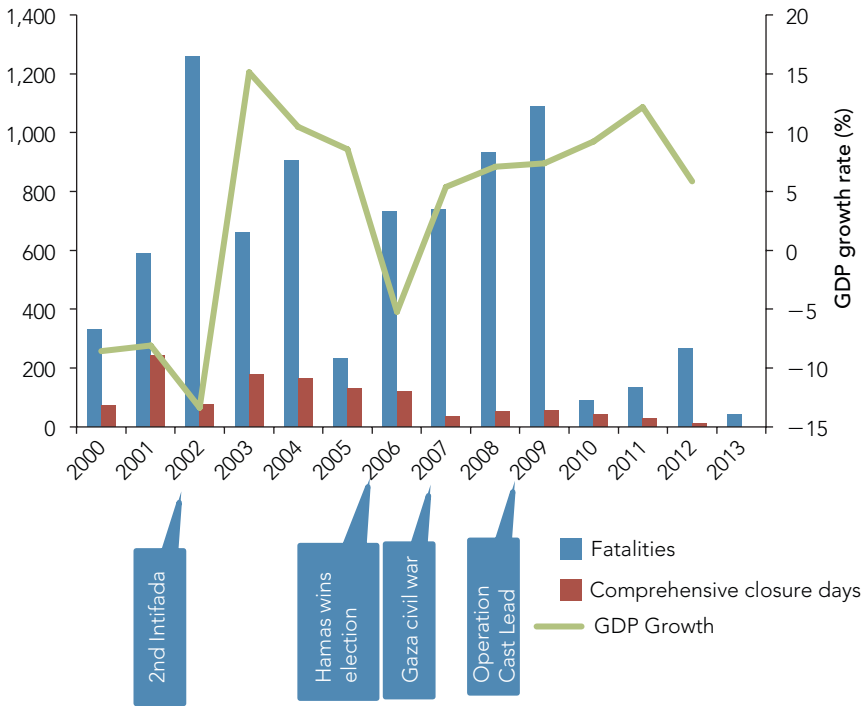
Political instability lies at the heart of the uncertainty characterizing the investment climate in the West Bank and Gaza. The absence of a political resolution to the conflict creates an environment which elevates the cost of doing business, raises the risk to business operations, and creates uncertainty with respect to investment returns. The uncertainty stems from a multitude of problems related to political instability – the recurrence of incidents and periods of violence; destruction of property; the growth of Israeli settlements in the West Bank and their associated infrastructure; continued limitations on access to resources in Area C for Palestinian economic benefit; the fiscal instability of the Palestinian Authority; continued separation and isolation of the Gaza Strip; changes in regulations and restrictions on access to resources and markets; and changes in the nature and degree of restrictions on the movement of people and goods.

The effects of violence, and the associated loss of life and property, extend beyond the immediate, tragic human impact to encompass adverse, long-term, socio-economic consequences. The 2011 “World Development Report: Conflict, Security, and Development” describes a vicious cycle whereby political instability and violence lead to reduced economic growth and increased poverty, which in turn leads to further instability and conflict. This negative cycle is perpetuated through injustice, joblessness, and weak institutions. Research has associated lagging economic growth with violence. The 2011 WDR states, “On average, a country that experienced major violence over the period from 1981 to 2005 has a poverty rate 21 percentage points higher than a country that saw no violence.”¹

The Palestinian territories are affected by recurrent and persistent conflict with periods of increases in volatility and violence. In the year 2008, for example, there were 2635 casualties (including 190 Israelis, with the vast majority being Palestinian casualties), 2132 curfew hours over Palestinian towns, 3078 flying checkpoints (impromptu checkpoints along roads in the West Bank), 4078 searches of Palestinian areas, and 3341 arrests.² Although specific data on the firm-level effects has not been collected, the macro-level effects of periods of violence and unrest are evident from economic data during those periods (see Figure 3.2). All of this undermines socio-economic institutions and growth, which in turn can lead to continued political instability.

The continued political impasse has also resulted in a situation where an unsustainable territorial division in the West Bank (with Areas A and B mostly con-

Figure 3.2: Economic Volatility, Levels of Violence, and Key Political/Security Events



Source: Fatalities and closure day data from B'Tselem. Gross domestic product (GDP) growth rate figures are from World Bank calculations based on National Accounts Data from the Palestinian Central Bureau of Statistics.

trolled by the PA, and Area C controlled by Israel, and with the status of East Jerusalem undetermined) — originally envisaged only as a temporary arrangement until the final status agreement— has become an increasingly binding constraint on Palestinian economic development. Land and natural resources in Area C are largely inaccessible for Palestinian economic development.³ Continued Israeli military control over planning and land use and the continued expansion of settlements and settlement infrastructure in these areas severely restricts Palestinian access, both public and private in Area C. Furthermore, it disrupts economic activity in the rest of the West Bank.⁴ A recent report on the economic impact of the restrictions on Area C found that an additional output of USD 3.4 billion, or 35 percent of the 2011 GDP, could be generated from the use of Area C land and other natural resources. This land could be used for agriculture, mining and quarrying, construction, tourism, and telecommunications.⁵

Since 2007, the split between the West Bank, governed by the Palestinian Authority, and the Gaza Strip, which is controlled by the de facto Hamas government there, has added another element of political uncertainty. Palestinian businesses

operating in both areas must contend with two governmental authorities—whether on taxes, licensing, courts, or other areas of business concern. Furthermore, businesses operating in the Gaza Strip have been isolated from their primary Israeli and West Bank markets, and access to global markets had been almost exclusively through illicit tunnel trade, which are reported to have been shut down in the last year. Consequently, the traditional private sector in Gaza has been devastated. Although the trade restrictions on Gaza businesses have eased in the last year with the shift toward a negative list of goods banned (as opposed to the extremely limited positive list of goods allowed previously), the arrangement is seen as still highly restricted and far from stable.

Political instability begets economic weakness, which in turn has led to a chronic fiscal crisis in the Palestinian territories. The PA has sustained a substantial recurrent deficit throughout the past decade, reaching 14.2 percent of GDP in 2012.⁶ Indeed, the last time the PA recurrent budget was in surplus was in the year 1999, following a period of average annual real GDP growth of about 8 percent between 1994 and 1999. This period in the first years after the Oslo Accords was characterized by an improved security situation, increased private sector investment, and rising employment levels.⁷ Since then, sustained high public expenditures relative to revenues have led to increasing deficits and arrears. The fiscal situation is further exacerbated by the unpredictability of donor support and of clearance revenue transfers from Israel to the PA. The blockade on Gaza and the political rift between the West Bank and Gaza has also contributed to fiscal fragility – Gaza contributes only 3 percent of revenues while accounting for 43 percent of the PA's expenditures.⁸

This country level risk looms large over the banking system, where it represents an underlying risk for most lending. Much of bank lending is to civil servants and government contractors who all depend on the PA budget. The situation threatens the stability of an otherwise well-performing banking sector. It also has resulted in chronic crises in the government's payment of salaries to the civil service, and of its arrears to the private sector and the public pension fund. The net arrears accumulation in 2013 stood at over 4 percent of GDP.⁹

Domestic bank loans to the PA have risen to \$1.35 billion as of March 2014, and the banking sector is increasingly reluctant to finance the government. The PA continues to be dependent on donor aid to fill the budgetary gap, but aid has been falling in recent years to less than US\$ 1 billion in both 2011 and 2012.¹⁰ A 2012 International Monetary Fund (IMF) report on the fiscal crisis urges urgent action, stating that the fiscal situation is precarious and that "the liquidity crisis has started to affect government operations, threatening some of the institutional improvements made in recent years (especially in the area of public financial management) and eroding public confidence in the PA."¹¹

3.2 Uncertainty in Governance – A Fragmented and Complex Legal and Regulatory Environment

The regulatory environment under which Palestinian businesses operate is complex. Businesses operating throughout the West Bank and Gaza may be subject to Israeli military orders, laws and regulations enforced by the Palestinian Authority in the West Bank, laws and regulations enforced by the de facto Hamas government in Gaza, and Israeli laws and regulations if they operate or do business with partners in East Jerusalem or in Israel. This is in addition to contending with the patchwork of the historical legacy of Ottoman, British Mandate, Jordanian, and Egyptian laws that predate Israeli military orders and current Palestinian law.

Further muddying this already complex legal and regulatory environment is the state of legislative paralysis resulting from the lack of a functioning parliament.¹²

All legislation passed into law since 2006 has been done exceptionally by presidential decree, which is not an environment conducive to furthering a legislative reform agenda. The Palestinian Authority has issued a number of laws and amendments to laws by Presidential decree between 2006 and 2013, due to the lack of a functioning Legislative Council. These emergency Presidential Decrees included amendments to the: Companies Law (2006, 2008); Anti-money Laundering Law (2007); Tax Exemption Law (2007); Law on Telecommunications Sector Regulatory Agency (2009); Electricity Law (2009); Banks Law (2010); Land Authority Law (2010); Public Procurement Law (2011); amendments to the Federation of Industries and Chambers of Commerce Laws (2011); Industry Law (2011); Income Tax Law (2011); amendments to the Investment Promotion Law (2011 and 2014); National Payments Law (2012); and, more recently, a new Deposit Insurance Institute Law (2013).

Where laws are in place, there are regulation gaps and redundancies that leave room for disparities in interpretation and implementation.¹³ Differences in regulations and even laws have also begun to emerge between the West Bank and Gaza since these Presidential Decrees, and even regulations issued by the Palestinian Authority's Council of Ministers, are mainly enforced in areas under the Palestinian Authority's jurisdiction in the West Bank, but in some cases not in Gaza or in Area C of the West Bank.

In Gaza, a new Civil Law and Companies Law has been passed by the parliament in Gaza and enacted by the de facto Hamas government (without presenting the laws to the PA President). Laws issued by Presidential Decrees must be brought before the Legislative Council in its first session and can be repealed or approved by the legislature. This uncertain and complex legal and regulatory environment surely affects existing Palestinian firms. However, it is more importantly viewed as a barrier to entry to new investment, particularly for foreign investors less capable of navigating through these complexities.

The new laws passed by Presidential Decree are generally viewed as positive by the private sector and are expected to have positive economic effects. For example, the recently passed amendment on the Investment Promotion Law (2014) is expected to improve tax revenues in the long term by limiting the sectors that can benefit from tax incentives (excluding banking and telecommunications), and it provides incentives based on employment rather than just capital investment. Other laws or amendments considered important to improving competition and the investment climate—including a competition law, telecommunications regulation law, land law, and leasing law—remain either not enacted or, if enacted, not implemented.

For existing Palestinian firms, factors related to business regulation and enforcement account for over 40 percent of the identified top constraints to business. (See Figure 3.3.) However, it is notable that this is dominated by practices of the informal sector and tax rates rather than the regulation of business activities (such as tax administration, customs and trade, and business licensing) which, with the exception of customs and trade regulations (which will be addressed in Section 3.3.), do not rank very high as the leading business constraint.

Small and medium formal firms have been found to be significantly more likely to compete against informal firms. Consequently, they are also more likely to report practices of informal competitors as a major or severe constraint to business. However, even the percentage of large firms reporting informal competition is high, at nearly 30 percent. (See Figure 3.4.) Small businesses (less than

Figure 3.3: Business Regulation and Enforcement Constraints

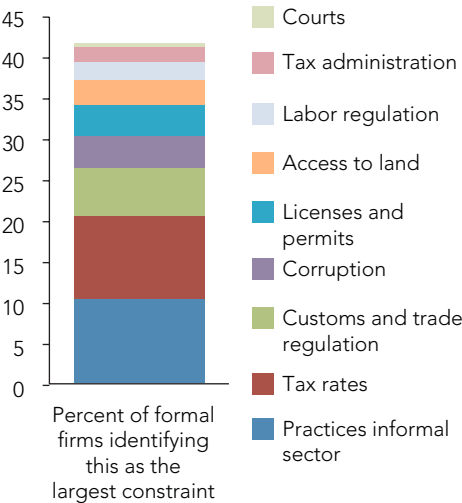
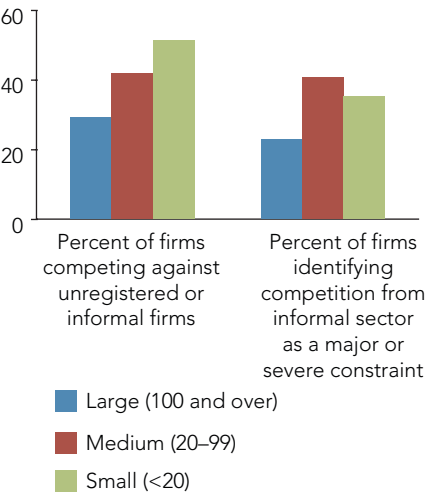


Figure 3.4: SMEs Report Being More Affected by Informal Competition



Source: Enterprise Survey 2013, weighted data.

Note: SMEs= small and medium enterprises.

20 employees) and informal enterprises both tend to be focused on local sales (limited to their locality or city) in some similar sub-sectors – 75.6 percent and 63.8 percent of informal and formal small enterprises respectively report selling entirely within their locality. Such a high proportion of firms competing with informal enterprises that play by a different set of rules make the competitive environment unpredictable, particularly for the smaller firms more directly in competition with informal businesses at the local level.

Tax rates and administration are frequently cited as constraints to business, with 59 percent of formal firms surveyed citing either tax rates or tax administration as a major constraint to business. Furthermore, 47 percent of informal enterprises cited taxes as one of the reasons for not registering as a business. Typical issues with tax administration examined by the survey are related to frequency of tax inspections and expectations of payments during these inspections. However, in the West Bank and Gaza, this does not appear to be a concern, with the average number of visits by tax officials at 1.4 per year. This is well below the regional and world averages (3.2 and 2.0 visits per year respectively). Less than 3 percent of firms report any expectation of informal payments (bribes) to a tax official, also very low in a region that averages 33 percent of firms reporting such expectations. The issue seems to lie more with a perception of high tax rates. However, this does not bear out in comparison with other countries in the region, or in how such taxes are determined and paid.

The 2014 *Doing Business* survey shows a comparatively low total tax rate (see Table 3.1), but a high number of payments per year (with what seem to be separate monthly payments for each type of tax, namely corporate income tax, personal income tax, and value-added tax [VAT]). Furthermore, all annual tax declarations are audited by the Ministry of Finance; risk-based audits have been proposed, but not implemented. Finally, and most importantly, VAT refunds owed to the private sector are reportedly rarely or at least inconsistently paid by the Ministry of Finance. They

Table 3.1: Tax Rates and Ease of Paying Taxes

| Indicator | West Bank and Gaza | Middle East and North Africa | OECD |
|---------------------------------|--------------------|------------------------------|------|
| Payments (number per year) | 39 | 18 | 12 |
| Time (hours per year) | 170 | 220 | 175 |
| Profit tax (%) | 16.2 | 12.4 | 16.1 |
| Labor tax and contributions (%) | 0 | 16.3 | 23.1 |
| Other taxes (%) | 0.3 | 3.6 | 2 |
| Total tax rate (% profit) | 16.5 | 32.3 | 41.3 |

Source: 2014 *Doing Business* Report. World Bank.

Note: OECD = Organisation for Economic Co-operation and Development.

are often subject to negotiation, whereby businesses must agree to forfeit a portion of their refunds to be paid.¹⁴ These factors perhaps account for some of the negative experience and perception by businesses about taxes.

Recent changes in the Tax Law were widely protested within the private sector due to the perceived social and economic impacts of the new law. A number of issues have been raised in feedback provided by the private sector. The 2011 Income Tax Law creates three tax brackets, with the threshold for the highest income bracket perceived as being relatively low by some in the private sector. In addition, the private sector criticized expanding the tax base to include sources not previously taxed, mainly the agriculture sector. Furthermore, the private sector challenged the constitutionality of the Income Tax Law that was issued by a Presidential Decree, while giving the Council of Ministers broad powers to amend the tax brackets and exemptions.¹⁵ Finally, businesses operating in both the West Bank and Gaza must deal with both the Palestinian Authority and the de facto Hamas government in Gaza in paying taxes.

Overall, 27 percent of businesses consider business licensing and permits to be a major constraint. However, only 3.6 percent report it as the leading business constraint. This has decreased from 39 percent of businesses in 2006 reporting the same. To some extent, this may reflect some improvement in this area in recent years, such as reforms in 2009 and 2014 that made starting a business both less costly and time consuming.

Starting a business was made less costly in 2014 due to the elimination of the paid-in minimum capital requirement when registering new limited liability companies. In 2009, an Information Management System was fully operationalized at the Commercial Registry, resulting in a substantial time reduction in registration. In 2006, it took 93 days to start a business compared to 45 days in 2013, according to the *Doing Business* Report.¹⁶ Firms also reported that, on average, it took 11.5 days to obtain an operating license compared to 21.3 days in 2006. Despite these improvements, the West Bank and Gaza ranked 143rd of 189 economies rated on the ease of starting a business in the 2014 *Doing Business* report. In this context, it lags behind the MENA region in both the time and cost required to start a business. (See Table 3.2.)

Additional obstacles remain for firms in obtaining construction permits and electricity connections in the West Bank and Gaza. Firms report that the average number of days to obtain a construction-related permit is 87 days. This aligns with what is reported in the *Doing Business* Report, and is actually lower than the average time in MENA (147 days) — and even for Organisation for Economic Co-operation and Development (OECD) countries (147 days). However, the average number of days to obtain a construction-related permit has increased from about 50 days in 2006 to 87 days in 2013. In addition, the cost of the construction permitting process acts as a constraint due to the high cost associated with obtaining a building

Table 3.2: Indicators for Ease of Starting a Business

| Indicator | West Bank and Gaza | Middle East and North Africa | OECD |
|--|--------------------|------------------------------|------|
| Procedures (number) | 9 | 8 | 5 |
| Time (days) | 45.0 | 19.8 | 11.1 |
| Cost (% of income per capita) | 85.5 | 28.9 | 3.6 |
| Paid-in minimum capital (% of income per capita) | 0.0 | 45.4 | 10.4 |

Source: 2014 *Doing Business* Report.

Note: OECD= Organisation for Economic Co-operation and Development.

permit from the authorities, including the requirement to hire an independent syndicate engineer to review building plans and approve them for submission (even if the project has in-house engineers prior to submission).

The cost to obtain electricity is similarly high (at 1,472 percent of income per capita) compared to averages in MENA (of 1,038 percent) and OECD countries (79 percent). Finally, the average number of days to obtain an import license has increased from an average of about 24 days in 2006 to 36 days in 2013.

Across the board, the amount of time that senior management must spend dealing with the requirements of government regulations has decreased for firms from about 5.7 hours per week in 2006 to 4.4 hours per week in 2013. However, on average, the firms surveyed in the panel sample spent *more* time dealing with requirements of regulations (increased by an average of 4 percent). This may be because the firms that survived were better equipped to maneuver and deal with government regulations and bureaucracy – and thus spent more time doing so in order to succeed.

Box 3.1: Following a Panel of Manufacturing Firms—What Has Changed since 2006?

A panel of 59 firms surveyed in both 2006 and 2012 provide an opportunity to examine the dynamics of firm behavior, performance, and experience with the business climate. Analyzing the changes reported for these same 59 firms eliminates any variability resulting from the sample, thereby providing a unique snapshot of these same firms across time.³

Performance and growth

Capacity utilization and export diversification improved among the panel of firms, but only with a marginal improvement in sales growth and no significant improvement in employment growth or capital investments. A small but significant increase in the value of sales, at 1.9 percent growth since 2006, can be detected. This is a very low figure, particularly given that a significant increase in capacity utilization from 48 percent in 2006 to 69 percent in 2013 was reported. This additional capacity utilization has translated not only into limited sales growth, but also into very limited employment growth or additional capital investment. Diversification of export markets is one bright spot in performance, with the percent of firm sales that were reportedly direct exports to third countries (beyond Israel) increasing from less than one percent to a modest 5 percent of sales of firms in the panel.

(Box continues on the following page.)

Box 3.1: Following a Panel of Manufacturing Firms—What Has Changed since 2006? (continued)

Business upgrading and innovation

Among the indicators related to business upgrading, there is a significant increase in firms using technology – including technology licensed from foreign firms, and the use of email and high-speed Internet for client and supplier relations. International Organization for Standardization (ISO) certification has also increased significantly among firms. This result is notable in that these indicators were not shown to have increased between 2006 and 2013 for the entire survey sample. It may be explained by the fact that the panel sample is biased toward firms that survived since 2006, that is, better-performing firms. It may also simply be a reflection of the greater statistical power in the panel sample. However, there has been no significant increase in the number of firms developing new or improved products or manufacturing processes. In fact, the percentage of firms developing new and improved manufacturing processes may have declined, as seen in the overall sample.

Business climate

As might be expected, there is a notable deterioration in the experience of firms with respect to the supply of electricity, with both the frequency and duration of power outages increasing significantly. As noted for the survey overall, this is driven by the deterioration of the power supply in Gaza.

On the positive side, firms are accessing financial services at a higher rate. A significantly greater number of firms have a checking or savings account at a bank, and fewer firms are using supplier credit financing, sales on credit, and internal financing. There has been no significant increase in firms using bank loans and lines of credit, however. In fact, there has been a significant increase in the percentage of firms who did not apply for loans because they did not want one, up 17 percent among the firms in the panel—as opposed to those who did not apply because they did not think that they would be approved or for other reasons.

There has been a significant increase in firms paying for security, which has nearly doubled from 25 percent in 2006, as well as in the average security costs (as a percent of sales). This is a counter-intuitive result given that in the overall sample in 2013, firms appeared less concerned with security as a constraint than in 2006. It's possible that this may in part be due to more firms having taken steps to mitigate their security concerns by buying security services.

Source: Enterprise Survey 2013; Enterprise Survey 2006

Note: The panel includes 48 manufacturing firms and 18 service firms (there are no retail or wholesale firms since these were not included in the 2006 survey), and is distributed regionally into 22 Gaza firms, 30 West Bank firms, and the remaining 8 in East Jerusalem. Note that the panel can only include firms that have survived since 2006, so it will have some bias towards better performing firms. The 2006 survey did not include productivity data, so conclusions cannot be drawn on changes in labor productivity.

Also notable is the low ranking of corruption among the top constraints perceived by businesses. Less than 4 percent of firms, mostly small West Bank firms, identified corruption as the leading constraint. On the other hand, 49 percent reported corruption as a major constraint to business. This seeming contradiction is explored further in Section 3.7 on Crime and Corruption.

3.3 Fragmentation and Isolation – Logistics and Access to Markets

The de jure trade regime in the Palestinian territories is defined by the 1994 Protocol of Economic Relations (Paris Protocol) signed between the Palestine Liberation Organization (PLO) and the Government of Israel as a supplemen-

tary agreement to the Oslo Accords. However, this quasi-customs union has been subverted by a range of non-tariff and security barriers to trade between the Palestinian territories and Israel. The Paris Protocol created a quasi-customs union between Israel and the Palestinian territories, with Israel effectively in control because it extended Israeli tax rates, tariffs, and most technical standards to the Palestinian territories. This could have produced mutual benefits of free trade of labor and goods between the two. However, the movement of goods and labor from the Palestinian territories to Israel is constrained by a collection of non-tariff barriers (which Palestinian firms often cannot meet due to capacity constraints or because Israeli inspectors are not allowed in the Palestinian territories), security restrictions, and logistics inefficiencies (most notably the ban on all exports from Gaza, but also restricted access through the commercial crossings in the West Bank, including back-to-back transfer of goods and scanner facilities).¹⁷ Beyond the typical trade regulations, trade and transport of goods to and from the West Bank and Gaza is complicated by a layer of commercial crossings, security restrictions, import controls, and associated logistics that have been subject to change in tandem with security and political events. The unpredictability and cost of these regulations and restrictions is a deterrent to new investments and creates uncertainty for existing businesses.

A close examination of trade logistics as experienced by Palestinian firms reveals the sources of cost and uncertainty. After leaving their port of entry, or prior to reaching their port of exit, the imports and exports of Palestinian firms in the West Bank (not including East Jerusalem) and in Gaza cross through an additional layer of controls. In the case of the West Bank, this consists of Israeli-controlled internal commercial crossings located near and along the borders of the West Bank through which all goods moving through, to, or from Israel must cross after undergoing both physical inspection and commercial controls. There is no official PA presence at these crossings. (See Image 3.1.)

For Gaza, exports are nearly completely banned, and all imports through or from Israel must pass through a single crossing run by the Israeli Ministry of Defense (Kerem Shalom). Gaza also trades informally through underground tunnels between the Gaza Strip and the Egyptian Sinai. However, this is illicit trade not formally authorized by Egypt. It is not a formal trade channel and recently tunnel trade has reportedly all but stopped. Consequently, the Palestinian territories effectively act as a landlocked country with no effective control over its borders.

The additional step of processing goods through these crossings significantly increases the time, cost, and uncertainty of trade logistics for Palestinian businesses. Export times are nearly doubled from just over two to four days, and import times increase from an average of 17 to 24 days, making it the worst performance among regional comparators.¹⁸ (See Figures 3.5 and 3.6.) This accounts only for actual processing time. By another measure, the *Doing Business* Trading Across

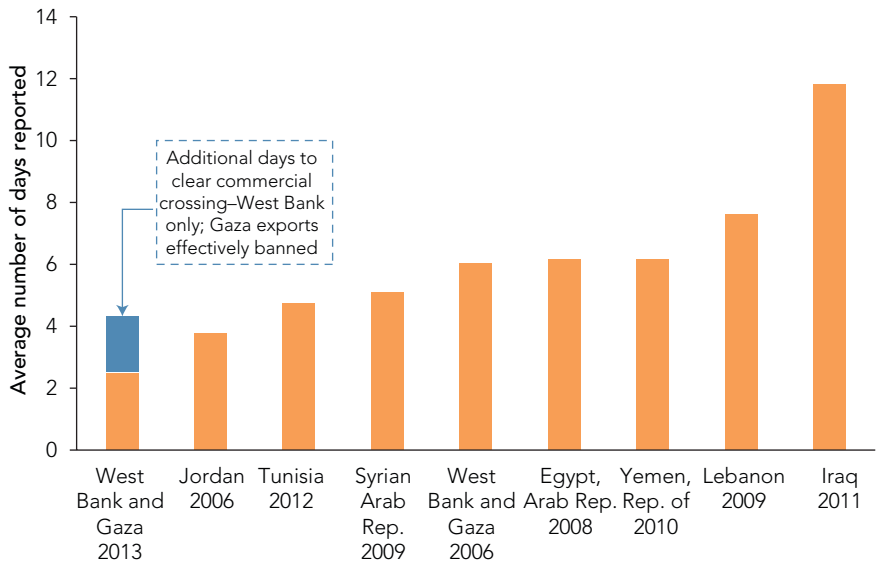
Image 3.1: Examples of Goods Transfer Facilities at Commercial Crossings

Back-to-back platform for the transport of pallets of goods at Shaar Ephraim (Tulkarm) crossing, Truck unloading/ loading areas at Bazaq (Bisan) checkpoint for agricultural goods in the Jordan Valley.



Source: Coordinator of Government Activities in the Territories (COGAT) website.

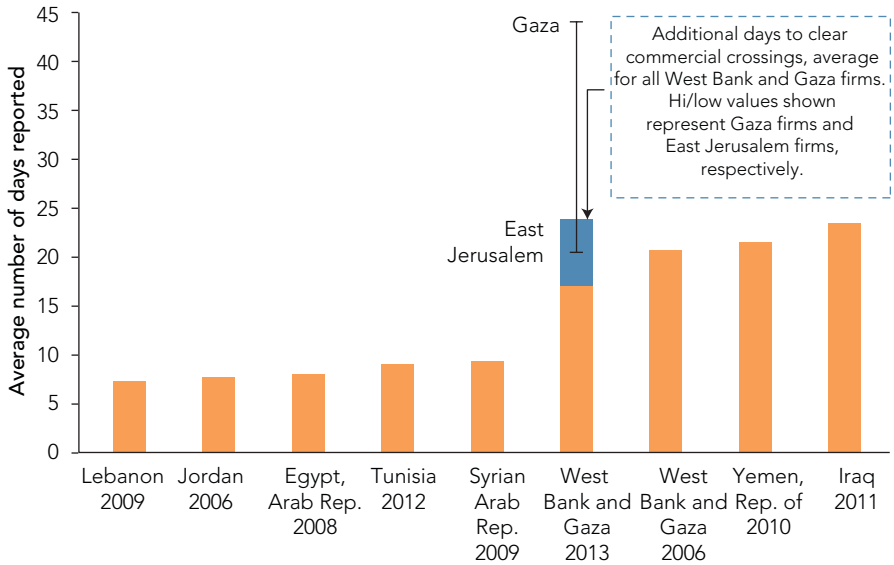
Figure 3.5: Days to Clear Direct Exports through Customs



Source: Data from World Bank Enterprise Surveys, weighted data. Data from Gaza and East Jerusalem firms has been excluded from estimate of time to clear commercial crossings due to small number of data points.

Note: Gaza export trade is effectively banned with some exceptions. Few East Jerusalem firms are subject to the commercial crossings due to their location. Time to clear crossings includes some transportation time, which is not included in other country data. Any delays due to closure of the crossings is not reflected in this data.

Figure 3.6: Days to Clear Imports through Customs



Source: Source data from World Bank Enterprise Surveys, weighted data.

Note: Time to clear crossings includes some transportation time, which is not included in other country data. Any delays due to closure of the crossings is not reflected in this data.

Borders Indicator, which includes the additional steps of preparation of trade documents, reports that it takes 23 days to export from the West Bank and 38 days to import, compared to just 10 days for Israeli traders to export and import similar goods through the same ports. This would account for not only the added time and complexity of the commercial crossings, but for the more limited capacity of Palestinian traders in dealing with Israeli trade regulations, procedures, and forms.

These issues are most pronounced for Gaza firms. Exports from Gaza are banned with extremely limited exceptions (to the extent that they have all but ceased entirely, with the exception of a few shipments which were facilitated by international donor agencies). Imports are also restricted, and when they are allowed, the time required to process them is long and uncertain. The Kerem Shalom crossing at Gaza, the only crossing available for the import of goods since 2007, closes at times and without warning.

The loss of access to the Israeli and West Bank markets by Gaza exporters due to the Israeli blockade of Gaza since 2007 was devastating to the Palestinian economy. The closure of these markets sent a shock wave through the Palestinian private sector from which the private sector in Gaza has yet to recover. The government of Israel blocked trade in and out of the Gaza Strip starting in June 2007 after the Hamas takeover, allowing only limited types of humanitarian goods into Gaza and

restricting export operations. It then shifted to a negative list of banned goods, with exports permitted outside Israel and the West Bank under restricted conditions.¹⁹

As a result, the private sector reported the shutdown of 95 percent of industrial establishments (an estimated 3750 establishments), the dismissal of 94 percent of workers (estimated at 33,000), and the suspension of nearly all construction work.²⁰ In addition, private sector direct damages as a result of Israel Defense Forces (IDF) incursions and air-strikes until December 2008 have been estimated at about US\$400 million (since 2000), mostly from the agricultural sector as a result of losses in export crops (estimated at \$332 million), with the remaining losses in the industrial, trade, and tourism sectors.²¹

A number of different authorities are responsible for regulating trade, adding to the difficulty facing Palestinian trading firms. The government of Israel has ultimate control over all trade passing to and from the Palestinian territories (with the exception of illicit tunnel trade in Gaza). However, the Palestinian Authority and de facto Hamas government in Gaza also have roles. The trade regulations have commercial and security aspects which are determined by a myriad of Israeli governmental agencies which differ based on the source or destination of the goods, and are subject to change based on security or other considerations. Navigating this complex web of policies, regulations, institutions, decrees, and practices – much of which are accessible only in Hebrew – can be a daunting task. Palestinian firms importing goods typically use the services of Israeli customs clearance agents since, despite the quasi-customs union, Palestinians cannot be licensed as clearance agents in Israel. (See Box 3.2.)

Dual-use restrictions, which are meant to restrict the import of any materials that could be used for terrorist activity, are a particularly opaque part of the import restrictions. While international standards limit the types of goods that are considered dual-use goods, the Israeli Ministry of Defense, the authority which regulates this aspect of import of goods into the West Bank and Gaza, employs a seemingly broader definition that excludes a range of communications equipment, metal working machinery, and agricultural inputs. Of all Palestinian firms directly importing goods, 12.7 percent report being denied entry of goods for security reasons, with West Bank firms reporting a significantly higher percentage (15.2 percent) of firms requesting and being denied import permission.²² (See Figure 3.7.)

Firms citing transportation as a major constraint have shown some improvement in terms of the easing of some movement obstacles within the West Bank. By contrast, the situation has deteriorated markedly for Gaza due to the severe restrictions on the movement of people in and out of Gaza. Overall, there is a significant decrease in the number of firms identifying transportation as the top obstacle to business (from 10 percent to 2 percent between 2006 and 2013) and as a major obstacle (from 52 percent to 34 percent), indicating an overall positive trend. However, a significantly larger percentage of West Bank firms report transportation as

Box 3.2: Case Study: Crib Producer Exports to Tunisia

After nearly over four years of halting production, AlKateeba AlKhardaa went back in business at full capacity after delivering its first export order for baby cribs to Tunisia.

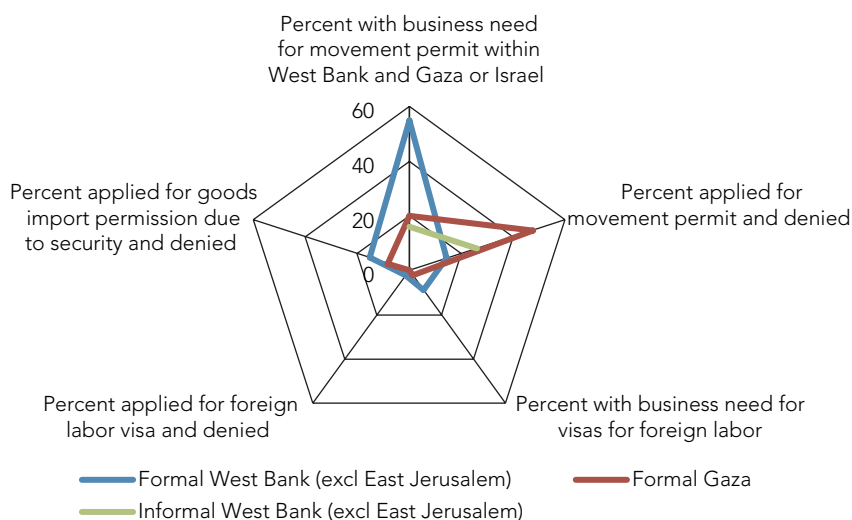
Known for its good quality and reasonable prices, AlKateeba AlKhardaa used to produce and export baby cribs to Saudi Arabia, Tunisia and Yemen prior to the blockade on Gaza in mid-2007. The manufacturing plant has shut its operations since then, and could not survive by only supplying the local market in Gaza. Upon hearing about the Israeli decision to allow exports to external markets, Mr. Hashem Karhaly (owner of the furniture company) conducted a few business missions to market his products in the region. After a few months of continuous efforts, he successfully managed to sign a contract with a Tunisia-based buyer to supply some 143 baby cribs. The owner was very pleased with this progress, which is putting his business back on track. However, Karhaly had to go back to Gaza to face multiple challenges and restrictions on exporting to external markets.

Due to the division between the West Bank and Gaza, Karhaly had to first verify where to issue the export document from. After a few weeks, he managed to issue the certificate of origin and custom documents from offices of the PA in Gaza (from the Crossing Coordination Committee). The shipment had to be packed in pallets of no more than one meter in height, following Israeli restrictions, which increases shipping costs and time. On December 6, 2012, the shipment was processed through Kerem Shalom crossing with Gaza to the Nitzana crossing with Egypt. It then travelled by land to Port Said in Egypt to be loaded on a vessel to Tunisia. The process took the company four days to move the shipment from the plant to the nearest (and accessible) sea port on the Mediterranean.

Source: PalTrade.

a top or major obstacle. Strikingly, more East Jerusalem firms report transportation as a major constraint today than in 2006 (44 percent in 2013 versus 11 percent in 2006), likely reflecting the greater complexities involved in moving goods in, around, and through the West Bank and East Jerusalem.

Figure 3.7: Different Experiences of Access Restrictions in the West Bank and Gaza



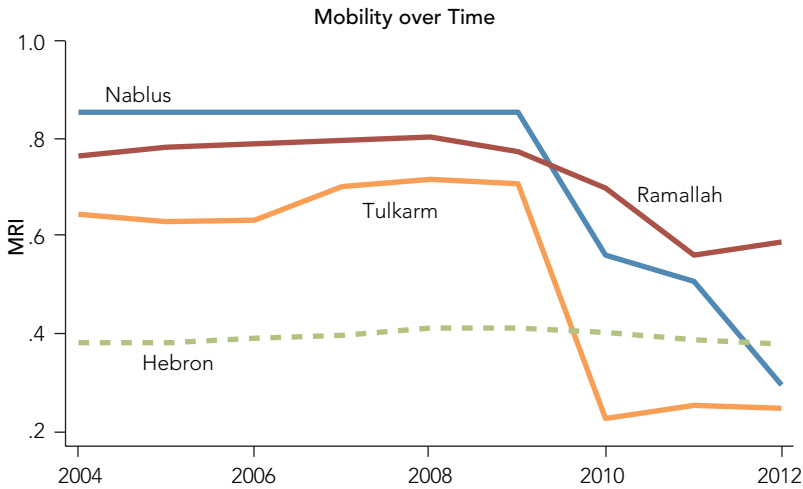
Source: West Bank and Gaza Enterprise Survey and Informal Survey, 2013.

Movement of people. A unique constraint in the Palestinian territories— not typically an issue in any other business environment— is the restriction of the movement on people. The personnel of Palestinian firms, depending on where they are located, may be restricted from accessing different parts of the West Bank, Gaza, Israel, or the rest of the world due to security restrictions imposed by the Israeli government. In the West Bank, a number of barriers to movement affect the mobility of people and goods, including permanent and “flying” (ad hoc) checkpoints, road closures, the Separation Barrier, and gates. Gaza firms that need to travel beyond Gaza are subject to the greatest levels of movement restrictions. For Gaza residents, access to the West Bank, including East Jerusalem, and Israel is by permit only. In addition, access to the rest of the world is also by permit or through the Rafah crossing with Egypt, which is also subject to frequent closures. West Bank residents must also obtain permits to travel to Gaza, East Jerusalem, and Israel. Finally, all Palestinians must have a permit to travel through the airport in Israel. However, most resort to using the airports in neighboring Jordan or Egypt, adding to both travel cost and time.

The experience of current businesses reveals that as much as 14.4 percent of West Bank firms requesting permits to travel within the West Bank, Gaza, East Jerusalem, and Israel are denied those permits, whereas 43.5 percent of Gaza firms requesting movement permits report being denied. (See Figure 3.7.) Only 14 percent of informal firms reported having a business need to travel between the West Bank and Gaza, to East Jerusalem, or to Israel. But of these, 24 percent of West Bank firms were denied permits. None of the Gaza informal firms that had a business need reported having applied. There is a business cost associated with obtaining these permits, particularly since applying and obtaining permits can entail multiple visits and wait times to the Israeli Coordination of Government Activities in the Territories (COGAT). Some firms interviewed have reported retaining facilitators whose only function is to submit applications, expedite, and obtain movement permits for firm personnel.

Equally important is the ability of Israelis to access the West Bank and Gaza; with some exceptions, access to Area A is legally restricted to all Israeli citizens. This has had an effect on the sale of Palestinian goods and services to Israeli citizens, especially in border town areas such as Jenin, Tulkarm, and Qalqilya. Their economies had been dependent on cross-border trade with Israel, particularly Arab citizens of Israel in neighboring border towns. In 2010, concerted efforts by the Office of the Quartet Representative and other international parties resulted in the opening of the Jalameh crossing near Jenin to Arab citizens of Israel, once again allowing them to cross into Jenin to shop and do business, albeit with some restrictions. This has reportedly had a positive effect on the retail and service sectors in the Jenin district. However, this arrangement has not been extended to other areas in the West Bank, and certainly not to Gaza.²³

Figure 3.8: Improvements in Mobility Restrictions for Key West Bank Localities



Source: “The Merits of Market Access: Mobility Restrictions and Economic Development in the West Bank”, Roy van der Weide, Bob Rijkers, and Brian Blankespoor. The World Bank, December 2013.

Note: The mobility restriction index (MRI) is calculated as a measure of the effect of the restrictions on mobility, taking into account the transportation infrastructure.

On a positive note, mobility restrictions within the West Bank have shown a marked improvement since 2006. (See Figure 3.8.) Analysis of mobility restrictions—taking into account the number and nature of checkpoints and estimates of the magnitude of delay caused by each barrier—show significant improvements in mobility during this period, particularly in the northern West Bank. The most notable improvement has been around the city of Nablus which had previously been severely restricted, especially for vehicular access in and out of the city and for the transport of goods. Much of the checkpoint infrastructure (towers, cement blocks), while unused, remains in place. Thus, the uncertainty resulting from these internal movement restrictions has diminished, but not disappeared.

3.4 The Costs and Constraints on Factors of Production—Land, Labor, and Finance

Land

The constraint on access to land for economic purposes is the foremost economic manifestation of the political impasse in the West Bank and Gaza. A recent report by the World Bank on the economic impacts of the restrictions to Area C, which comprises approximately 61 percent of the West Bank and is the only contiguous area in the West Bank, concludes that a conservative estimate of additional GDP output that could be generated from use of some resources in Area C,

excluding the settlements or areas under Israeli military control, is USD 3.4 billion, or 35 percent of the 2011 GDP.²⁴ The report examines specific types of economic use, including agriculture, tourism, mining, housing, and other economic activities. Its findings indicate specific lost economic opportunities in each of these sectors as a result of lack of access to land and natural resources, including tourism sites, water, and minerals, in Area C. (See Box 3.3.)

Restrictions on access to land also manifest themselves not only in direct private sector access to land, but also in restrictions on local and central government agencies in using land for public infrastructure, including roads, water supply, waste treatment, and industrial parks. Efforts to construct public services such as wastewater treatment plants and industrial parks in Area C have been derailed by the Palestinian authorities' inability to gain permission to construct these services.²⁵ The potential indirect economic benefits of public investment in this type of infrastructure— not to mention access to roads, water resources, and tourism sites, and easing of other movement and access restrictions in Area C — was not included in the above estimate. Potential long-term effects of improved fiscal stability, investor confidence, improved public service provision, and employment are also not accounted for here.

Land within the Palestinian-controlled Areas A and B is ostensibly available for economic use. However, it also suffers from a variety of constraints. Due to restrictions on the availability of Area C land, the land in Areas A and B has been

Box 3.3: The Risks and Rewards of Date Farming in the Jordan Valley

Nakheel Palestine of Agricultural Investment Ltd. cultivates over 2000 dunums of medjool date palms in Area C of the Jordan Valley (with clear title), and runs a processing and packing plant nearby in Area A. The company employs 60 full-time staff and 100 seasonal staff. Water is obtained through the pumping or trucking from Area A/B because of the inability of the company to obtain water in Area C.

The company exports most of its production of premium medjool dates to markets in the US, Europe and beyond and plans to increase its exports. The management views the local market to be dominated by dates of lesser quality, or by medjool dates produced in the Israeli settlements which are able to undercut their prices.

Two institutional investors provided substantial equity of about USD 11 million. It was used for expansion in 2010, as well as for the purchase of political risk insurance from the World Bank Group's Multilateral Investment Guarantee Agency (MIGA) to cover expropriation risk in particular.

In 2011, the company received an order from COGAT to evacuate the land. The owner submitted the case to the Israeli High Court of Justice, and COGAT subsequently withdrew the order to evacuate. However, the uncertainty surrounding the order caused some delay in investment in additional cultivation, and the owner still considers expropriation or other COGAT action preventing or delaying operations in Area C a major risk.

Furthermore, another case with the Israeli High Court of Justice regarding a request for permission to dig a water well and construct a few structures in Area C is still pending. The inability to access water near the cultivation sites in Area C is considered the primary driver of cost, and the primary constraint to expansion.

Source: Interview with Nakheel's General Manager.

found to be subject to higher prices, reflecting scarcity of land resources in and around many population centers.²⁶ In the commercial center of Ramallah, for example, the price per square meter is on par with commercial property in some of the megacities of the world. The land scarcity and high prices in parts of Areas A and B increases housing costs and decreases productive investments.

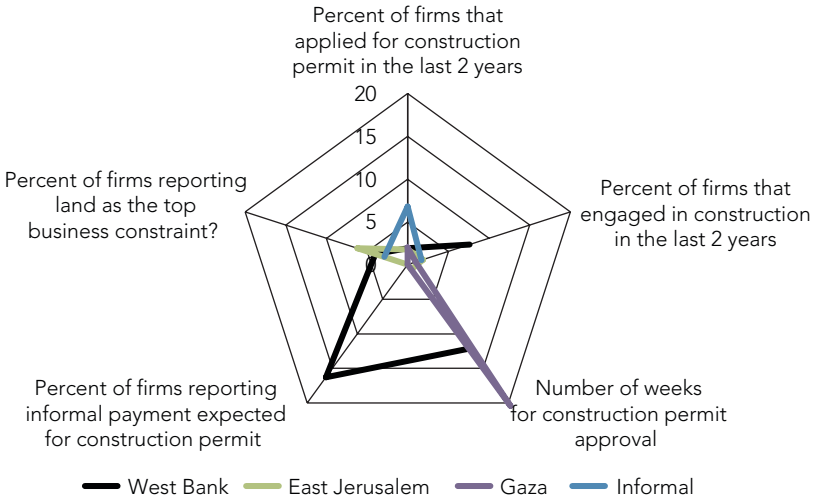
The economic use of land within Areas A and B is further frustrated by the lack of legal reform on land and real estate. The majority of land in the West Bank has not been registered, and even where land has been registered, titles are often more than a generation old, with unresolved rights to numerous inheritors complicated further by the issue of absentee ownership. Registration claims, inheritance, and common property cases are the most common land cases brought to trial court in the West Bank. A public land inventory has not been completed or made public, creating opportunities for inefficiency and misuse.²⁷ In the meantime, commercial and residential tenant protections distort the real estate market further, affecting prices, leasing and renting, and the mortgage market.

The Second Land Administration Project (LAP-2) financed by the Government of Finland and the World Bank provides support to the Palestinian Land Authority (PLA) in rolling out systematic land registration in a pilot area with a tested methodology that can be replicated nationwide at reasonable time and cost. However, low institutional capacity and lengthy decision-making procedures significantly slow implementation progress.

In the West Bank, and even more so in Gaza, access to land constrains the entry and expansion of new businesses more so than existing businesses that have already sized themselves within the constrained context. (See Figure 3.9.) The 2013 Surveys of Formal and Informal Businesses found that few existing businesses cite access to land as the top obstacle to business. Just over 3 percent overall, and about 27 percent cite it as a major (or severe) obstacle. However, a closer examination shows that this varies significantly between different areas, with a significantly higher percentage of East Jerusalem businesses citing it as the biggest obstacle to business (6.2 percent) and not a single surveyed Gaza business citing it as the top constraint. This difference reflects the different realities under which these businesses operate. In East Jerusalem, land use is an issue of significant proportion and contention, particularly land planning and use in the predominantly Palestinian populated areas.

For existing businesses, some indicators on access to land warrant a closer inspection. Informal firms seem to be applying for construction permits at a higher rate than formal firms. Possibly, the construction permits of informal firms may be considered residential construction, and may be less constrained by limitations on serviced land than for industrial or commercial use. A significantly higher proportion of West Bank firms engage in construction than have requested build-

Figure 3.9: Access to Land Indictors—Location Determines the Degree and Nature of the Constraint



Source: 2013 Enterprise and Informal Surveys, the World Bank.

ing permits, which to some degree could be due to a time lag or other factors. However, it could also reflect building without permits. Obtaining a construction permit in Area C or East Jerusalem is difficult for Palestinian applicants, with low rates of approval. Over time, this has evolved into a low number of requests.²⁸ In Gaza, the time to receive a construction permit exceeds 20 weeks. Nonetheless, access to land is not reported by a single surveyed firm as a constraint. This is likely due to the fact that most construction in recent years would have been constrained by lack of building materials (due to the Israeli ban on their import) than to problems related to permits. This is also reflected in a lower percentage of firms engaging in construction activities than those that received permits in the last two years.

Labor

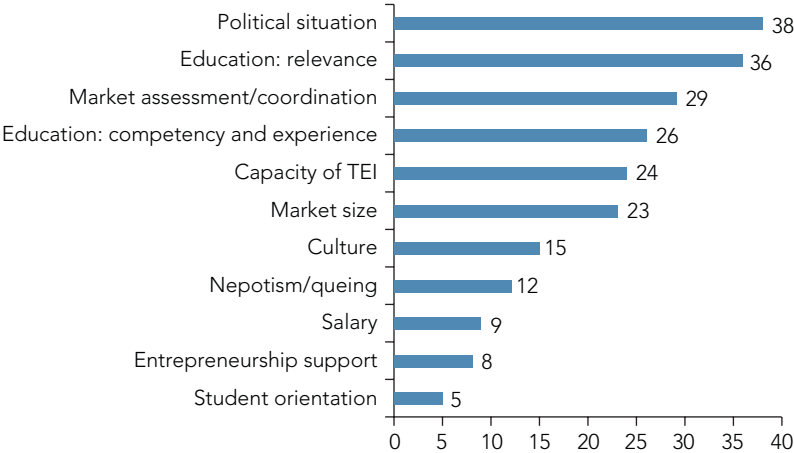
The Palestinian workforce has high levels of educational attainment. However, the workforce is not necessarily skilled and trained to fuel growth in the high value-added manufacturing or service sectors. Literary rates are the highest in MENA at 95.6 percent (compared with 77 percent for MENA), with the highest gender parity in the region at 95 percent gender parity overall, and a near full 100 percent gender parity for youth literacy (ages 15-24). An estimated 38.6 percent of those over the age of 15 have attained at least a secondary education, whereas about 24 percent of the labor force has received a tertiary education, and 12 percent of the population has completed a bachelor's degree or higher.²⁹ However, high educational attainment has not translated into improvement in the quality of education.

An international comparative assessment (Trends in International Mathematics and Science Study (TIMSS) shows Palestinian students ranking low on mathematics and science compared to their counterparts in MENA countries. The specializations of tertiary graduates are skewed toward fields with low demand; the vast majority of the college-educated have degrees in non-technical specializations, such as education and social sciences with attendant high unemployment rates. Less than 15 percent of graduates chose to study sciences or engineering, which are critical fields both for individual and national competitiveness.³⁰

Further downstream, an assessment of the framework for workforce development in the Palestinian territories reveals numerous challenges, including a somewhat ad-hoc championship of the workforce development strategy focused on initial (rather than continuing) technical and vocational education and training, and a limited role for employers and industry. Further, inconsistent quality service delivery also lacking in standards and quality control, in turn affects the public perception and demand for these services.³¹

The result of this is a mismatch between workforce skills and market needs, with an oversupply of workers in areas with little market demand. This is supported by the perceptions of focus groups of business owners and tertiary education graduates, who identify the relevance of their education as the biggest constraint to education-to-work transition, second only to the political situation. (See Figure 3.10.) A number of programs, mainly donor-funded, have been put in place to address these systemic challenges, including a raft of

Figure 3.10: Relevance of Education among the Leading Constraints for Education-to-Work Transition



Source: From *Education-To-Work: Opportunities And Challenges In The West Bank And Gaza*, Stefanie Brodmann, Ernesto P. Cuadra, Mohamad Ismail Allouche, and Samira Ahmed Hillis, MENA Quick Note Series. January 2012, No. 55.

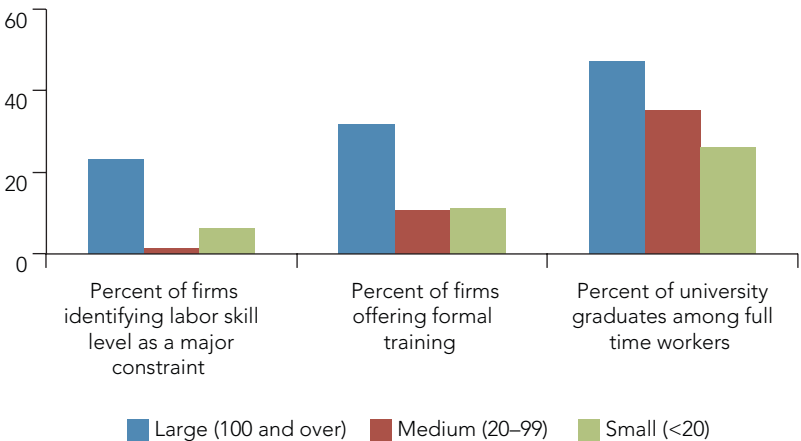
Note: TEI= Tertiary Education Institutions.

German Society for International Cooperation (GIZ)-led initiatives on technical vocational education and training (TVET) and the World Bank-supported Education to Work Transition Project. In the meantime, there are no government incentives for workforce training in the West Bank for either the formal or informal sector. In Gaza, even the donor-funded programs have limited access, with the notable exception of service delivery in the refugee camps through the United Nations Relief and Works Agency (UNRWA).

Compared to SMEs, large firms are significantly more likely to report skilled labor as a major constraint, hire more university graduates, and provide formal training to their workers to improve their skills. (See Figure 3.11.) Only 5.9 percent of firms overall identify labor skills as a major constraint. This may simply be attributable to the fact that those firms that need skilled workers are able to find them because the needed skill levels are available in the market, or because they are in a period of slow activity or are not hiring. It may also indicate that those high value-added manufacturing and service firms with a high demand for advanced skills have yet to significantly emerge and shape the Palestinian economy. Existing firms are likely more preoccupied with political instability than human resource constraints.

The actions and perceptions of some of the leading manufacturing and technology firms in launching training initiatives further underscores this issue as a priority for larger firms and technology firms. In more than one study and in stakeholder interviews, business owners have identified the education system, poor technology education, and the lack of higher order skills as impediments to business.³² Some private sector firms have taken the initiative to address this issue, as demonstrated by the private sector-designed and funded Tamayyaz initiative. It provides training

Figure 3.11: Worker Skills More of a Concern for Large Firms



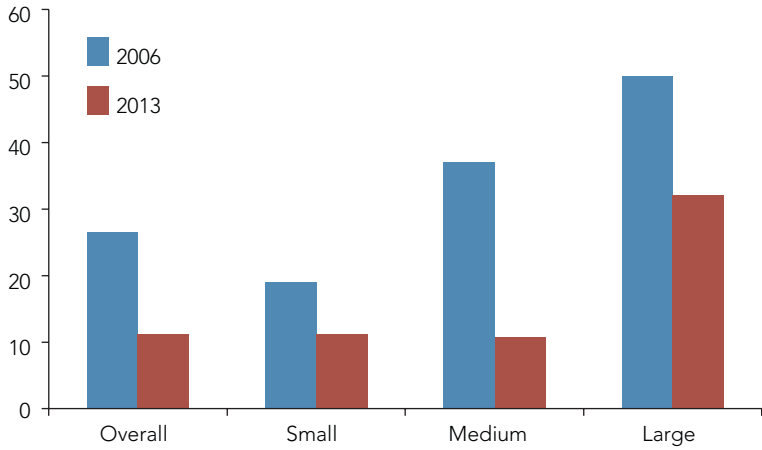
Source: Enterprise Survey data, 2013.

to cohorts of university students, as well as the internship programs of leading technology firms which provide intensive training to information technology (IT) graduates.

As previously noted, there are currently no incentives for continuing technical and vocational training (training funds, tax incentives, or other initiatives), and this is reflected in low levels of formal training among firms. Despite some positive developments at the local level, the overall percentage of firms offering formal training decreased from 2006 to 2013, with medium size firms in particular sharply reducing formal training for employees. (See Figure 3.12.) Only about 3 percent of firms in Gaza offer formal training, compared to 14 percent in the West Bank, and 9 percent in East Jerusalem.

The Palestinian labor force is marked by very low female participation and employment rates, even by MENA standards. There are pronounced pay disparities between male and female workers in both the formal and informal sectors. At 20 percent, the female labor force participation rate is low even when compared with the MENA average of 26 percent. This is in contrast to the high rates of education parity by gender, even in tertiary education. Labor regulations provide women with maternity and childcare benefits that are perceived by some employers as excessive. Absent any measures to prevent employment discrimination against women, this may be one of the factors contributing to the exceedingly low rates of participation and employment among women. Another contributing factor may be the uncertainty surrounding movement and access, which may discourage women from seeking work outside of the home.

Figure 3.12: Fewer Firms Offering Formal Training



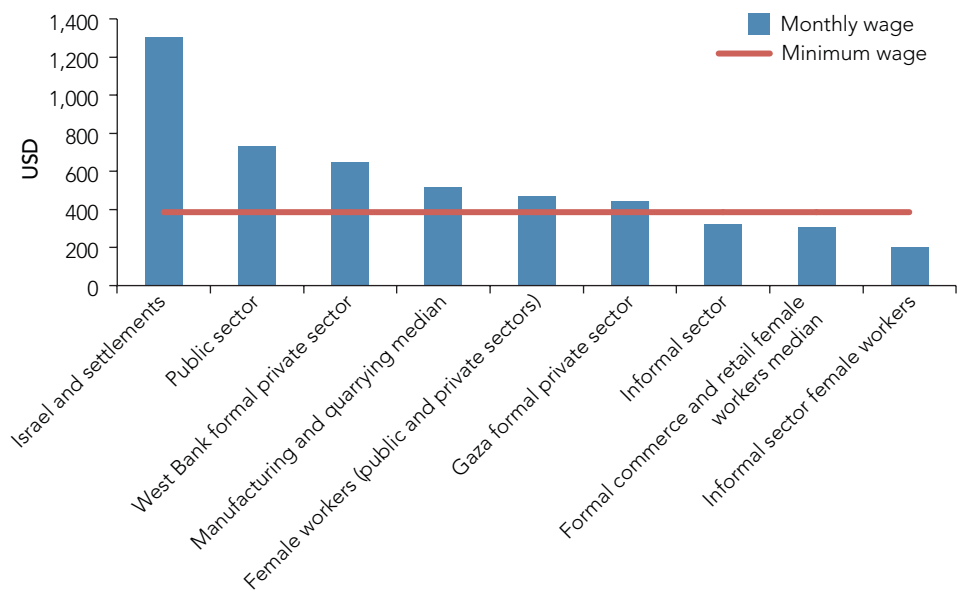
Source: Enterprise Survey data, World Bank, 2006 and 2013.

Finally, labor regulations are more significantly reported as a major constraint in the West Bank than in Gaza or in East Jerusalem, with 14.9 percent of West Bank firms reporting it as a major obstacle compared to 2.9 percent in Gaza and 5.6 percent in East Jerusalem. This situation has not changed significantly since 2006. A closer look at the labor regulations of the Palestinian Authority—which are not in force in East Jerusalem and may or may not be enforced in Gaza—may provide some insight about the extent to which this may be a constraint for existing firms as well as for potential investors, including also the motivations of the informal sector.

The most relevant recent development on labor regulations in the West Bank was the introduction of a minimum wage of new Israeli Shekels (NIS) 1450 per month in the year 2013, or the equivalent of USD 385. A scan of median and average wage rates among regions and sub-sectors in the economy reveal that the minimum wage rate may have some effect at the lower end of the wage scale for some parts of the formal economy. It is also higher than the mean wages reported in parts of the informal sector. (See Figure 3.13.) Therefore, it may constitute a disincentive for formalization of informal firms if it is enforced.

The extent to which the minimum wage rate is enforced in the West Bank is not yet clear. It is not in effect in Gaza, so this may in fact not be a binding constraint in practice. With the exception of a legally mandated two-year limit on fixed-term contracts, other aspects of labor regulations are mostly comparable to neighboring countries. (See Table 3.3.)

Figure 3.13: Average Wage Rates



Sources: Labor Force Survey 2012, PCBS. Informal Sector Survey 2013, PCBS.

Table 3.3: Some Features of Labor Regulations in the Region

| Country | Egypt, Arab Rep. of | Iraq | Israel | Jordan | Lebanon | Syrian Arab Rep. | Tunisia | West Bank and Gaza | Yemen, Rep. of |
|--|---------------------|----------|----------|----------|---------|------------------|---------|--------------------|----------------|
| Fixed-term contracts prohibited for permanent tasks? | No | Yes | No | No | No | No | No | No | No |
| Maximum length of fixed-term contracts, including renewals (months). | No limit | No limit | No limit | No limit | 24 | 60 | 48 | 24 | No limit |
| Paid annual leave for a worker with 1 year of tenure (in working days) | 21.0 | 20.0 | 14.0 | 14.0 | 15.0 | 14.0 | 12.0 | 12.0 | 30.0 |
| Third-party approval if 1 worker is dismissed? | Yes | No | No | Yes | No | Yes | Yes | No | No |
| Retraining or re-assignment obligation before redundancy? | No | No | No | No | No | No | Yes | No | No |
| Notice period for redundancy dismissal (for a worker with 1 year of tenure, in salary weeks). | 8.7 | 0.0 | 4.3 | 4.3 | 4.3 | 8.7 | 4.3 | 4.3 | 4.3 |
| Severance pay for redundancy dismissal (for a worker with 1 year of tenure, in salary weeks). | 4.3 | 0.0 | 4.3 | 0.0 | 0.0 | 0.0 | 1.7 | 4.3 | 4.3 |
| Severance pay for redundancy dismissal (for a worker with 10 years of tenure, in salary weeks) | 54.2 | 0.0 | 43.3 | 0.0 | 0.0 | 0.0 | 13.0 | 43.3 | 43.3 |
| Minimum wage 2013 (USD/month). | \$111 | \$92 | \$1141 | \$257 | \$430 | \$152 | \$119 | \$385 | \$93 |

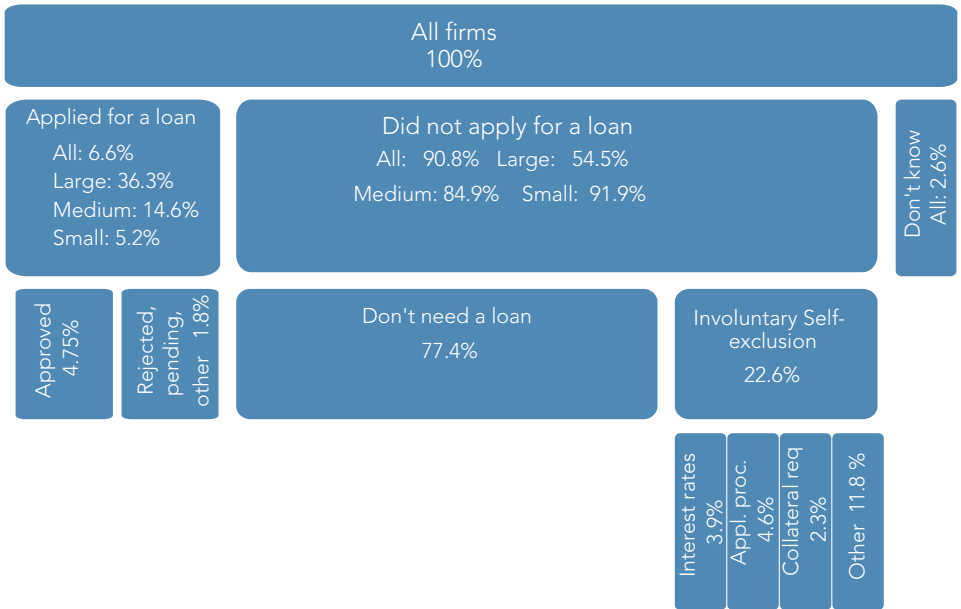
Source: *Doing Business 2014*, World Bank. Employing Workers Data.

Finance

Access to finance does not appear to be a binding constraint for most Palestinian firms, but small and informal firms appear to be more constrained in accessing finance. Although 54 percent of firms identify access to or the cost of finance as a major constraint, only about one in ten formal firms in the West Bank and Gaza identify access to finance as the biggest obstacle to business operations. Most formal firms (69 percent) report financing the majority of their investments and working capital with retained earnings. The vast majority of firms (90.8 percent) report not getting a loan in the last fiscal year because they did not apply. (See Figure 3.14.) Seventy-seven percent of firms report that they have not applied for a loan because they do not need one, compared to the MENA average of 45 percent, and 38 percent of firms in lower-middle income comparator countries. (See Figure 3.15.)

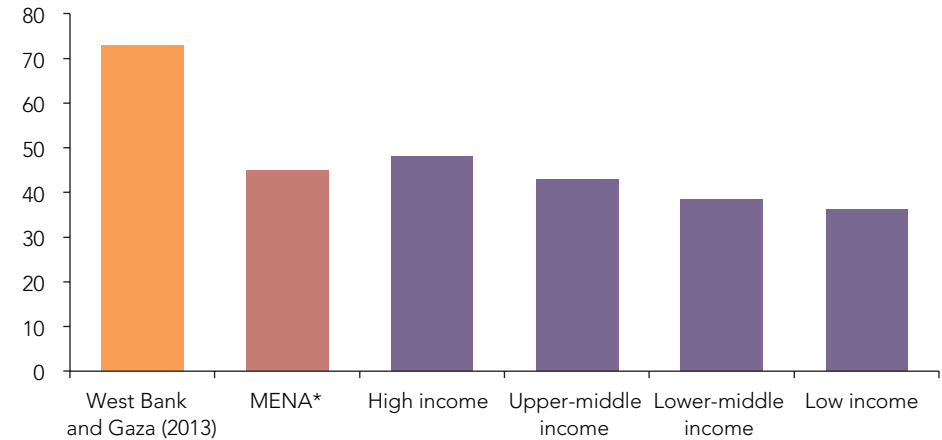
This seems to indicate that the constraints lie more in identifying profitable opportunities for investment under the current conditions and constraints than in financing these opportunities. Although over 70 percent of firms report having a checking or savings account, only 6 percent of firms report having a bank loan or a line of credit. However, this does not seem to be due to a bank refusal. Only about one in ten firms report having a loan application rejected. However, loan application rejection was reported exclusively by small firms and nearly all for reasons of insufficient collateral.

Figure 3.14: Borrowing by Palestinian Firms – Most Firms Do Not Want a Loan



Source: Enterprise Survey data, World Bank. 2013.

Figure 3.15: Percentage of Firms Not Needing a Loan



Source: Enterprise Survey data 2013. World Bank.

Note: * Middle East and North Africa (MENA) regional average includes: Global countries Iraq (2011) and Yemen (2010), both of which are survey-weighted. Averages from Algeria (2007), Egypt (2008), Jordan (2006), Morocco (2007), and Syria (2009) are Non-Global and un-weighted.

Survey results and an examination of the financial infrastructure and regulations all point to greater limitations for small firms, and less use of banking services in Gaza in particular. Only about 4 percent of small firms have bank loans, compared with nearly 40 percent of large firms. (See Figure 3.16.) Most lending is collateral based, with 68 percent of loans requiring collateral. A significant difference in the size of collateral was reported. Although available data is limited, it seems that the size of collateral required for small firms is significantly greater than for larger firms. Again, although data is limited, there does not appear to be a significant difference in interest rates by size of firm, although large firms may be getting better financing terms due to being granted credit over a longer time period. Perhaps as a consequence, small firms are much more likely to use supplier credit for financing.

There are significant differences in the use of bank services by region, size, and gender of ownership. Fewer Gaza firms have bank accounts, loans, or use bank financing for working capital or investments. (See Figure 3.17.) The same is true for small firms, with a significantly smaller share having bank accounts or loans. Finally, despite being less likely to be a small firm or located in Gaza, businesses with some female ownership are significantly less likely to have a loan, with only 1.9 percent reporting having a loan compared to 6.6 percent of firms with no female ownership having loans. This is despite the fact that a significantly higher percentage of firms with female ownership have a checking or savings account (94.8 percent) compared to firms with no female ownership (67.6 percent).

The banking sector in the West Bank and Gaza consists of 17 commercial banks, including two Islamic banks that are well capitalized and liquid. These banks have high

Figure 3.16: Greater Limitations for Small Firms

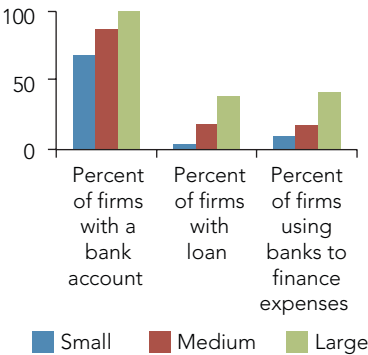
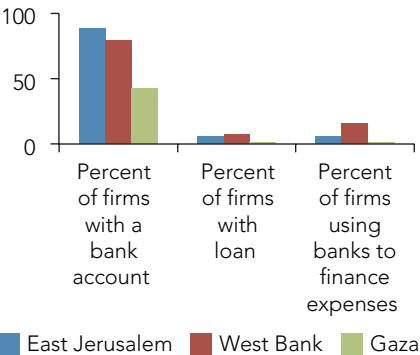


Figure 3.17: Gaza Firms have Less Access to Finance



Source: Enterprise Survey data, 2013. World Bank.

levels of lending for personal and consumer loans, primarily to PA civil servants rather than for private capital investment. Banking services have a fairly good degree of penetration, with 245 bank branches spread throughout the West Bank and Gaza. About half of the banks are foreign owned. The banking sector is regulated by the Palestinian Monetary Authority (PMA), which has helped ensure the sector’s stability. Palestinian banks are highly liquid and credit to the PA accounts for about 9 percent of total banking assets.³³ Although the banking sector continues to perform well, potential areas of risk include increasing exposure to the PA and its employees, and the consumption orientation of the majority of loans. Lack of bank credit to firms is currently unlikely due to any crowding out effects from the public sector— though the IMF has recently advised the PMA that this risk could increase due to banks’ high, growing, and volatile exposure to the PA, particularly for those banks with lower liquidity ratios.³⁴

Non-bank finance is less developed than the banking sector. Insurance companies are not major institutional investors as in other countries, as they contribute less than 3 percent of the financial sector’s GDP. Financial leasing is in its infancy, although a draft Leasing Law was recently signed by the President, and the related Secured Transactions Law is still in draft form. When enacted, the laws would facilitate financial leasing as a financing mechanism. Nine non-bank microfinance institutions lend to over 55,000 active borrowers for loans mainly used for production, consumption, and home improvements ranging from USD \$200-20,000, with an average amount of about USD \$1,500. Funding for microfinance institutions (MFIs) has been mainly provided by donors, rendering most MFIs unsustainable in the long-term. Efforts are currently underway to convert MFIs into commercial entities with effective corporate governance structures and procedures.

Equity financing is offered by several players in the market (see Table 2.3 in Chapter 2), albeit with reported difficulties in finding qualified projects for financing. Financiers

mostly fund projects with capital requirements of \$250,000 and higher. It appears that a gap exists for smaller size equity financing for startups. All of these funds were established since 2011 with a total committed capital exceeding US\$ 206 million, and estimated investments of at least US\$ 45 million. Early stage, small-scale financing appears to be lacking, with insufficient upstream volume for a growing equity market.

The apparent gaps in access to finance among smaller firms could be mitigated by improving key aspects of the financial infrastructure, namely the limitations in the credit bureau and lack of a collateral registry. In the 2014 *Doing Business* report, the West Bank and Gaza is ranked 165th out of 189 economies on the indicator for obtaining credit, lower than the already low MENA average of 133. Marginal improvements have occurred on the depth of credit information available, as well as the percentage of adults covered by the public registry in the past decade (though only 8.8 percent of adults are covered). However, access to credit remains limited due to the lack of a collateral registry and a private credit bureau, both of which would, in theory, facilitate access to credit.

Over 40 percent of informal enterprises report access to finance as their top obstacle to doing business. However, this finding is driven almost entirely by West Bank informal enterprises. A greater percentage of West Bank informal enterprises report having a bank account, but the overall percentages of firms applying for loans or accessing formal credit institutions are very small among all Palestinian informal businesses surveyed.³⁵ (See figure 3.18.) Most informal firms (59 percent) report not applying for a loan because they did not need one. (See Figure 3.19.) However, significant percentages of enterprises also cite high interest rates, complex procedures, and their expectation of being rejected due to non-registration as among

Figure 3.18: Percentage of Informal Businesses using Bank Services

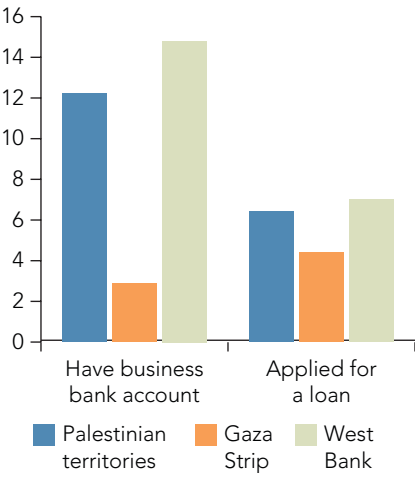
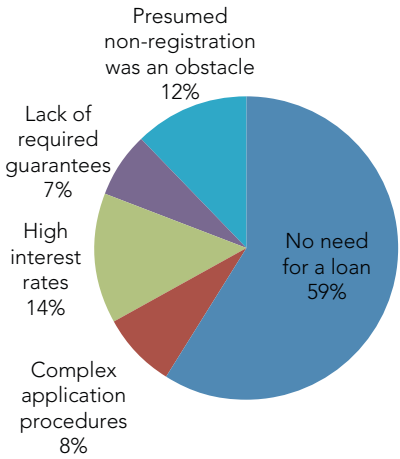


Figure 3.19: Reasons Cited among Informal Businesses for Not Applying for Credit



other reasons. Given the high proportion of firms stating that they have no need for a loan, and the expectations of ill-suited products or rejection among others, gaining access to finance does not constitute an incentive for formalization among Palestinian firms.

3.5 Infrastructure

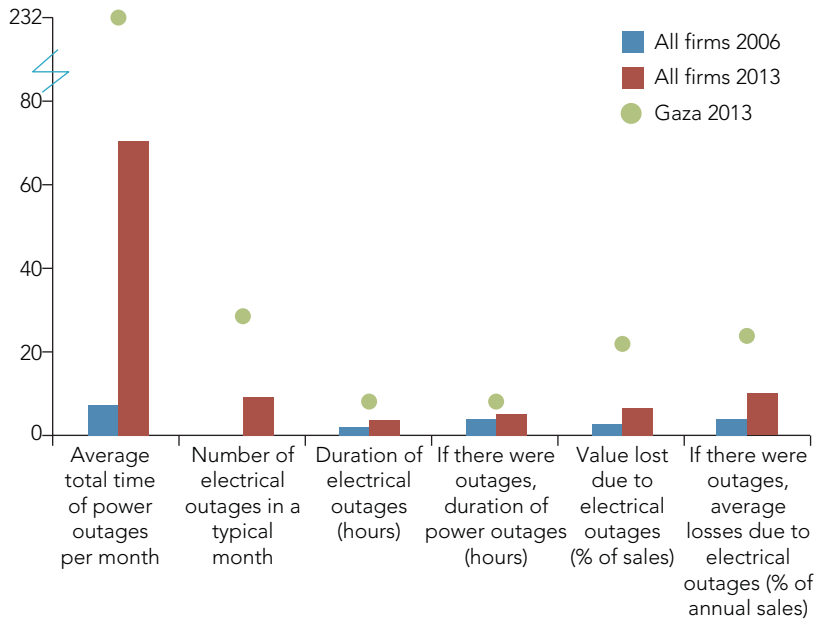
Overall, the availability of infrastructure services—including roads, water supply, power, telecommunications, waste treatment and disposal, and industrial parks—is constrained not only by public financial resources, but also by the restrictions on access to Area C in the West Bank. The majority of West Bank land is not under the control of the Palestinian Authority for purposes of land planning and use, but rather is controlled by the Israeli military's Civil Administration. As a result, neither the central government nor local government units (municipalities or village councils) can allocate land for public services or infrastructure. The newly planned town of Rawabi north of Ramallah is illustrative of how this acts as a constraint to development.³⁶ Although Rawabi is located in Area A, it will require roads and infrastructure services partially running through Area C. This has resulted in significant project delays due to difficulties in obtaining permits to construct an access road through Area C, and in obtaining approval from COGAT for its water infrastructure.³⁷

Reliable power supply in the West Bank and Gaza has deteriorated in the past few years, and water supply has not improved. Electricity has become the top binding constraint reported by Palestinian firms in Gaza, second only to political instability. Given that power outages in Gaza are linked to political instability, the two constraints should be considered jointly. It is important to note that this is the second most cited top constraint only for SMEs in Gaza. Regardless of their location, West Bank firms, East Jerusalem firms, and large firms (over half of which use a private generator) do not frequently cite electricity as a top constraint. This is not to say that electricity is not recognized as a major constraint in the West Bank and East Jerusalem. Indeed, more than half of all Palestinian firms in all areas cite it as a major constraint.

The electricity crisis in Gaza is a result of long-term power generation capacity deficits and poor distribution infrastructure. However, it has intensified in recent years as a result of chronic fuel shortages. Fuel supplies to the power plant from both Israel and Egypt have been disrupted; supply from Egypt was primarily through the illicit tunnels, which have since reportedly shut down. Gaza has suffered from frequent and long outages ever since with power cuts, averaging around eight hours per day, which equates to over 230 hours per month.

The duration and length of power outages are much longer in Gaza than in the West Bank and East Jerusalem. (See Figure 3.20.) Indeed, they have increased

Figure 3.20: Deteriorating Reliability of Power Supply in Gaza



Source: 2006 and 2013 Enterprise Survey data. World Bank.

quite significantly overall since 2006, as have losses. In the West Bank, firms suffer from more frequent and lengthy water shortages than for power. This is in contrast to Gaza, which also has a significant water problem. However, Gaza's water problems are related more to water quality and long-term sustainability rather than to daily outages.

Telecommunication services have improved in terms of better competition in the telecommunications market. However, it remains restricted from the provision of 3G and 4G services. In 2009, a second mobile operator started operations in the market and total mobile and internet penetration among businesses subsequently increased. However, the continued restriction of bandwidths by the government of Israel for telecommunications, as well as restrictions on the development of telecommunication infrastructure in Area C, has affected service delivery, costs, and the provision of 3G and 4G services. Telecommunications regulation reform has been stalled, with the telecommunications regulation passed into law, but never implemented. Impediments to the use of land in Area C and the import of telecommunication equipment (due to dual-use restrictions) constitute a constraint and cost for the telecommunications sector.³⁸

The past few years have seen a building of momentum in the development of industrial estates in the West Bank. There are now four industrial estates in existence or under establishment in the Palestinian territories, with three in the West

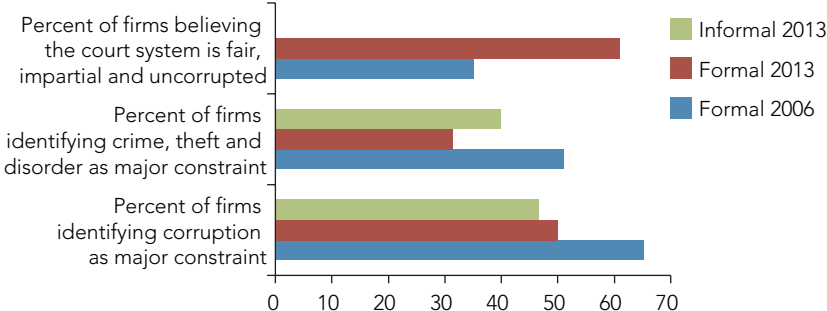
Bank, in addition to the long-standing industrial estate in Gaza. All three industrial estates were established with industrial development assistance and partnerships or concession agreements with the private sector. The Jericho agro-industrial estate, established on 615 dunums (in Areas A and B; the planned expansion in Area C is on hold) with assistance from the Japanese government, has begun to receive occupants. The Bethlehem Industrial Estate, established as a public-private partnership with French and Palestinian investment, has been established on 195 dunums. The Jenin Industrial Estate, with a concession agreement with a Turkish private partner, is still under development.

In all three new industrial estate developments, one of the main stumbling blocks was access to land, underscoring the need for access to land in Area C— as well as for land reform by the PA in Areas A and B. This would increase the availability of registered land for investment and ensure appropriate procedures and transparency in the use of public lands, and the appropriation of private lands for public use.

3.6 Improving Perceptions of Crime and Corruption as a Business Constraint

Recent trends, particularly in the West Bank, indicate that since 2006 a significantly lower percentage of businesses consider crime and petty corruption as major obstacles to businesses. (See Figure 3.21.) However, there are some significant differences between the West Bank, East Jerusalem, and Gaza on some indicators of crime and petty corruption. For example, while only 15 percent of East Jerusalem firms consider crime a major (or severe) constraint, compared to over one-third of West Bank and Gaza firms, a significantly higher number of East Jerusalem firms pay security costs—and higher costs at that. This seemingly contradictory report may indicate that East Jerusalem firms are more confident in the security measures they have taken, and that these measures are effective

Figure 3.21: Diminished Perception of Crime and Corruption as a Business Constraint



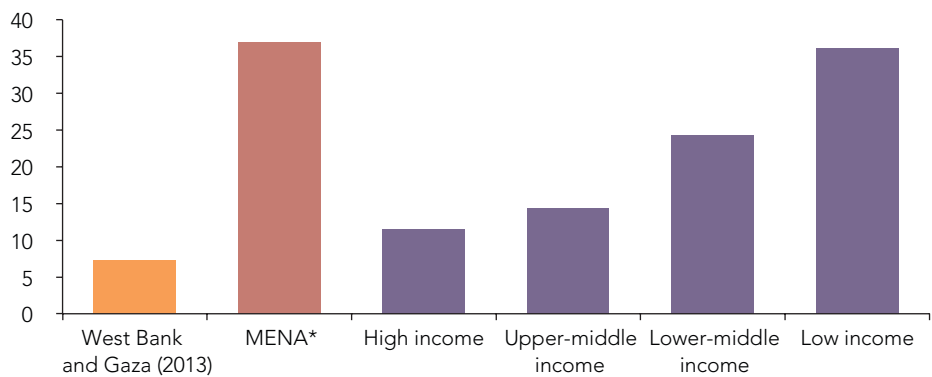
Source: 2013 Enterprise Survey data.

(reflected in the fact that the average losses per firm are lower in East Jerusalem than in the West Bank and Gaza, even though the value of losses per firm when a loss has occurred, is higher).

A similar trend can be observed regarding corruption, whereby a smaller percentage of firms report corruption as a major (or severe) constraint since 2006. The biggest contributor to this change is the shift in opinion in Gaza. In 2006, more Gaza businesses (78 percent) reported corruption as a major constraint than in the West Bank or East Jerusalem. In 2013, this percentage dropped to 43 percent. The same trend is evident in the West Bank, although not as significant in magnitude. There are other minor variations in the reported frequency of requests for informal payments for various public services.

The most striking result from the Survey is the overall low incidence of expected informal payments, or petty bribes. (See Figure 3.22.) With few exceptions at low percentages, and on nearly every indicator—including payment for an operating license, tax officials, electricity connection, water connection, securing government contracts, import licenses, and construction permits—the *percentage of firms reporting an expected informal payment is statistically zero or in the low single digits.*³⁹ This is an important conclusion since this is in stark contrast with some of the other business climates in the region (for instance, the MENA average is about 37 percent), but mostly since about 50 percent of all firms still identify corruption as a key constraint. So what could be driving this paradoxically high perception of corruption despite the fact that few if any firms have experienced any need to make any payments to corrupt officials?

Figure 3.22: Percentage of Firms Expected to Pay Informal Payments (to get things done)



Source: Enterprise Survey data.

Note: The Middle East and North Africa (MENA) regional average includes Global countries: Iraq (2011) and Yemen (2010), both of which are survey-weighted. Averages from Algeria (2007), Egypt (2008), Jordan (2006), Morocco (2007), and Syria (2009) are Non-Global and un-weighted.

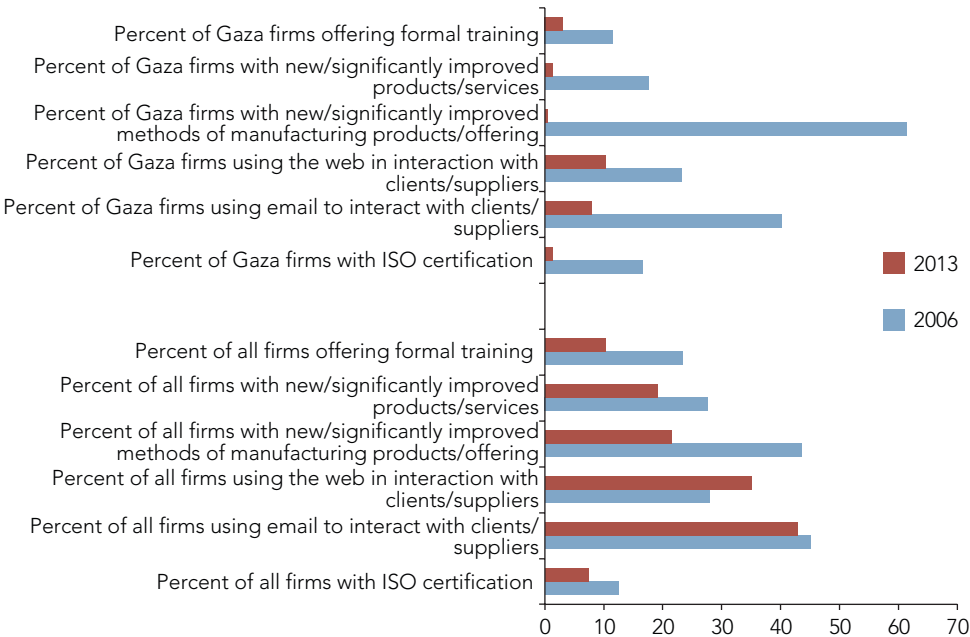
This same finding is consistent with the conclusion of a World Bank study into governance and corruption in the Palestinian Authority which found that while the incidence of corruption related to public services was low, perceptions of corruption surrounding those very same services was high. The report found that public procurement, typically a government activity of high importance to the private sector and very vulnerable to abuse, was reasonably well managed. Indeed, most respondents surveyed disagreed when asked if bribes were paid (95 percent), or if family or connections affected procurement outcomes (75 percent). This may in part be attributed to the fact that many public procurement activities are undertaken under international donor agency procedures. For all centrally provided and municipal services, no more than 2 percent of respondents in the governance study reported that they or their household members had experienced demand for bribes. Although household experience of preferential treatment (“wasta”) was higher, it only exceeded 10 percent for public employment and police services. The report concludes that *“the PA and private sector associations backing anti-corruption reforms should be given due credit, particularly in light of the fact that many more experienced governments struggle to develop effective governance arrangements for regulating the activities of the private sector.”*⁴⁰

The reasons behind the gap between perceptions and experience of corruption are two-fold. The first is a persistent perception of corruption despite consistent gains made by the PA since its inception in 1994. These perceptions are due to the lack of sufficient institutionalization of these gains (anti-corruption measures, legal frameworks, and access to information), examples of which include the lack of a public land registry, the failure to implement the 2009 telecommunications law, and the failure to complete the competition law. The absence of a functioning legislature with oversight of the government has not helped, and efforts to institutionalize alternative means of public-private-civil dialogue and consultation have been limited. The second reason for the perception gap is the fact that the definition and nature of corruption in the Palestinian context does not typically manifest itself as a petty bribe, that is, as a *quid pro quo* payment for a public service, but rather in the use of connections or abuse of position to provide favorable treatment to well-connected individuals or businesses (known as *wasta*).

3.7 Innovation and Technology—Avenues for Future Growth

Since 2006, Palestinian firms do not appear to have increased their activities to improve their products, production or management processes, or use of technology. In fact, on some indicators, these types of activities have declined, driven mainly by the deterioration of the private sector in Gaza since 2007. (See Figure 3.23.) Firms in the West Bank are much more likely to have engaged in product, process and management systems upgrading, use of technology, acquisition of knowledge, and other innovative activities, than those in Gaza or East Jerusalem—although not at significantly higher rates since 2006. SMEs are more likely to have

Figure 3.23: Innovative Activities and Use of Technology Suffer, Especially in Gaza



Source: 2006 and 2013 Enterprise Survey data, weighted, limited to manufacturing and services (wholesale and retail firms excluded from 2013 data for comparability).

Note: ISO=International Organization for Standardization. All firms indicates all firms in the West Bank (including East Jerusalem) and Gaza.

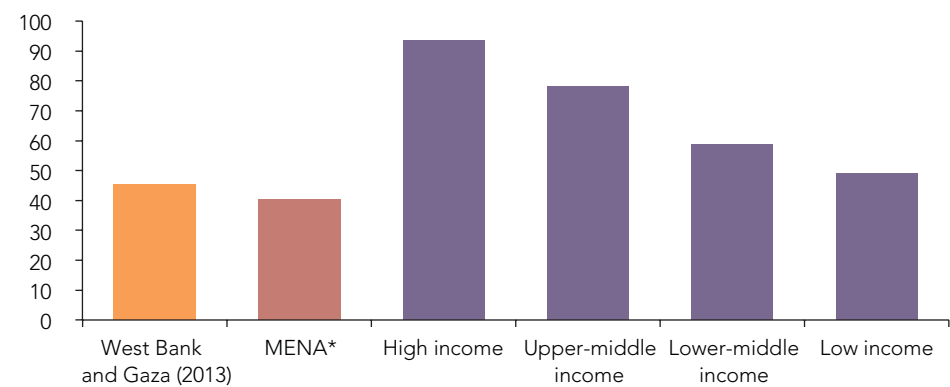
decreased their engagement in these upgrading and innovative activities, likely due to their more limited financial resources.

While this may present a bleak picture, it is not unexpected that Gaza firms, affected by the impacts of Israeli military action and effectively blockaded from trade with the rest of the world, would reduce their investments in training, cease to develop new products, and allow ISO quality system certifications to expire. As this decline is a result of external events rather than diminished capacity, to some extent, some ground could be regained with appropriate interventions. However, the outdated intellectual property laws offer inadequate protection and therefore do not encourage investment in research and development.

Moreover, activity in the innovation and entrepreneurship space in both the West Bank and Gaza is indicative of Palestinian participation, albeit at the periphery, of a nascent but growing technology-enabled entrepreneurial trend throughout MENA. (See Figure 3.24.) Although anecdotal in nature, evidence of this activity can be seen, for example, in the activities of the Gaza Startup Weekend (which only began in 2011, and has held three events since) and Gaza Sky Geeks, a technology startup accelerator supported by Mercy Corps through a grant from Google.org.

West Bank firms show the highest levels of business upgrading, innovation, and technology use among Palestinian firms. (See Figure 3.25.) Indicators on innovation show them to be more significantly engaged in practices such as web/ internet use with customers and clients, and purchasing of business development services. An innovation ecosystem has also been growing in the West Bank, unfortunately distinct and separate from that in Gaza, but with a range of initiatives and resources, both formal and informal, to support technology-based entrepreneurs. (See Box 3.4.) Sadara Ventures is a USD 30 million venture capital firm seeking investments in technology startups in the West Bank and Gaza, with current investments in three startups. Sharakat, a Palestine Investment Fund-supported SME equity fund, also operates in this space. Incubation and accelerator programs include the Palestine Information and Communications Technology Incubator (PICTI), Fast Forward, and the Arab Development Network Initiative (ADNI supported by Mercy Corps and Google.org). This nascent ecosystem is strengthened by linkages to regional actors such as Oasis 500, Mowgli, and others. However, it is also constrained by gaps in the technology infrastructure, such as the unavailability of a 3G network and lack of access to the PayPal payment mechanism.

Figure 3.24: Percentage of Firms using Email to Interact with Clients/Suppliers



Source: Enterprise Survey data.

Note: The Middle East and North Africa (MENA) regional average includes Global countries of Iraq (2011) and Yemen (2010), both of which are survey-weighted. Averages from Algeria (2007), Egypt (2008), Jordan (2006), Morocco (2007), and Syria (2009) are Non-Global and un-weighted.

Box 3.4: Case Study: Unit-One Off-Shoring Services (Trademark Archiving)

Background: A technology company was established in 2005 as a training center in information technologies. However, within a few years, the company shifted its specialty to software programming. The primary owner of the company was an active participant at various local and international marketing and networking activities.

Off-shoring Opportunity: In 2012, the company won a bid for providing trademark archiving services in the MENA region to a Dutch firm. The firm was interested in outsourcing part of its Arab world work to an information technology (IT) company based in the MENA region. Unit-One managed to participate in the bidding process and to compete with companies in Jordan, Egypt and the West Bank and Gaza in an archiving exercise for selected industrial trademarks. Unit-One was asked to confirm the capacity of the company to recruit 400 full time data-entry persons and complete the assignment with 12 months. It was accordingly awarded a contract of 700 million characters, with one month for preparations.

Challenges: The Gaza firm was buoyed by winning its first off-shoring contract, but found it challenging to start implementation within one month. Its attempts to receive financing from several Palestinian banks, and one Palestinian equity fund were unsuccessful. Instead, it relied on financing through informal loans from business associates and friends to begin operations (an amount of \$40,000), and then ultimately resorted to borrowing from the Islamic National Bank in Gaza, which is not registered with the Palestinian Monetary Authority (PMA). Rather, it was established under the supervision of the de facto government in Gaza. The Islamic National Bank agreed to provide a USD 56,000 loan (*Murabaha*^a) to cover the costs of the desktop computers at an interest rate of 4 percent. The re-payment plan was set at 2 years, with a grace period of 2 months.

The firm moved forward and recruited 150 new employees, all female, including 50 percent with hearing or other physical disabilities. The initiative was supported by the University College of Applied Sciences (UCAS), the United Nations Relief Works Agency (UNRWA), and the Al Azhar University in providing lists of qualified fresh graduates to consider for employment.

In January 2013, the firm started implementation and managed to deliver the agreed works in the first month of operations. During that month, the firm received repeated visits and inquiries from the interior security in Gaza related to their employment of female workers. The firm was also queried by Gaza authorities when they delayed the payment of first-month salaries for a few days. The firm had further complications in receiving payment from the Dutch firm, due to the fact that their bank account was registered in Gaza, and Israeli banks would not transfer funds directly to a Gaza-based account (they had to open a “virtual account” in the West Bank).

Having overcome these different hurdles, the firm is now implementing the contract, and discussing new business opportunities with its Dutch partner in 2014.

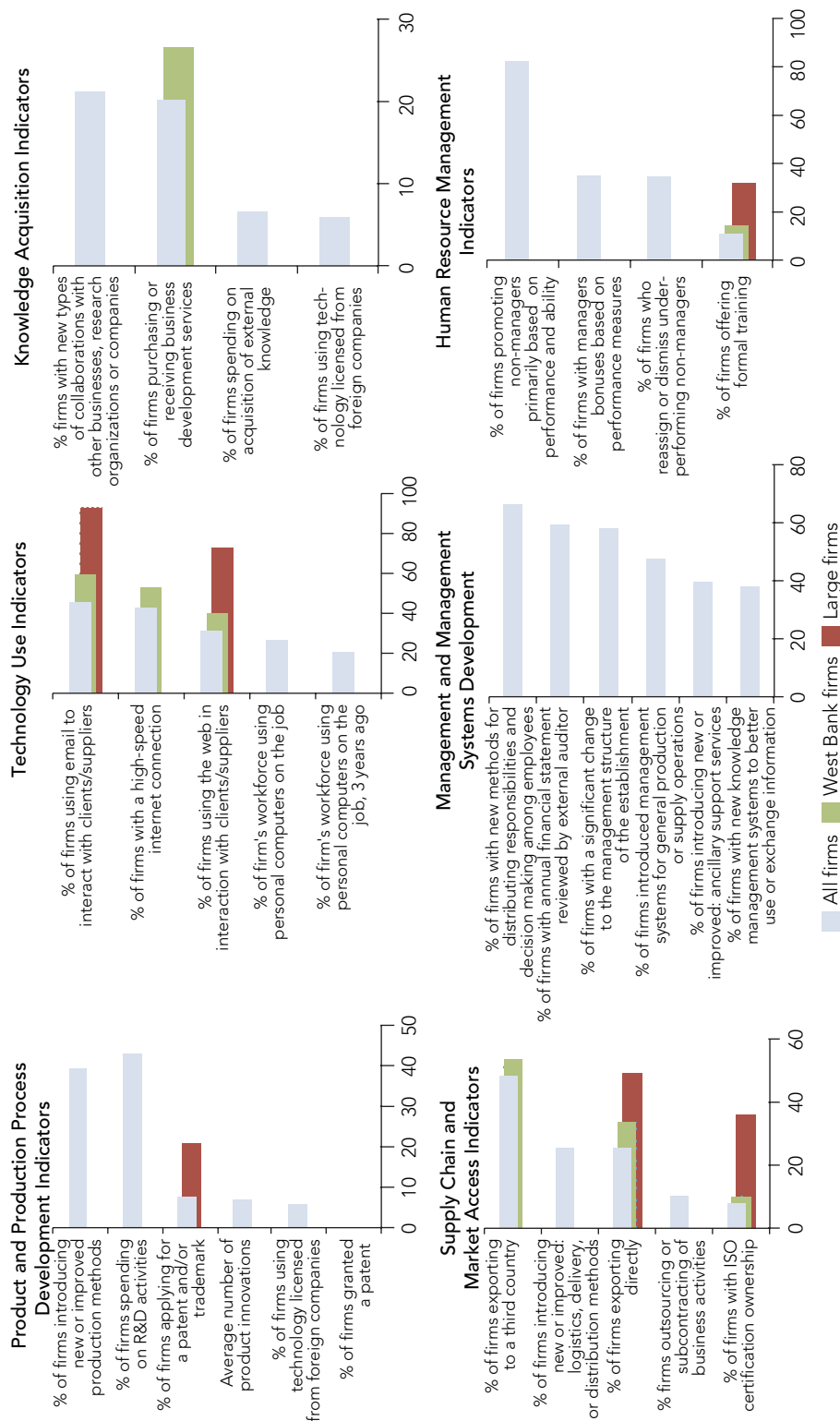


Photo for the firm's premises in Gaza, March 2013

Source: Interview with the firm owner, March 2013

a. *Murabaha* is the most popular and most common mode of Islamic financing. It is also known as mark up or cost plus financing. http://www.islamic-banking.com/murabaha_sruling.aspx.

Figure 3.25: Innovation, Technology Use, and Business Management Indicators in the Palestinian territories, 2013



Source: Enterprise Survey data, 2013. The World Bank.

Note: ISO=International Organization for Standardization; R&D=research and development.

Notes

1. World Development Report 2011: Conflict, Security and Development. The World Bank.
2. U.N. Office for the Coordination of Humanitarian Affairs (OCHA) in the Occupied Palestinian Territories. Protection of civilian summary of data tables, October 2008. Data is from the latest year for which data was reported (2008), and is reported only through September.
3. Agricultural use is the exception, provided it involves no additional use of water resources and no permanent construction. Other economic activities are subject to approval by the Israeli Coordination of Government Activities in the Territories (COGAT) in the West Bank.
4. Area C is the only contiguous area in the West Bank. Areas A and B are scattered within Area C, and access to some of these areas is disrupted by the Separation Barrier, checkpoints, or other impediments—the extent of which can vary with the security situation.
5. *Area C and the Future of the Palestinian Economy*, The World Bank, 2013.
6. Staff Report Prepared for the September 2013 Meeting of the Ad Hoc Liaison Committee, IMF, 2013.
7. *Towards Economic Sustainability of a Future Palestinian State: Promoting Private Sector-Led Growth*. The World Bank Group, April 2012.
8. World Bank estimates from Ministry of Finance data.
9. Palestine Ministry of Finance and IMF staff calculations in “Between a Rock and Hard Place: Recent Economic Developments in the Palestinian Economy” presentation by Dr. Udo Kock, IMF, Feb. 2014.
10. Staff Report Prepared for the September 2013 Meeting of the Ad Hoc Liaison Committee, IMF, 2013. The same report projects a higher figure for 2013 at \$US 1.33 billion.
11. Recent Experience And Prospects of The Economy of The West Bank And Gaza, Staff Report Prepared for The Meeting of The Ad Hoc Liaison Committee, IMF, March 2013.
12. The parliament that was elected in 2006 has not convened since 2007.
13. *Towards Economic Sustainability of a Future Palestinian State: Promoting Private Sector-Led Growth*. The World Bank Group, April 2012.
14. Private Sector Position Paper at the Fourth National Public- Private Dialogue Conference. February, 2014.
15. Palestine Economic Policy Research Institute (MAS) Report: Workshop on the Income Tax Law held on Dec. 7, 2011 at: <http://jurist.org/datetime/2012/06/mais-qandeel-palestine-tax.php>.
16. Note that *Doing Business* is for limited liability corporations (LLCs) in Ramallah with 60 employees. These indicators are undoubtedly much different in other areas, and possibly for sole proprietorships or other company forms.
17. *Towards Economic Sustainability of a Future Palestinian State: Promoting Private Sector-Led Growth*. The World Bank Group, April 2012.
18. This would apply for all goods traded through the crossings with Israel. Any goods imported from or exported through the Allenby Bridge with Jordan would not be likely to have crossed through an additional crossing point, but may encounter checkpoints depending on the source or destination.
19. The government of Israel allowed entry of only 20 basic commodities in mid-2007, and the number increased to 100 items by the end of 2008 (out of more than 4,000 items registered by Palestinian importers).
20. “Gaza Private Sector: Post War Status and Needs”, Private Sector Coordination Council, 2009.
21. Palestinian Economic Council for Economic Development and Reconstruction (PECDAR), 2008.
22. The higher refusal rate for the West Bank firms is due to the fact that the dual-use restrictions do not apply to East Jerusalem firms. It is also likely that Gaza firms are self-selecting out of the permission process due to the well-known, much higher restrictions on imports to Gaza.
23. With the possible exception of some days during holidays, when Israeli citizens were also allowed into Nablus and other cities.
24. *Area C and the Future of the Palestinian Economy*. 2014. The World Bank.
25. Economic Effects of Restricted Access to Land, The World Bank, 2008.

26. *Area C and the Future of the Palestinian Economy*, The World Bank, 2013. *Economic Effects of Restricted Access to Land*, The World Bank, 2008.
27. *Towards Economic Sustainability of a Future Palestinian State: Promoting Private Sector-Led Growth*, the World Bank, 2012.
28. In the West Bank, Area C building permits are reviewed and approved by COGAT rather than the PA. Data obtained by Bimkom, an Israeli planning rights organization, from COGAT found that for the period of 2000 to 2007, the number of demolitions executed vastly exceeded the number of building permits issued in the West Bank. Source: *Economic Effects of Restricted Access to Land*, the World Bank, 2008.
29. PCBS education statistics, 2012, and World Development Indicators, World Bank.
30. From *Education-To-Work: Opportunities And Challenges In the West Bank and Gaza*, Stefanie Brodmann, Ernesto P. Cuadra, Mohamad Ismail Allouche, and Samira Ahmed Hillis. MENA Quick Note Series. January 2012, No. 55.
31. SABER report, World Bank 2013, and Portland Trust Private Sector Strategy document.
32. *Beyond Aid: A Palestinian Private Sector Initiative for Investment, Growth, and Employment*. Portland Trust, 2013. From *Education-To-Work: Opportunities And Challenges In The West Bank And Gaza*, Stefanie Brodmann, Ernesto P. Cuadra, Mohamad Ismail Allouche, and Samira Ahmed Hillis, MENA Quick Note Series. January 2012, No. 55, and author interviews.
33. *Towards Economic Sustainability of a Future Palestinian State: Promoting Private Sector-Led Growth*, the World Bank, 2012.
34. Staff Report Prepared for the September 2013 Meeting of the Ad Hoc Liaison Committee, IMF, 2013.
35. The surveyed informal enterprises excluded single-owner firms without any paid workers or premises outside of the home. They may possibly be the targeted client base for microfinance programs, so this may not be representative of microfinance use in the entire informal sector. Among microfinance institutions (MFIs) that report to the Microfinance Information Exchange (MIX), eleven MFIs in the West Bank and Gaza lend to nearly 50,000 active microfinance borrowers for a gross loan portfolio of around USD \$150 million.
36. Financed primarily by the Siraj Fund and a Gulf Cooperation Council (GCC) sovereign wealth fund, Rawabi is the first planned city and the largest private sector project ever carried out in the West Bank and Gaza. Its full plan comprises over 5,000 housing units spread across 23 neighborhoods that include schools, commercial areas, and other services.
37. Source: Palestinian Business Committee for Peace and Reform.
38. Telecommunications Sector Note – Introducing Competition in the Palestinian Telecommunications sector. The World Bank, 2008.
39. This is based on a 90 percent confidence interval. The exceptions are an average of 3.5 percent of firms reporting an expected payment to tax officials in the West Bank.
40. *West Bank and Gaza: Improving Governance and Reducing Corruption*, The World Bank, 2011.

RECOMMENDATIONS

4.1 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.¹ 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 under-investment. 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.

4.2 Concrete Priorities in the Short Term

In the short-term, policy makers must recognize that the overwhelming constraint to investment and business in the Palestinian territories is political instability. The highest priority actions are those that address the main constraints that result from instability. These actions require joint PA, government of Israel, and international community action and cooperation to improve access to resources and trade— and to reverse the trends of fragmentation and isolation (Themes 1 and 2 in the recommendations below). While these are the highest priority actions with the greatest potential positive impact on the investment climate, they are also the most challenging since they require a combination of political will from both

the government of Israel and the PA, as well as policy reforms, investment, and capacity building.

Short of improving on the conditions above, short-term recommendations must 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 these constraints. The recommendations below do not represent a complete list of all that can and should be done to improve the investment climate in the short term. Rather, they contain a set of key priorities grouped under five primary themes that have been identified as a result of the analysis:

- **Theme 1:** Improving access to resources and trade
- **Theme 2:** Reversing the trends of fragmentation and isolation
- **Theme 3:** Mitigating political risk
- **Theme 4:** Improving business regulation and enhancing the role of the private sector
- **Theme 5:** Investing in skills, technology, entrepreneurship, and innovation

4.2.1 Improving Access to Resources and the Predictability of Business-Enabling Functions and Services

With the overall binding constraint of political instability, in the short term, priorities should focus on actions that can be taken to mitigate the overarching symptoms of political instability and reduce uncertainty in the business environment. Improving the accessibility, efficiency, and predictability of business and trade can reduce barriers to entry and risks to investment. Public service functions and services such as land use planning and administration, trade facilitation, customs and standards are all aspects of the investment climate. They exhibit inefficiency and unpredictability due, in varying degrees, to the combined effect of the multiplicity of authorities controlling these functions – the government of Israel, the Palestinian Authority, and the de facto government in Gaza – as well as the quality of execution of these functions and delivery of these services by the three authorities.

Proposed actions require a combination of political will, coordination, and capacity development by several parties, including the PA, the government of Israel, the international community, and other parties. 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, these recommendations could potentially be acted upon in the context of the current political agreements. However, history has made clear that this level of cooperation is an ambitious goal.

However, to the extent that the current period represents a window of opportunity, it is one certainly worth reaching for.

Enable Palestinian administration of resource planning and use functions in parts of Area C. Evidence has shown that the inability of Palestinians to mobilize Area C land and resources for economic use is constraining economic development. The World Bank report on *Area C and the Future of the Palestinian Economy* concluded that alleviating today's restrictions on access to and production in Area C has the potential to generate an additional \$US 3.4 billion in value added, or 35 percent of Palestinian GDP as of 2011. This is based on a conservative estimate of direct and indirect effects on agriculture, minerals, stone quarrying, construction, tourism, and telecommunications.²

The GoI maintains control over the planning and use of land and other resources in these areas. This is the case even in areas of the West Bank that were part of the Israeli disengagement plan in 2005, namely in the Jenin district. The Israeli cabinet decision included the dismantling of the settlements in the area, and states that as a result of the move "there shall no longer be any permanent presence of Israeli security forces", and that such a move would "enable territorial contiguity" in the area." It indicates that it would be one of the steps in the West Bank (along with improving "transportation infrastructure") that will "facilitate normal life and Palestinian economic and commercial activity in the West Bank". However, these desirable effects of the withdrawal in Jenin have not been fully realized, in part due to the continued Israeli control over land planning and use in the area.³ The former settlement areas remain vacant and undeveloped. Any activity along the vital main artery through the Jenin district and other parts of the Jenin district classified as Area C remains under the control of COGAT.

Without prejudice to final status negotiations and with due consideration to security, Palestinian administration of the planning and use of public lands and registration—and administration of private lands in parts of Area C—has the potential to unleash development. By making public land available for infrastructure, tourism, extractive and other public purposes, it could unlock private land for economic use. This would be expected to have positive effects on the Palestinian economy, both direct and indirect. Although limited, there is a precedent for such actions on the part of the Israel, namely the reclassification of Area C land to Area B for the site of the Jalameh Industrial Estate in the early years after the Oslo Accords.

Improving Palestinian economic access to land within Areas A and B through land registration and administration. Access to land has been identified by the PA as a national priority. However, policies and resources need to be brought to bear to elevate this issue on the development agenda and on the ground in Areas A and B. These are areas where the PA already has the ability to implement policies and programs. A national campaign by the Palestinian Authority to promote land surveying, adjudication, and registration in Areas A and B—as well as reforms to

better reduce and streamline the handling of land disputes— would release significant assets into the economic space and help spur growth. Today, only about 28 percent of land in the West Bank is registered. Around 3.5 million *dunums*, equivalent to 3,500 square kilometers, have yet to be systematically surveyed.⁴ At the current rate and under current arrangements, and even with a continuous systematic registration process, registration would not be complete for another 80 years.

Registration needs to be simplified, costs need to be reduced, and incentives for registration need to be put in place. The National Land Policy Framework (NLPF), adopted by the Cabinet in 2008, should be implemented. The Palestinian Land Authority (PLA) needs to adopt measures to simplify surveying and registration to speed up systematic land registration.

The PA needs to implement an integrated, systematic mechanism for dealing with land disputes with special attention to absentee rights, including formalizing arbitration and mediation mechanisms and improving the capacity of the judiciary to address the backlog of land disputes in the court system. This is all the more necessary given the likely increase in land disputes should an aggressive systematic land registration program be implemented throughout the Palestinian territories.

Improve reliability of electricity supply to Gaza. Electricity supply to Gaza would need to grow rapidly to support any increase in economic activity. Several short- to medium-term actions are possible to support increased electricity supply to Gaza. These include increasing fuel supply to the Gaza power plant, providing an additional supply of electricity through a planned high-voltage transmission connection, and rehabilitation of the Gaza electricity network to reduce system losses. In the longer term, the Gaza power plant could be converted to use gas for fuel, as was originally designed. This would allow for greater output at a lower cost, with environmental benefits as well. Gaza could also be connected to the Arab Regional Grid through Egypt, with sufficient investment in transmission infrastructure.

Trade facilitation – enabling Palestinian management of Palestinian trade. The Palestinian Authority has very limited involvement in facilitating Palestinian trade. While Palestinian traders benefit from efficient Israeli ports on the one hand, the benefits are diminished entirely or in part by additional procedures, logistics, or outright restrictions on trade, particularly for Gaza but also for the West Bank. The Palestinian institutions that ostensibly should have a role in facilitating trade have little direct role in the process – namely the Palestinian Customs Authority, the Palestinian Standards Institute, and the border authority (for Allenby). This is especially the case for imports.

If undertaken with support for capacity development of the relevant institutions, Palestinian management of trade facilitation has the potential to improve service delivery by institutions accountable to their constituency, namely the Palestin-

ian traders. This could entail roles for Palestinian Authority institutions as well as for Palestinian business membership organizations in some cases (for instance, at commercial crossings between Gaza, the West Bank and Israel). This agenda would include: (i) Palestinian customs clearance (in-land clearance in bonded warehouses is an option that has been repeatedly presented); (ii) Palestinian testing of goods imported into the Palestinian territories (beyond the limited goods and quantities in List A of the Paris Protocol); and (iii) trade facilitation at commercial crossings (possibly by Palestinian trade associations) and at the Allenby Bridge. It is important to note that this would only serve Palestinian economic interests if the Palestinian role did not simply duplicate that of the Israeli authorities, thereby adding time and complexity rather than reducing it. It would also mean that Palestinian capacity would need to be built to execute these functions. The two key aspects of trade facilitation which could be addressed, customs and standards, are addressed below.

Import controls – customs clearance by the PA. Currently all customs clearance on imports into the Palestinian territories is controlled by Israeli customs. Goods can only be transported to the West Bank or Gaza after clearance by Israeli customs. Therefore, the release occurs at the port of entry, typically the Ashdod or Haifa ports, or at the Allenby Bridge. The Palestinian Customs Authority has no access to points of entry, and no information on cleared shipments until after the fact. Therefore, it is limited to post-release audits of imported goods. Enabling customs clearance of Palestinian imports by PA customs at in-land, bonded warehouses (or possibly even virtually) could contribute to decreasing the cost and time for import clearance. In this context, it could contribute to the building of capacity of the Customs Authority. Crucially, it would also be expected to contribute to increased customs revenues for the PA. For such a transfer of authority over customs clearance to occur, Palestinian customs would need technical assistance to upgrade its systems and human capacity. In addition, physical trade infrastructure (if the bonded warehouses solution was adopted) would be needed. A system for licensing and qualification of Palestinian customs clearance agents would also be necessary.

Enable the Palestine Standards Institute (PSI) to control health and safety standards and testing of imports into the Palestinian territories. Goods imported into the West Bank and Gaza are required to meet Israeli product standards and specifications, as set by the Standards Institute of Israel (SII). The Palestine Standards Institute cannot impose Palestinian standards on imported goods since it has no control over the entry of goods into Palestinian territory. PSI currently provides product testing and certification for exported products, and conducts inspection on some goods and measurement devices in the local market. A memorandum of understanding between ISI and PSI on mutual recognition of test reports and factory inspection reports for trade between the Palestinian territories and Israel has been signed, but not enacted. Another memorandum of understanding has been drafted, but not completed or implemented. It would allow the PSI to undertake

testing for certain product imports, thereby enabling advance conditional release of goods from Israeli ports, specifically, conditional based on satisfactory testing by PSI. These agreements need to be completed and implemented. In addition, providing capacity building to PSI to undertake further testing and to provide up-to-date information to the Palestinian market on SII requirements would be beneficial. It would help reduce the uncertainty in dealing with import standards and requirements for Palestinian businesses.

Support the development of quality infrastructure and provide information on market requirements. In the meantime, work to improve the flow of information on SII requirements to Palestinian traders through a PSI information center (funded by the European Union) is a positive initiative. It also supports aspects of the broader agenda of PSI-SII cooperation. The PSI and other public institutions should also work to provide Palestinian exporters with information on mandatory requirements and other export market standards. More broadly, supporting the development of the quality infrastructure in the Palestinian territories—including metrology, standardization, testing, conformity assessment, quality systems management, certification, and accreditation—can contribute to better product quality, productivity, and integration into global markets.

4.2.2 Reversing the Trends of Isolation and Fragmentation

The physical and political separation between Gaza and the West Bank has taken a socio-economic toll. Already low economies of scale in the small Palestinian economy have been depressed even further. Yet another layer of regulatory complexity has been added to the already convoluted legal and regulatory environment. Further, the cost and restrictions to the movement of people and goods between the areas have increased. All of this has led to a decrease in trade, investment, and economic collaboration between the areas. This also applies to Palestinian firms in East Jerusalem that had been dependent on business and trade with the rest of the West Bank, and to a lesser extent with Gaza. These firms face the physical Separation Barrier as well as other security restrictions in any effort to interact economically with the rest of the West Bank and Gaza. Efforts to increase the ability of Palestinians to move between Gaza and the West Bank and within the West Bank would help to mitigate these effects to an extent. In addition, proactive initiatives to maintain socio-economic ties are needed.

Improve freedom of movement and private trade between the West Bank and Gaza and within the West Bank—including between the West Bank and East Jerusalem—to improve access to markets and enhance economies of scale. Predictability of mobility and access over time will be crucial to building investor confidence for long-term economic growth. Left unchecked, the effects of movement and access restrictions in the West Bank, the Separation Barrier (particularly for those enclave communities enclosed by the Separation Barrier), the settlements, the closure of Gaza, and associated violence will continue to have broader socio-economic effects.

Improving local movement and access restrictions has been shown to have local positive effects on economic activity in the West Bank. Improved, predictable movement and access, especially between the West Bank and Gaza and in and out of Gaza, would be expected have broader positive effects. Although this is determined for the most part by Israeli policy, opportunities to improve facilitation of movement should be explored and seized wherever possible. The Chambers of Commerce currently play a facilitation role in this regard. It may be possible to expand and improve the role of this or other business or public institutions to increase access and to help support business and trade between disconnected areas of the Palestinian territories. They could help in cases where access is not granted, for example, by helping to facilitate visas and business visits for potential diaspora investors.

Leverage civil society and business organizations to strengthen socio-economic ties between Gaza and the West Bank, building on civil society current initiatives. Efforts to stem, mitigate and potentially reverse the socio-economic divide between Gaza and the West Bank in consultation with civil society should continue. Civil society organizations, such as professional associations, business membership associations, and academic institutions can play a positive role in bridging and reconciling the socio-economic drift between the two regions, thereby mitigating its effects. Lawyers associations could also play an important role in supporting stakeholder dialogue about the required legislative reforms. Such associations could also support businesses operating or planning to invest in both areas by helping to navigate the legal and regulatory gaps and inconsistencies between the two legal systems. Business membership organizations could work to maintain economic and business ties. Academic institutions and businesses could provide scholarships, internships, and training opportunities for Gaza students and graduates in the West Bank.

Diversify trade and investment ties with the Arab region and the rest of the world. The deep roots of Palestinian economic integration with Israel continue until today through the quasi-customs union with Israel and attendant economic dependence. Most trade is with Israel, although trade with Arab countries and the rest of the world is on the rise. The dependence of Palestinian garment, cash crops, and furniture exporters in Gaza on the Israeli market led to disastrous results after the government of Israel prevented their products from entering the Israel market in 2007.

Diversification of Palestinian ties in global supply chains beyond Israel and Israeli intermediaries would further mitigate against more shocks to the economy stemming from political and military events. Furthermore, it would create an incentive for business upgrading and innovation. It could also present an opportunity for Palestinians to integrate into the nascent Arab trend for technology-driven entrepreneurship, gaining entry into the new economy. Attempts at trade diplomacy in the past seem to have yielded limited results, likely due to the prevalence of non-tariff barriers to trade.

Inroads into these markets could be made with concerted and coordinated efforts to deal with the technical barriers limiting trade, including transport logistics and mandatory requirements imposed on these markets. As highlighted in the National Export Strategy, success on this front is also dependent on simplifying trade facilitation out of the Palestinian territories, particularly through the Allenby Bridge, as well as on transportation logistics and trade information.⁵ Efforts to improve the ability of the Palestinian diaspora and other investors to obtain visas could also contribute to increasing both foreign trade and investment.

4.2.3 Mitigating Political Risk – Investment Facilitation and Insurance

Investment facilitation and intervention – encouraging first movers. The role of international institutions and development agencies in promoting investment in the Palestinian territories has already been noted. Grants, equity investment, and technical assistance provided by development agencies have undoubtedly enabled new investments in a number of sectors. *Investment and trade facilitation by these organizations could play an important role in bringing in first movers and investors since it serves to mitigate political risk for foreign and domestic investors alike*, and may continue to play an important role in the coming years. Further, it could potentially have positive follow-on effects for the rest of the economy, especially if efforts are made to create backward linkages to the rest of the economy, where most businesses have neither the scale nor the access to facilitate their investments. It must be noted, however, that this approach is both time intensive and limited to large-scale investments, and it cannot replace initiatives to improve the investment climate for the broad swath of Palestinian businesses.

The Palestinian Authority, through the Palestinian Investment Promotion Agency (PIPA) should play an increasingly prominent role in this regard. The recent restructuring of the Board of PIPA and new provisions regarding PIPA's role and mandate under the new Investment Promotion Law may represent an opportunity to institutionalize investment facilitation as the primary role of PIPA. In the context of the Palestinian investment climate, this is its most important role, that is, for promotion or administration of investment incentives.

Ensuring the availability of political risk insurance. After eleven years of relative inactivity, the political risk insurance (PRI) program offered in the Palestinian territories by the Multilateral Investment Guarantee Agency (MIGA) is currently being actively deployed. In fact, it is approaching its capacity limit in terms of commitment and interest. This turn-around is due to relative improvements in the investment environment since the period following the Second Intifada when the PRI fund was first launched. Improvements include: the promotion of joint ventures by bilateral donors which largely subsidized the purchase of political risk insurance, and most importantly perhaps, the modification of the Fund's Operational Rules in 2008. This modification allowed it to facilitate and support, not only FDI, but also local private sector investment.

As a result, the PRI Fund has witnessed a dramatic turnaround in interest and a rapid increase in project registrations. Indeed, as of March 31, 2014, MIGA had conducted an initial preliminary review of 20 projects representing US\$100 million in investments. Consequently, most of the initial funding capacity available under the Fund at present (US\$26 million) has already been earmarked and/or has been used to provide PRI for investment transactions. Moreover, over the past year, demand for PRI cover is still being registered by both local and foreign investors in new projects, or through project expansions in the West Bank and Gaza. Additional funding to replenish the PRI fund will be needed if this service is to continue to be made available to future investors.

4.2.4 Improving Business Regulation and Enhancing the Role of the Private Sector

Prepare a roadmap for economic legislative reform, including the reconciliation of the legal differences that have been created between the West Bank and Gaza since 2007. In light of recent developments, including the possibility of reactivating the Palestinian Authority's Legislative Council and forming a new government, the executive and legislative branches need to work together toward putting on track the economic reform agenda that has been handicapped by the absence of a legislative council for several years. A priority for this agenda should be to reconcile legal differences that have been created as a result of enacting different legislation by the PA and the de facto government in Gaza since 2007. These differences should be reconciled in the short term. Over the longer term, differences in the legal frameworks generally applicable in both areas will need to be harmonized.

A comprehensive legislative reform plan should aim at submitting all primary laws promulgated by presidential decrees to the Legislative Council in accordance with the Palestinian Basic Law. At the same time, a dialogue should be opened among all stakeholders about the broader legislative agenda. Special attention to economic and commercial legislation is warranted to help harmonize, modernize and improve the legal and regulatory frameworks for doing business in the Palestinian territories. This includes modernizing the Companies Law and passing the Secured Transactions Law. In addition, legislation and regulation that are needed to promote public-private participation in the provision of services and infrastructure should also be high on the agenda.

Undertake reforms with regard to the secondary business regulation agenda. A number of reforms to improve the climate for doing business could be undertaken through regulations and practices of the PA. Their potential impact is not insignificant. Examples of this include measures already taken by the PA to eliminate the minimum capital requirement and to simplify business registration—both of which were accomplished within the confines of existing laws. A number of other reforms were recently proposed by a public-private technical committee chaired by the Ministry of National Economy (which also proposed the afore-mentioned accomplished reforms). These

reforms include improving the regulations and processes for construction permits, registering property, trading across borders, and providing access to credit. These positive steps should continue to identify current priorities for secondary legislation and associated practices. They should include steps to streamline and reform the requirements and processes imposed by other line ministries and agencies, including those of municipalities and local government, with regard to business registration and licensing. In designing and implementing the secondary legislation agenda, the government should pay special attention to harmonizing current differences in the regulatory and administrative procedures that have been introduced since 2007 by the PA and the de facto government in Gaza. It is important for the PA to actively involve all stakeholders in the legislative dialogue—especially the private sector.

Enhance public-private-civic dialogue on economic development priorities. A meaningful dialogue between Palestinian authorities and the private sector and civil society has become increasingly important — especially given the prolonged absence of a legislative body to represent public interests and exert government oversight. It is also important given the increasing socio-economic divide between Gaza and the West Bank. With the possibility of reactivating the Legislative Council in the coming years, legislators would also be an important part of this dialogue. Supporting and enhancing existing platforms for dialogue, creating new ones, and deepening them to link local priorities identified by specialized business and industry associations close to the firms with higher-level decision-making bodies should be a priority once a new parliament is in place. It should also be a priority in the interim period.

Provide incentives for informal firms to formalize. Informality in the market was found to be another aspect of uncertainty, with formal firms competing with informal firms in the same markets— but not playing by the same rules. At the same time, it should be recognized that informal businesses provide employment and incomes. A strategy for formalization may be difficult to formulate in the current context since the primary reason cited for informality is the lack of any benefit to formalization. Incentives to formalize could include access to finance and programs that link informal firms to formal supply chains. Chambers of commerce could potentially play a bridging role in this respect. They could encourage some degree of formality by registration with the Chambers, and by providing support and information on full formalization and the payment of taxes. Likewise, the removal of disincentives is just as important, and could include simplifying tax collection and business registration.

4.2.5 Investing in Skills, Technology, Entrepreneurship, and Innovation

Investments in knowledge, skills, and innovation can act as a bridge toward integration into the new global economy, focusing on technology-driven entrepreneurship and higher value-added services. Even in the best of long-term scenarios,

the Palestinian economy will remain small and resource poor. Future Palestinian economic growth will depend on investment in human resources, the skills of its workers, and the entrepreneurship of its business community.

Make a national priority to implement a policy agenda for aligning education and workforce development to economic development. Directions for a policy agenda were put forward through consultations with the relevant ministries and private sector actors in the recent report on workforce development in the Palestinian territories.⁶ These recommendations should be adopted, starting with the creation of a Higher Council on Employment, comprising the public and private sector. In addition, the Higher Education Council on TVET should be reactivated to set the strategic direction for education and workforce development.

The recommendations have a focus on a demand-driven approach, institutionalizing the involvement of employers and industry. A focus on continuing vocational education and training (CVET) is also advocated, underscoring the need for a demand-driven workforce geared to private sector priorities. Proposals for the creation of a TVET agency and fund should be explored. The National Qualifications Framework (NQF), recently finalized to create standards of workforce training and enforce TVET accreditation, requires implementation mechanisms.

The sustainability of workforce skills programs would be better secured through the establishment of a TVET Fund or similar program, with funding linked directly to results and accountability to the private sector. In the meantime, donor-funded programs should increasingly adopt a demand-driven approach, allowing employers and industry to develop in-house CVET and inform curricula development in educational and training institutions. Business membership organizations could potentially be a platform for developing, providing, and advocating for specialized CVET programs relevant to their sub-sectors. A range of possibilities associated with sub-sectors come to mind. These include: stone and by-product fabrication technology in the limestone sub-sector; wood carving in the furniture sector; hotel and hospitality training in the tourism sector; good manufacturing practices (GMP); and Hazard Analysis and Critical Control Points (HACCP) in the food industry and agribusiness.

Continue to invest in firm-level capacity. Research on SMEs suggests that the majority of new jobs in diverse economies are generated by a small percentage of fast-growing SMEs, or “gazelles”. While accounting for some gaps in available data, being a high-employment growth SME in MENA is positively correlated with specific initiatives and activities including: new/ improved product development, offering workers formal training, having international quality certification, and having a company website.⁷ Yet, these are precisely the type of practices that smaller firms find particularly challenging to adopt. Difficulties include information asymmetries, limited finance, and capacity limitations (inexperience in procuring business services,

for example). Support to overcome these challenges should be continued through current programs, such as the market development program funded by the UK's Department for International Development (DFID) and the European Union. Such programs could be expanded based on lessons learned from current and past programs. Interventions targeted at clusters (groups of interconnected firms, suppliers and institutions in a common sub-sector and geographic location) can help integrate firm-level capacity building with cross-cutting priorities. These could include business regulation reform, workforce development, trade facilitation and development, and public-private dialogue. Mechanisms that would promote capital investment and industrial modernization of SMEs as well as investment in tradable services should be considered given the low capital intensity among SMEs. However, these would need to be designed and targeted carefully to prevent market distortions and unfair advantage and competition. An approach that focuses on promoting transfer of technology (through meso-level industrial associations) with facilitation of access to finance for SMEs may hold promise.

Facilitate MSME access to finance. Access to finance appeared as an important constraint for micro and small firms, including both formal and informal firms. Improving access to finance for such firms should begin with supporting financial inclusion. This should include the use of bank accounts and addressing the collateral constraint that seems to be the stumbling block for many micro and small businesses. This effort should begin with work to determine the existing obstacles to accessing finance, including assessing the penetration and efficacy of microfinance and loan guarantee programs in the Palestinian territories that are specifically meant to address this issue. Another initiative that could increase the access of small businesses to capital equipment is the establishment of the movable assets registry and the spread of leasing in the Palestinian territories. Both of these initiatives could provide small businesses with new avenues through which to gain access to capital equipment and financing needed to improve productivity and/or expand operations.

Invest in technology-driven entrepreneurship and innovation. The innovation and entrepreneurship ecosystem in the Palestinian territories is nascent, but developing quickly. In the past few years, incubators, accelerators, start-up competitions, entrepreneurship training, mentoring programs, informal entrepreneur networks, and even a venture capital fund have been created. This is no doubt linked to the move toward a knowledge economy in the region as a whole. Indeed, the ecosystem in the Palestinian territories is strengthened by support and ties to a number of regional technology and entrepreneurial actors, such as Oasis 500, Mowgli, and others. There is an apparent gap between seed financing and support to entrepreneurs through training, competitions, incubators, and accelerators, and firms entering the venture capital and small/ medium-capital equity investment pipeline.

The focus should be on building a pipeline of growth-oriented entrepreneurs. These entrepreneurs could feed into this nascent ecosystem by leveraging the Pal-

estinian diaspora and regional actors to develop angel investor groups and other forms of early-stage financing and mentorship (in the range below \$250,000 where venture capital and private equity investors typically would not engage). Related to this trend is the interest in high value-added business and technology services, building on the foundation of IT firms that have successfully operated in the Palestinian territories for years. Such firms have been engaged in exporting outsourcing and development services to the US, Europe, and Arab countries.

Notes

1. A World Bank publication, *Towards Economic Sustainability of a Future Palestinian State: Promoting Private Sector-Led Growth*, published in 2012 provides a more thorough treatment of policy recommendations regarding the scenario of a future Palestinian state.
2. *Area C and the Future of the Palestinian Economy*, The World Bank, 2013.
3. The Cabinet Resolution Regarding the Disengagement Plan as published by the Prime Minister's office, June 4 2005. Government of Israel.
4. Briefing Note on Land Administration Project II (LAP II). The World Bank and Government of Finland, 2014. This includes Areas A, B and C.
5. National Export Strategy of the State of Palestine, International Trade Centre (ITC), Ministry of National Economy, and Paltrade, December, 2013.
6. Systems Approach for Better Education Results (SABER) Country Report, Palestinian Territories, World Bank, 2013.
7. SME Innovators and Gazelles in MENA – Educate, Train, Certify, Compete!, World Bank, MENA Knowledge and Learning Quick Note Series, Andrew Stone and Lina Tarek Badawy, September 2011, No. 43.



ANNEXES

ENTERPRISE SURVEY DATA AND METHODOLOGY

Data and analysis are taken from the West Bank and Gaza 2013 Enterprise Survey data set, which was conducted as part of the Joint World Bank/European Bank for Reconstruction and Development/European Investment Bank Enterprise Survey in the Middle East and North Africa. The survey was conducted by the Palestinian Central Bureau of Statistics (PCBS) between June and September 2013.

Sampling Structure

The sample for the West Bank and Gaza was selected using stratified random sampling, following the standard methodology of the World Bank's Enterprise Surveys. Stratified random sampling was preferred over simple random sampling for several reasons:

1. To obtain unbiased estimates for different subdivisions of the population with some known level of precision.
2. To obtain unbiased estimates for the whole population. The whole population, or universe of the study, is the non-agricultural economy. It comprises: all manufacturing sectors according to the group classification of ISIC Revision 3.1: (group D), construction sector (group F), services sector (groups G and H), and transport, storage, and communications sector (group I). Note that this definition excludes the following sectors: financial intermediation (group J), real estate and renting activities (group K, except sub-sector 72, information technology (IT), which was added to the population), and all public or utilities-sectors.
3. To ensure that the final total sample includes establishments from all different sectors, and that it is not concentrated in one or two industries/sizes/regions.
4. To exploit the benefits of stratified sampling where population estimates, in most cases, will be more precise than using a simple random sampling method (that is, lower standard errors, other things being equal.)
5. Stratification may produce a smaller bound on the error of estimation than would be produced by a simple random sample of the same size. This result is particularly true if measurements within strata are homogeneous.
6. The cost per observation in the survey may be reduced by stratification of the population elements into convenient groupings.

Three levels of stratification were used for this economy, namely: industry, establishment size, and region. In addition to this breakdown, an additional priority was made for re-interviewing panel establishments which had previously been interviewed under the World Bank's 2006 Investment Climate Assessment (ICA) survey. The selection of these 'panel' firms was determined by matching contact information from the previous round with results from the latest PCBS Establishment Census.

The original sample design with specific information of the industries and regions chosen is described below.

Industry stratification was designed as follows: the universe was stratified into one collective manufacturing industry, and two service industries (retail and other services). (See Table A1.1.)

Size stratification was defined following the standardized definition for the rollout: small (5 to 19 employees), medium (20 to 99 employees), and large (more than 100 employees). For stratification purposes, the number of employees was defined on the basis of reported permanent full-time workers. This seems to be an appropriate definition of the labor force since seasonal/casual/part-time employment is not common practice, apart from the construction and agriculture sectors which are not included in the survey.

Regional stratification was defined into two (the West Bank / Gaza) regions (city and the surrounding business area) throughout the West Bank and Gaza.

Sampling Implementation

Given the stratified design, sample frames containing a complete and updated list of establishments, as well as information on all stratification variables (number of employees, industry, and region), are required to draw the sample. Great efforts were made to obtain the best source for these listings.

The Palestinian Central Bureau of Statistics (PCBS) was hired under the main implementing contractor, Gallup Europe, to implement the West Bank and Gaza 2013 Enterprise Survey.

The sample frame used for the survey in the West Bank and Gaza was from the PCBS Enterprise Census 2012 database.

The enumerated establishments were then used as the frame for the selection of a sample. The aim was to obtain interviews at 360 establishments with five or more employees.

Table A1.1: Original Sample Design, West Bank and Gaza
Fresh Sample Design

| Region | Firm size (number of employees) | Number of firms | | | |
|----------------|------------------------------------|-----------------|--------|----------------|-------------|
| | | Manufacturing | Retail | Other services | Grand total |
| West Bank | Small (5 to 19) | 18 | 54 | 30 | 102 |
| | Medium (20 to 99) | 10 | 34 | 17 | 61 |
| | Large (100+) | 8 | 2 | 5 | 15 |
| Regional total | | 36 | 90 | 52 | 178 |
| Gaza | Small (5 to 19) | 5 | 27 | 4 | 36 |
| | Medium (20 to 99) | 16 | 3 | 26 | 45 |
| | Large (100+) | 3 | 0 | 1 | 4 |
| Regional total | | 24 | 30 | 31 | 85 |
| Grand total | | 60 | 120 | 83 | 263 |

Panel Sample Design

| Region | Firm size (number of employees) | Number of firms | | | |
|----------------|------------------------------------|-----------------|--------|----------------|-------------|
| | | Manufacturing | Retail | Other services | Grand total |
| West Bank | Small (5 to 19) | 18 | 0 | 10 | 28 |
| | Medium (20 to 99) | 9 | 0 | 12 | 21 |
| | Large (100+) | 9 | 0 | 4 | 13 |
| Regional total | | 36 | 0 | 26 | 62 |
| Gaza | Small (5 to 19) | 5 | 0 | 4 | 9 |
| | Medium (20 to 99) | 16 | 0 | 7 | 23 |
| | Large (100+) | 3 | 0 | 0 | 3 |
| Regional total | | 24 | 0 | 11 | 35 |
| Grand total | | 60 | 0 | 37 | 97 |

Source: Enterprise Survey for the West Bank and Gaza, World Bank, 2013.

In the course of the field work, it was determined that in order to meet certain precision targets by sector, size, and location, over-coverage would be required. This resulted in the following breakdown of achieved interviews of fresh and panel establishments.¹ (See Table A1.2.)

Analysis of the Data and Use of Survey Weights

Since the sampling design was stratified and employed differential sampling, individual observations should be properly weighted when making inferences about the population. Under stratified random sampling, unweighted estimates

Table A1.2: Realized Interviews with Fresh and Panel Establishments

Realized Fresh

| Region | Firm size (number of employees) | Number of firms | | | |
|----------------|------------------------------------|-----------------|--------|----------------|-------------|
| | | Manufacturing | Retail | Other services | Grand total |
| West Bank | Small (5 to 19) | 38 | 76 | 55 | 169 |
| | Medium (20 to 99) | 8 | 19 | 38 | 65 |
| | Large (100+) | 9 | 6 | 5 | 20 |
| Regional total | | 55 | 101 | 98 | 254 |
| Gaza | Small (5 to 19) | 10 | 32 | 20 | 62 |
| | Medium (20 to 99) | 19 | 6 | 23 | 48 |
| | Large (100+) | 1 | 0 | 5 | 6 |
| Regional total | | 30 | 38 | 48 | 116 |
| Grand total | | 85 | 139 | 146 | 370 |

Realized Panel

| Region | Firm size (number of employees) | Number of firms | | | |
|----------------|------------------------------------|-----------------|--------|----------------|-------------|
| | | Manufacturing | Retail | Other services | Grand total |
| West Bank | Small (5 to 19) | 16 | 0 | 5 | 21 |
| | Medium (20 to 99) | 8 | 0 | 5 | 13 |
| | Large (100+) | 7 | 0 | 0 | 7 |
| Regional total | | 31 | 0 | 10 | 41 |
| Gaza | Small (5 to 19) | 5 | 0 | 3 | 8 |
| | Medium (20 to 99) | 12 | 0 | 1 | 13 |
| | Large (100+) | 2 | 0 | 0 | 2 |
| Regional total | | 19 | 0 | 4 | 23 |
| Grand total | | 50 | 0 | 14 | 64 |

Source: Enterprise Survey for the West Bank and Gaza, World Bank, 2013.

are biased unless sample sizes are proportional to the size of each stratum. With stratification, the probability of selection of each unit is, in general, not the same. Consequently, individual observations must be weighted by the inverse of their probability of selection (probability weights or pw in Stata, the statistical analysis package used for this report).

Special care was given to the correct computation of the weights. It was imperative to accurately adjust the totals within each region/industry/size stratum to account for the presence of ineligible units (the firm discontinued business operations or was unattainable; education or government establishments; establishments with less

than 5 employees; no reply after having called on different days of the week and at different business hours; no signal on the phone line, answering machine, or fax line; wrong address or moved away and could not get the new references).

The information required for the adjustment was collected in the first stage of the implementation, that is, the screening process. Using this information, each stratum cell of the universe was scaled down by the observed proportion of ineligible units within the cell. Once an accurate estimate of the universe cell (projections) was available, weights were computed using the number of completed interviews.

Table A1.3 shows the survey weights calculated for use for the 2013 Enterprise Survey:

Under the stratified random sampling, weights should be used when making inferences about the population. Any estimate or indicator that aims to describe some

Table A1.3: Median Cell Weights West Bank and Gaza (relative weights shown)

Median Weights, Fresh

| Region | Firm size (number of employees) | Number of firms | | |
|----------------|------------------------------------|-----------------|--------|----------------|
| | | Manufacturing | Retail | Other services |
| West Bank | Small (5 to 19) | 50.66 | 23.52 | 27.29 |
| | Medium (20 to 99) | 16.71 | 2.15 | 3.18 |
| | Large (100+) | 1.24 | 1.05 | 1.23 |
| Regional total | | | | |
| Gaza | Small (5 to 19) | 40.23 | 13.07 | 22.15 |
| | Medium (20 to 99) | 1.06 | 1.16 | 1.76 |
| | Large (100+) | 1.72 | | 1.21 |

Median Weights, Panel

| Region | Firm size (number of employees) | Number of firms | | |
|----------------|------------------------------------|-----------------|--------|----------------|
| | | Manufacturing | Retail | Other services |
| West Bank | Small (5 to 19) | 1.41 | | 1.00 |
| | Medium (20 to 99) | 3.67 | | 1.00 |
| | Large (100+) | 2.01 | | |
| Regional total | | | | |
| Gaza | Small (5 to 19) | 2.97 | | 1.17 |
| | Medium (20 to 99) | 1.00 | | 1.58 |
| | Large (100+) | 1.00 | | |

Source: Enterprise Survey for the West Bank and Gaza, World Bank, 2013.

feature of the population should take into account that individual observations may not represent equal shares of the population.

Approaches to Various Types of Analysis

For the current ICA, several distinct types of analysis were employed, depending on the specific requirements of the data. These consisted of:

1. *Cross-sectional analysis*: This is the analysis of the data at a single point in time from the 2013 Enterprise Survey data, utilizing survey weights to preserve economic representativeness. All comparisons made using this data incorporated information from the survey design based on weights, clustering, and strata using the `svyset` subset of commands in Stata. In particular, comparisons made between cuts of the data (for example, by size group) were determined by utilizing standard errors from the `over ()` option in Stata's package to ensure correct calculation of standard errors.
2. *Repeated cross-sectional analysis*: This is the analysis of the pool of establishments (cross-sectional data) over various periods of time, the first period being the 2006 ICA and the second being the 2013 Enterprise Survey. As the 2006 ICA survey was not initially weighted, post-stratification weights were calculated and used. In addition, to ensure full comparability between the two cross-sections, the universe of inference was limited to ensure that both rounds covered the same type, size, and location of included establishments.
3. *Panel data analysis*: As compared to the 'pooled' analysis for both types of cross-sectional data, this analysis utilized the information from panel firms, which were observed in both 2006 and 2013. For this analysis, a subset of questions which were comparable in both rounds were identified. The values for these questions were taken using the `xtset` commands within Stata, which runs analysis based on the difference in the two responses over time. All reported effects are the mean estimated values of the difference of the two round values, and significance levels were determined by regressing this difference on the effect of time. As this analysis only intends to describe the subset of panel firms over time, all estimations are weighted.

Note

1. After further review, it was determined that 59 establishments were successfully matched with information from the 2006 ICA survey.

INFORMAL SECTOR SURVEY

The objective of the Informal Survey is to provide analysis on the performance, constraints, and capabilities of informal enterprises relative to formal enterprises in the West Bank and Gaza Strip. A firm-level survey and analysis of the informal sector in the West Bank and Gaza has never been previously conducted.

The informal sector data was undertaken to add further breadth and depth to the ICA by providing insights into a segment of the domestic economy that is perceived to play an important role in contributing to household incomes and employment. Data and analysis are taken from the Palestinian Central Bureau of Statistics (PCBS) 2013 Quarter 1 Labor Force Survey, and the 2012 PCBS Establishment Census.

I. The Methodology

The Questionnaire

The questionnaire for the survey, designed to meet the objectives of the ICA, required identifying characteristics pertinent to the local business environment. The questionnaire included questions in the following areas:

1. Location and Infrastructure
2. Crime
3. Sales and Supplies
4. Finance
5. Labor
6. Business Registration
7. Business Environment

Survey Frame and Sample

The target sample frame consisted of enterprises in the informal sector that operated in the West Bank and Gaza in 2013.

PCBS classified economic units in the informal sector into two categories:

- *Outside Establishment:* The location of the establishment is inside a housing unit with no separate location for the economic activity. The household location (housing unit) is the address for this type of establishment.
- *Inside Establishment:* There is a separate location for the economic activity and the address of the establishment can be found in the sampling frame from the 2012 PCSB Establishment Census.

In addition, to classify whether an economic unit was in the informal sector or not, the following criteria were adopted:

- a) The owner of the project is either an employer or is self-employed;
- b) The legal status is either that of individual property or of a partnership;
- c) There were not any used books of accounts;
- d) The economic unit is not registered in the taxation records; and
- e) The number of employees is less than 5, but only for the inside establishments. For the outside establishments the criterion adopted was: "the economic unit has at least one paid employee."

All of the criteria had to be met to classify the economic unit as belonging to the informal sector. The application of these criteria excluded a vast number of informal enterprises which are household based and are owned and operated by a sole proprietor working for their own account. This survey is therefore not representative of the informal sector in its entirety, but rather of a subset that is more comparable to the formal enterprises in the Enterprise Survey at the smaller scale end of the spectrum.

Sampling Frame

Due to the difficulty of identifying one contiguous sampling frame that could contain all informal sector economic activity, several scenarios were considered to determine the appropriate sampling frame.

Inside Establishments: Since there is a separate physical location for these establishments, the appropriate sampling frame was the 2012 PCBS Establishment Census. This sampling frame provides all of the necessary information to classify firms as either formal or informal. Table A2.1 shows the distribution of the total number of informal sector firms classified as Inside Establishments by region from the 2012 PCBS Establishment Census.

Outside Establishments: The 2013 Quarter 1 Labor Force Survey was used as a sample frame for Outside Establishments. Outside Establishments can be distinguished based on basic economic characteristics, such as the economic activity and the number of employees. The distribution of Outside Establishments according to region is illustrated in Table 2.2 from the 2013 Quarter 1 Labor Force Survey.

Table A2.1: Informal Sector Inside Establishments

| Location | Number of establishments | Percentage % |
|------------|--------------------------|--------------|
| West Bank | 23,436 | 58.7 |
| Gaza Strip | 16,488 | 41.3 |
| Total | 39,924 | 100 |

Source: 2012 PCBS Establishment Census.

Of the total number of informal sector Outside Establishments identified in the Labor Force Survey, 145 firms met the condition of having at least one paid employee, and could therefore be included in the sample frame.

Sample Size and Stratification

PCBS included all 145 Outside Establishments with one paid employee from the Labor Force Survey in the sample, and the rest of the sample (281) was selected from the 2012 Establishment Census frame for a total of 426 firms. (See Table A2.2.)

In addition to classifying informal firms as Inside and Outside Establishments, the sample is also stratified according to region and economic activity. This stratifica-

Table A2.2: Informal Sector Outside Establishments

| Location | Number of establishments | Percentage % |
|------------|--------------------------|--------------|
| West Bank | 608 | 70.5 |
| Gaza Strip | 254 | 29.5 |
| Total | 862 | 100 |

Source: PCBS 2013 Quarter 1 Labor Force Survey.

Table A2.3: Sample Allocation by Main Strata (number of firms)

| Region | Sample from Establishment Frame 2012 | Sample from Labor Force Survey Q1-2013 | Total |
|------------|---|---|-------|
| West Bank | 199 | 93 | 292 |
| Gaza Strip | 82 | 52 | 134 |
| Total | 281 | 145 | 426 |

Source: PCBS Informal Sector Survey Implementation Report to the World Bank, 2013.

Table A2.4: Response Rates to Questionnaire

| Interview result | Number of cases |
|---|-----------------|
| Completed | 353 |
| Permanently closed (over coverage) | 36 |
| Temporally closed (non-response) | 10 |
| Different informal activity (completed) | 8 |
| Repeated (over coverage) | 1 |
| Refuse (non-response) | 10 |
| Other (non-response) | 9 |
| Total | 426 |

Source: PCBS *Informal Sector Survey Implementation Report to the World Bank*, 2013.

tion improves the representation of the sample and, in theory, reduces standard error. Table A2.3 provides an overview of the sample allocation by the main strata.

An overview of the response rates to the questionnaire is provided in table A2.4. The response rate was 92.6 percent, and the non-response rate was 7.4 percent.

II. Summary of Main Findings

The results of the survey depict an informal sector that is young, predominantly male, and with some secondary education.

The survey results do not show significant differences between the West Bank and Gaza Strip, except for very few variables.

Regarding economic activity, the data indicate that 22.7 percent of the informal enterprises are involved in construction and home repair, 15.9 percent sell food or groceries, 4.7 percent repair motor vehicles and motorcycles, and 27.3 percent sell other services.

Profile of the Enterprise Ownership

Analyzing the profile of enterprise ownership, the informal enterprises have on average one owner, who is also in 94.9 percent of the cases, the main decision-maker of the business.

The main owner of an informal business is on average, male, approximately 42 years old, with about 12 years of experience, and with some primary or secondary education.

Regarding gender and informal businesses, only in 12.1 percent of the businesses is the principal owner or one of the principal owners of the informal enterprise female. In only 10.2 percent of the informal businesses is the main decision-maker female.

In 89.2 percent of the cases, the informal entrepreneurs acquired the ownership of the business by starting it on their own or with partners, indicating that often informality has been the only concrete alternative to being employed. Indeed, 87.3 percent of the surveyed entrepreneurs declared that the informal enterprise is their main activity.

Location of the Informal Enterprises

In terms of location, the majority of informal enterprises (77.8 percent) have establishment premises outside of their household, whereas 22.2 percent have them within household premises (since they consider that it costs less to run a business from home (41.4 percent), and it makes it easier to manage family responsibilities along with work (27.1 percent). However, this is of course a result of the nature of the sample taken (which limited the informal enterprises that are on household premises to those that had at least one worker in addition to the owner).

Furthermore, 68.3 percent of the informal businesses in the West Bank and Gaza have fixed premises and permanent structures, indicating that the majority of the informal businesses have a pretty stable business.

However, 56.1 percent of the informal entrepreneurs with fixed premises do not own the location or space occupied by their businesses.

Infrastructure

About 95 percent of the informal Palestinian enterprises with fixed premises use electricity, and about half of them (50.9 percent) experienced power outages—with a breakdown of 100 percent of the businesses in the Gaza Strip and 36.9 percent of the businesses in the West Bank.

In the month previous to the Survey, these businesses had experienced an average of 14.4 power outages (30.3 in the Gaza Strip and 2.2 in the West Bank), with an average duration of about 7 hours each.

As a result, for 57.8 percent of the informal businesses with fixed premises, the electricity supply is a severe obstacle to the current operation of their business or activity. The value of 57.8 percent can be broken down as: 88.5 percent for the Gaza Strip and 49.2 percent for the West Bank. This confirms how the electricity situation is especially challenging for businesses in the Gaza Strip.

Conversely, about 80 percent of the informal entrepreneurs with fixed premises do not consider water supply as a severe obstacle to their business.

Similarly, 68.4 percent of the informal entrepreneurs with fixed premises do not consider the problems of telecommunications a major obstacle to the current operation of their businesses. About 81 percent of informal enterprises with fixed premises declared that they use cell phones for their operations, but only 19.8 percent of them use the internet.

Sales and Supplies

The data on sales and supplies confirm that the informal enterprises in West Bank and Gaza serve uniquely the local, domestic market. In particular, about 92 percent of the sales of the informal businesses are domestic, and about 8 percent are direct exports to Israel, with the latter coming from firms located uniquely in the West Bank.

The informal sector is so strictly focused on the local market that 75.6 percent of the informal sales occur inside the locality where the enterprise is located.

Also, 93.3 percent of the customers of the informal businesses are individuals/households, and 6.7 percent are other businesses. Similarly, 74.4 percent of the suppliers of the informal businesses are individuals/households, and 23.1 percent are other businesses.

Looking at the value of the sales of the informal businesses, the average value of sales per business is about US\$ 1,641 in a regular month (neither the busiest, nor the slowest of the year). This value can be broken down as follows: US\$ 1,778 for the West Bank and US\$ 1,180 for the Gaza Strip.

Overall, these data indicate that the informal business in the West Bank and Gaza really strive to grow. This situation is further confirmed by the fact that about 77 percent of the informal businesses declared that, in the three years previous to the survey, their number of employees, the machinery used, and the space they occupy had not increased.

Financing Data

Only 1.3 percent of the informal enterprises in the West Bank and Gaza borrow from microfinance institutions, and 0.6 percent from banks. About 80 percent of the informal businesses use their own funds— either business or personal — as the most common financial instrument to finance their operations. About 94 percent of the informal businesses did not even apply for a loan in the year previous to the Survey.

Currently, about 52 percent of the informal entrepreneurs consider limited access to finance or loans as an obstacle to the current operation of their business. Access to finance is perceived as an important problem mainly by informal en-

terprises in the West Bank, since the value of 52 percent can be broken down as 56.8 percent for the West Bank and 33.8 percent for the Gaza Strip. Further examination of the data indicates that the problem is particularly acute in the Gaza Strip, where the informal enterprises reported borrowing exclusively from friends and relatives and not from microfinance institutions and banks. This may be an artifact of the survey sample, since it would likely exclude many home-based businesses which may be microfinance clients, or indicate some issue having to do with the reach of microfinance institutions or financial inclusion in Gaza more generally.

All of these data once more depict a situation characterized by low levels of investment. Further, this was confirmed by the fact that during the three years previous to the Survey, only 44.4 percent of enterprises bought the following: machinery for an average amount of US\$4,776; equipment and tools for an average amount of US\$3,330; vehicles or other means of transport for an average amount of about US\$8,528; and buildings (purchased or constructed by themselves) for an average amount of US\$ 14,000.

Finally, the data indicate that 68.8 percent of the informal entrepreneurs do not keep their business accounts separately from their household expenses, and 87.8 percent of them do not have a bank account for their business.

Labor

The informal enterprises surveyed in the West Bank and Gaza have, on average, two paid employees and 1 unpaid employee. Also, none of these employees is female. In the month previous to the Survey, on average, one family member of the owner of the informal business worked in the business as well. Finally, the average monthly salary for a full-time worker in the informal sector is about US\$423 for men, and US\$229 for women, indicating a wide disparity in pay between male and female workers in the informal businesses.

Registration

More than 98 percent of informal businesses are not registered and have never been registered with the Ministry of National Economy. In addition, 67.8 percent of informal entrepreneurs in the West Bank and Gaza declared that they do not want their business or activity to be registered with the Palestinian Authority/Ministry of National Economy. Indeed, 64 percent of the informal entrepreneurs do not see any benefits to registration; 46.7 percent see it as an obstacle because of the taxes that need to be paid if the enterprise is registered; 32.2 percent because of the time, fees and paper work required to complete the registration; and 11.2 percent because of the inspections and meetings with government officials that would have to take place if the business were to be registered.

Conclusions

In conclusion, 42.1 percent of the informal enterprises consider access to finance their major obstacle, 18.3 percent political instability, 11.3 percent the transport/movement of people and goods, and 10.6 percent electricity. Looking more closely at the data, it emerges that access to finance is mainly an obstacle for the informal businesses in the West Bank, whereas, conversely, electricity is the major obstacle for the informal firms in the Gaza Strip. Overall, the analyzed data are similar to what emerges from the analysis of the formal sector. The data present an informal sector that is pretty stable and resilient, with potential to grow— but stagnant.

FIRM PERFORMANCE AND LABOR PRODUCTIVITY ANALYSIS

For productivity measures that are measured in monetary terms, all currencies are converted into 2009 US dollars.¹ Appendix 1 describes the conversion into a common currency and how each specific productivity measure is calculated. Although the Enterprise Surveys cover services and retail and wholesale trade as well as manufacturing, this chapter focuses on manufacturing firms. Enterprise Surveys collect the detailed financial data needed to calculate value-added and other performance measures only for manufacturing firms in most countries. Therefore, to ensure comparability, all cross-country comparisons are only for manufacturing firms, even for those countries where data are available for firms in other sectors.

Most comparisons are for median firms in terms of the different measures of performance. Medians are preferred to means because means can be affected greatly by a few outliers—possibly due to misreported or miscoded information. For the purpose of brevity, the term ‘median firm’ is used to refer to the median firm in relation to each particular measure of firm performance. For example, in the section on labor productivity, the ‘median firm’ refers to the median firm in terms of labor productivity. Similarly, in the section on capital productivity, ‘median firm’ refers to the median firm in terms of capital productivity.

Labor Productivity

Value-added per worker is a basic measure of labor productivity. It is calculated by subtracting the cost of the raw materials (such as iron, grain, or cotton) and intermediate inputs (such as engine parts or textiles) from the sales value of output, and then dividing that number by the number of workers. Labor productivity is higher when firms produce more output with fewer raw materials and workers. Labor productivity can be affected by technology, organizational structure, worker skills, and management ability. Because labor productivity does not take the use of capital (that is, machinery and equipment) into account, it will also generally be higher in firms that use capital in place of labor (that is, firms that are capital intensive).

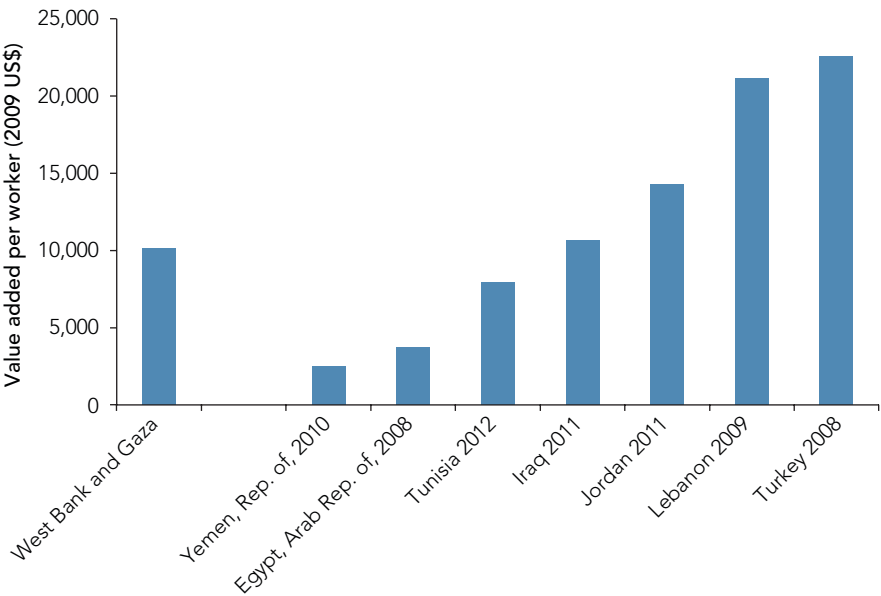
It might seem that total factor productivity, a measure of productivity that takes capital use into account, is inherently superior to a partial productivity measure such as labor productivity. However, labor productivity has some advantages over more complex measures such as total factor productivity. Most importantly, it is

relatively easy to measure. In contrast, when firms misreport the value of their capital, total factor productivity will likewise be miscalculated. Given that capital is difficult to measure even under the best of circumstances, this is an especially serious problem when dealing with small firms in developing countries that might not keep accurate accounts. This is a concern in the West Bank and Gaza as well, because only about 60 percent of firms report that they have audited accounts, and only about 20 percent of firms reported numbers directly from their accounts.

Ideally, value-added would be measured in terms of a physical measure of output. In practice, however, it is difficult to obtain physical measures of output that can be compared across firms in a consistent way. Because of this measurement difficulty, most analyses including those using data from the *Enterprise Surveys* use sales (that is, output multiplied by unit price) rather than output.² This can be a problem when firms produce heterogeneous products and, therefore, have market power. For instance, when sales are used in place of physical output, a firm with market power that charges high prices (for example, a monopolist) will appear to be more productive than a similar firm in a competitive market that has to charge lower prices.³

The median manufacturing firm in the West Bank and Gaza produced about \$10,000 of output (value-added) per worker (see Figure A3.1). This is considerably higher than for Egypt or Yemen, but lower than in the best-performing comparator

Figure A3.1: Labor Productivity is Lower in the West Bank and Gaza than in the Best-Performing +Comparator Countries



Source: Authors calculation based on data from World Bank Enterprise Surveys.

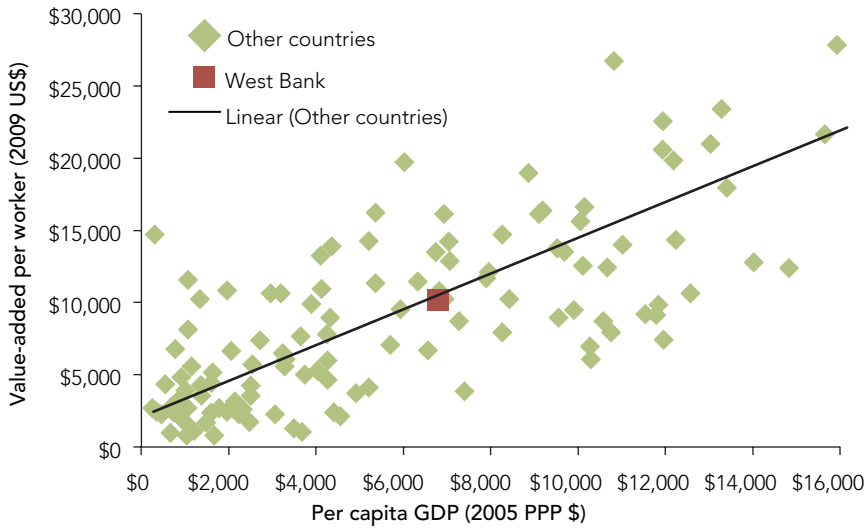
Note: Partial productivity measures are measured in 2009 US\$. See Annex 4 for details. All data points are for the median firm on each measure of performance.

countries. Labor productivity is about 40 percent higher in Jordan and is over twice as high in Turkey.

Although comparisons with individual countries are interesting, it is also useful to compare firms in the West Bank and Gaza with firms in other countries with similar levels of development. Figure A3.2 shows per capita income plotted against labor productivity (value-added per worker) for countries where Enterprise Surveys have been completed since 2006.⁴ Labor productivity is higher in countries where per capita income is higher for a number of reasons. Although per capita GDP is not perfectly correlated with external factors that affect firm performance, many factors vary with income. For example, infrastructure access and the quality of institutions are, on average, lower in poorer countries.⁵ That is, corruption is higher in low-income countries, access to electricity and water is lower, the rule of law is less well protected, and government efficiency is lower.⁶ To control for this, Figure A3.2 graphs value-added per worker against GDP per capita.

The graph also shows a simple linear regression line of value-added per worker on per capita income. This line shows what we would expect labor productivity to be, on average, at different income levels.⁷ Although the fit is not perfect, it is consis-

Figure A3.2: Labor Productivity in the Manufacturing Sector is Similar in the West Bank and Gaza as in Other Countries at Similar Levels of Development



Source: Authors calculation based on data from World Bank Enterprise Surveys.

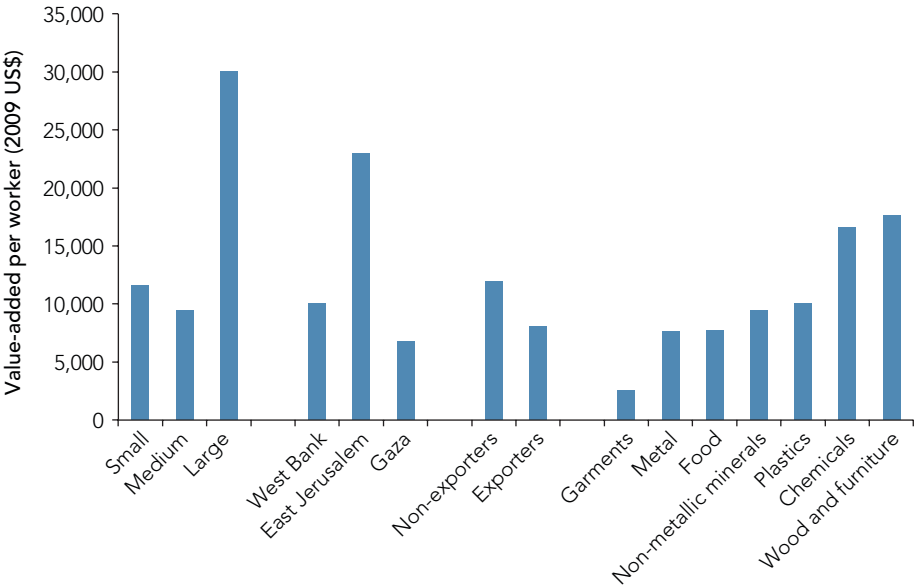
Note: Since purchasing power parity (PPP)-adjusted GDP was not available for the West Bank and Gaza, real per capita GDP in US\$ is used. This is likely to underestimate GDP in the West Bank and Gaza relative to its true value in PPP terms. All data points are for the median firm on each measure of performance. For presentational purposes, the chart is shown only for countries with per capita GDP between \$0 and \$16,000. Countries with a GDP per capita over this amount are, however, included when we calculate the linear projection.

tent with the idea that firms are more productive on average in richer countries. For points above the line, labor productivity is higher than would be expected given the particular countries per capita income. For points below the trend-line, the reverse is true. The West Bank and Gaza lies very close to the regression line. This suggests that labor productivity is close to what we would expect given the West Bank and Gaza’s level of development.

It is also possible to compare labor productivity for firms within the West Bank and Gaza. Because the sample is relatively small—only about 129 manufacturing firms provided enough data to calculate labor productivity—these comparisons should be treated with care. Some differences might be due to sampling variation. With this caveat in mind, Figure A3.3 shows labor productivity across regions within the West Bank and Gaza, for firms of different sizes, and by other firm characteristics.

Large firms are considerably more productive than small and medium-sized firms. Labor productivity is about \$30,000 for the median large firm in the West Bank and Gaza, compared to about \$10,000 for the median small and medium-sized firms. Large firms are more productive in most countries. This is often because they are more capital intensive and have better access to technology.

Figure A3.3: Labor Productivity is higher in the West Bank and East Jerusalem than in Gaza



Source: Authors’ calculation based on data from World Bank Enterprise Surveys.

Note: Partial productivity measures are measured in 2009 US\$. See Annex 4 for details. All data points are for the median firm on each measure of performance.

Firms in East Jerusalem are far more productive than firms in the West Bank and Gaza. The median firm in East Jerusalem produces about \$23,000 of output per worker compared with about \$10,000 for the median firms in the West Bank, and about \$6,800 for the median firms in Gaza.

In contrast to most countries, non-exporters are no less—and possibly more—productive than exporters in Gaza and the West Bank. This is unusual. Because firms need to be productive to enter export markets (self-selectivity) and because firms in export markets have easier access to new technologies in export markets, exporters are usually more productive than non-exporters. There are also notable differences across sectors, with plastics, chemical and wood and furniture firms being the most productive.

Capital Intensity

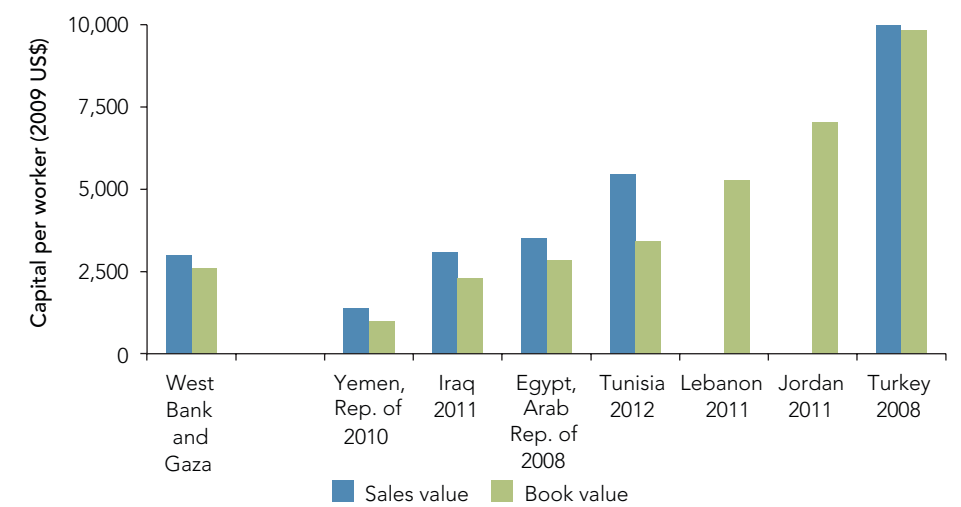
One plausible reason why labor productivity might be low in the West Bank and Gaza relative to the best-performing comparator countries might be that manufacturing firms are less capital intensive than firms in similar countries. As noted, labor productivity does not take capital use into account. As a result, capital-intensive firms (that is, firms that have a lot of capital for each worker) might appear to be productive only because they have substituted capital for labor.

Because of the difficulty in making cross-country comparisons of capital intensity, two measures of capital are presented. The first is based on the book value of capital (see Figure A3.4). The second is the manager's estimate of the value of the capital if sold in its current condition. Although the second measure is probably closer to the economic concept that we are interested in—at least when capital markets are competitive—it will often be difficult for managers to accurately estimate the value of all machinery and equipment that their firm uses.

Firms in the West Bank and Gaza are not as capital intensive as firms in most other countries in the region, whether measured by sales value or book value of capital. Although the median firm in the West Bank and Gaza has more capital per worker than the median firm in Yemen, for example, the median firms in other countries are generally more capital intensive than the median firm in the West Bank and Gaza. For example, although labor productivity is lower in Egypt and Tunisia than in the West Bank and Gaza (see Figure A3.4), firms in these two countries are more capital intensive.

As with labor productivity, it is also possible to compare capital intensity with a broader cross-section of countries where Enterprise Surveys have been completed (see Figure A3.5). Because firms in countries with higher per capita income tend to be more capital intensive than firms in other countries, it is useful to plot capital intensity against per capita income. This also suggests that firms in the West Bank

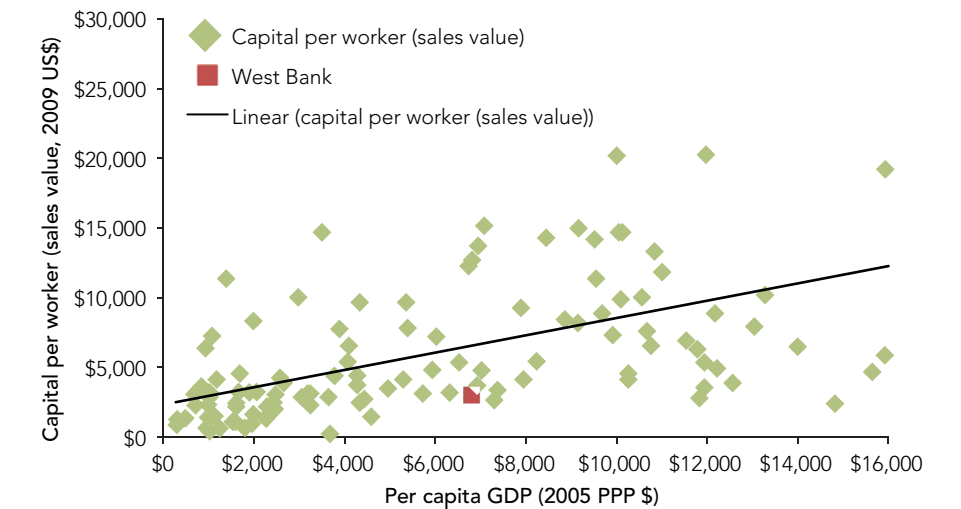
Figure A3.4: Firms in the West Bank and Gaza are Also Less Capital Intensive than Firms in Other Countries



Source: Authors' calculation based on data from World Bank Enterprise Surveys.

Note: Partial productivity measures are measured in 2009 US\$. See Appendix 1 for details. All data points are for the median firm on each measure of performance. Sales value of capital was not available for Jordan in 2001 or for Lebanon in 2011.

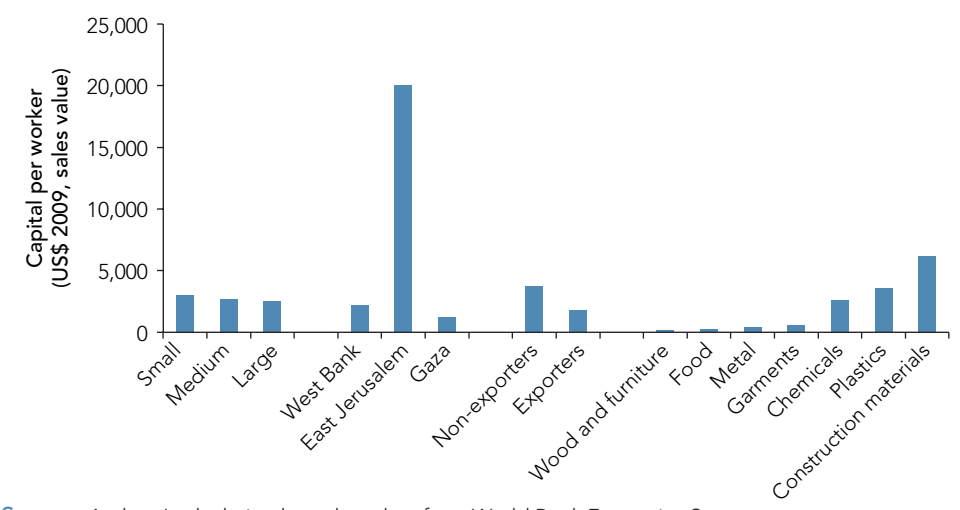
Figure A3.5: Manufacturing Firms in the West Bank and Gaza are Less Capital Intensive than Firms in Other Countries at Similar Levels of Development



Source: Authors' calculation based on data from World Bank Enterprise Surveys.

Note: Since purchasing power parity (PPP)-adjusted GDP was not available for the West Bank and Gaza, real per capita GDP in US\$ is used. This is likely to underestimate GDP in the West Bank and Gaza relative to its true value in PPP terms. All data points are for the median firm on each measure of performance. For presentational purposes, the chart is shown only for countries with per capita GDP between \$0 and \$16,000. Countries with a GDP per capita over this amount are, however, included when we calculate the linear projection.

Figure A3.6: Firms in East Jerusalem are Far More Capital Intensive than Firms in the West Bank and Gaza



Source: Authors' calculation based on data from World Bank Enterprise Surveys.

and Gaza are not very capital intensive. The observation for the West Bank lies below the regression line, suggesting that firms in the West Bank and Gaza are less capital intensive than firms at similar levels of economic development.

There are, however, large differences in capital intensity across the West Bank and Gaza. (See Figure A3.6.) Most notably, firms in East Jerusalem are, on average, far more capital intensive than firms in the West Bank and Gaza. The median firm in East Jerusalem has over ten times as much capital per worker as the median firm in Gaza, and has almost ten times as much capital as the average firm in the West Bank. This might partly account for the large differences in labor productivity between the different regions of the Palestinian territories.

Another interesting observation is that non-exporters are more capital intensive than exporters in the West Bank and Gaza. This might also account for why labor productivity is higher for non-exporters than for exporters. In most countries, exporters are more productive and more capital intensive than non-exporters.

Total Factor Productivity

Although labor productivity in the West Bank and Gaza is lower than in the best-performing comparator countries, firms in the West Bank and Gaza are also less capital intensive than firms in these countries. Labor productivity might be lower not because firms are poorly run or not technologically advanced, but rather because they substitute labor for capital. It is useful, therefore, to look at total factor productivity.

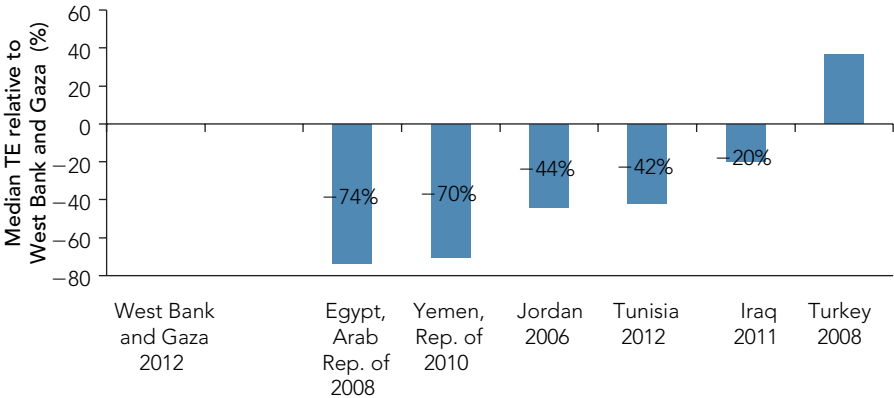
Total factor productivity (TFP), or technical efficiency (TE), is calculated using regression analysis. The way that it is calculated is described in detail in Appendix 1. The Appendix also describes how average TFP is calculated across countries, sectors, and for different firm types in the West Bank and Gaza.

Total factor productivity differs from labor productivity in two ways. First, TFP takes capital use into account. Second, the measure of TFP also controls for the sub-sector of manufacturing. To the extent that low labor productivity is due either to firms not using capital intensively or that firms are operating in low productivity sub-sectors, TFP should control for this. Despite this, however, it is important to note that TFP and labor productivity are very highly correlated at the country level.

Although total factor productivity is appealing in some ways, it has some limitations. First, like other partial productivity measures, it is affected by exchange rate under- and over-valuation. Both capital and value-added need to be converted into a common currency (2009 US\$ in this case) before TFP can be calculated. Second, as noted, capital is harder to measure than labor or value-added. If capital is mis-measured, TFP will also be mis-measured. In contrast, labor productivity is not affected by the mis-measurement of capital. These and other limitations are discussed in detail in the Appendix to this chapter.

A final point is that total factor productivity does not have natural units. It is not measured in monetary units—although, as noted, it will be affected by exchange rate over- or under-valuation. Results are therefore presented relative to TFP in the West Bank and Gaza. So, for example, the results suggest that TFP in Iraq in 2011 was approximately 25 percent lower than in the West Bank and Gaza in 2012 (see Figure A3.7).

Figure A3.7: Total Factor Productivity is Higher in the West Bank and Gaza than in Most of the Comparator Countries in the MENA region



Source: Authors’ calculation based on data from World Bank Enterprise Surveys.
Note: The country estimates are from the least absolute deviations (LAD) regressions (see Annex 3 for additional details). Lebanon is omitted due to missing data on the sales value of capital.

Country-Level Differences in Productivity

Figure A3.8 compares total factor productivity in the West Bank and Gaza with TFP in other countries in the region. By construction, TFP in the other countries is measured relative to TFP in the West Bank and Gaza. So, for example, TFP for the median firm in Egypt is about 74 percent lower than TFP for the median firm in the West Bank and Gaza. TFP is higher in the West Bank and Gaza than in any of the comparator countries in the region except for Turkey.⁸

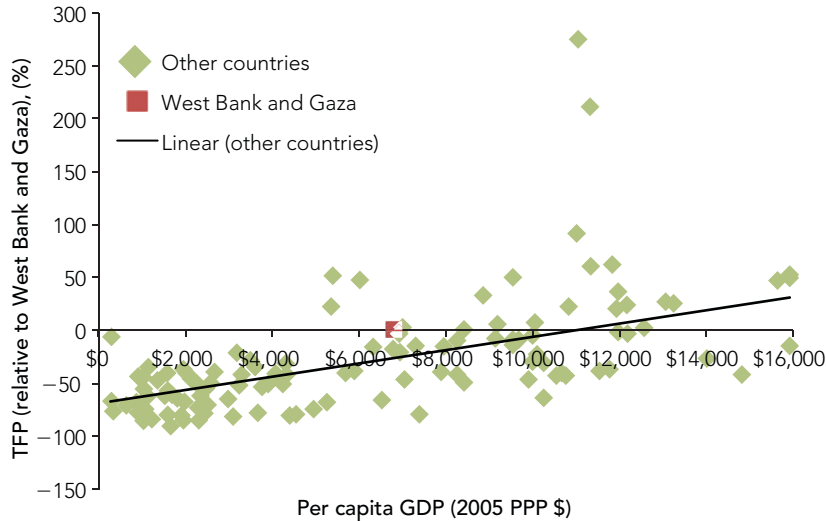
Firms in the West Bank and Gaza compare more favorably based on total factor productivity than based on labor productivity. TFP is slightly higher in the West Bank and Gaza than in several of the comparator countries, even though labor productivity is lower. There are two possible explanations for this. First, as noted, firms in the West Bank and Gaza are less capital intensive than firms in the comparator countries, other than Yemen. Since labor productivity does not take capital use into account, firms in these other countries might appear more productive because they have more machinery and equipment. Second, firms in the West Bank and Gaza might be in relatively low productivity sub-sectors of manufacturing.

It is also possible to compare total factor productivity in the West Bank and Gaza with the full sample of countries with available Enterprise Surveys (see Figure A3.8). TFP consistently varies with per capita income.⁹ Therefore, the estimates of TFP are plotted against per capita income (in 2005 PPP international \$). The positive regression line is consistent with the idea that TFP is higher in higher-income countries. The estimate of TFP lies above the regression line. This suggests that TFP is higher in the West Bank and Gaza than in other countries at similar levels of per capita income. In part, this might be because we are under-estimating per capita GDP in the West Bank and Gaza. Because PPP-adjusted per capita income was not available, an exchange rate estimated measure of per capita GDP was used for the West Bank and Gaza. In general, per capita GDP tends to be higher when measured using PPP-adjusted prices than when using exchange rate methods.¹⁰

Within country differences. As discussed in the Appendix, it is possible to include additional variables to look at productivity differences between different types of firms. The results suggest that exporters, firms that have bank loans, firms that are ISO certified, firms with access to the Internet and firms that train their workers are more productive than other firms (see Figure A3.9). The results for the West Bank and Gaza are similar to the results in other countries. The one exception is that Internet access appears to have a significantly greater impact on TFP for firms in the West Bank and Gaza than it does for firms in the other countries in the sample.

Another difference between the West Bank and Gaza and other countries is for foreign- and domestic-owned firms. In most countries, foreign-owned firms are

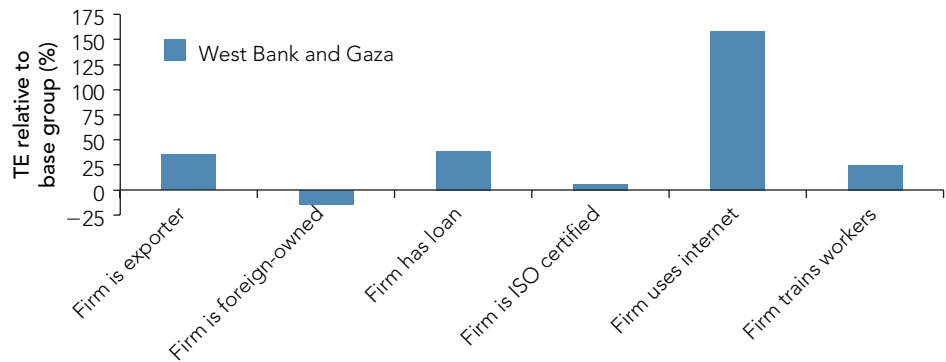
Figure A3.8: Total Factor Productivity is Slightly Higher in the West Bank and Gaza than in Other Countries at Similar Levels of Per Capita Income



Source: Authors’ calculation based on data from World Bank Enterprise Surveys.

Note: Since purchasing power parity (PPP)-adjusted GDP was not available for the West Bank and Gaza, real per capita GDP in US\$ is used. This is likely to underestimate GDP in the West Bank and Gaza relative to its true value in PPP terms. For presentational purposes, the chart is shown only for countries with per capita GDP between \$0 and \$16,000. Countries with GDP per capita over this amount are included in calculating the linear projection. The country average estimates are from the least absolute deviations (LAD) regressions, although the results are virtually identical when coefficients from the ordinary least square (OLS) and frontier regressions are used instead.

Figure A3.9: Differences in Total Factor Productivity for Firms in the West Bank and Gaza, by firm type



Source: Authors’ calculation based on data from World Bank Enterprise Surveys.

Note: The coefficients are from the least absolute deviations (LAD) regressions for description. The numbers can be interpreted as the difference in productivity between each group and the base group (for example, the first column represents the different in productivity between exporters and non-exporters). In practice, however, the results are virtually identical in the ordinary least squares (OLS) and frontier regressions (see Annex 3). The average coefficients are statistically significant at a 5 percent significance level. Other than for Internet access, the null hypothesis that the differences are identical for the West Bank and Gaza and the average for other countries cannot be rejected.

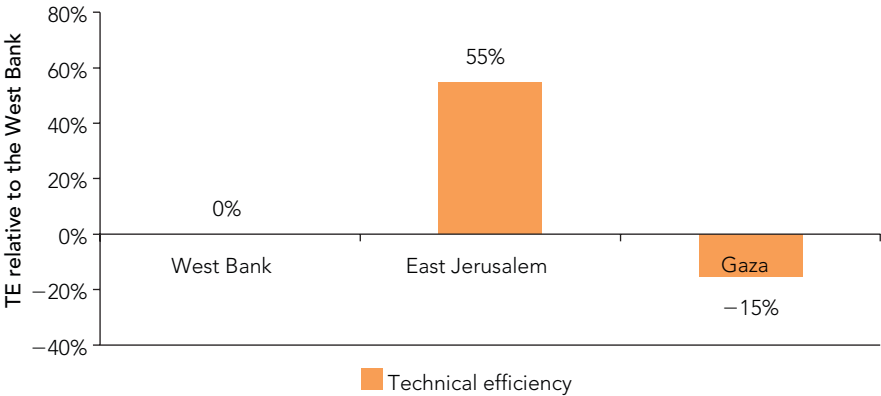
significantly more productive than domestic firms. This does not appear to be the case in the West Bank and Gaza.¹¹

Regional differences within the West Bank and Gaza. As noted, labor productivity is considerably higher in East Jerusalem than in the West Bank, and is higher in the West Bank than in Gaza. A similar pattern can be observed for total factor productivity, although the differences appear to be slightly smaller (see Figure A3.10). TFP for the median firm in East Jerusalem is about 55 percent higher than for the median firm in the West Bank. Similarly, TFP for the median firm in the West Bank is about 15 percent higher than for the median firm in Gaza. The smaller differences suggest that differences in labor productivity between the three regions are partly due to differences in capital intensity or sector of operations.

Productivity gap between the best and average firms. Another notable feature of the data is that there is a large gap between the best-performing firms in the West Bank and Gaza and the average firm in terms of total factor productivity. In the garment sector, the average firm is only about 40 percent as productive as the most productive firms. The gap in other sectors, however, is even larger (see Figure A3.11). Typically, the average firm is only about 15 percent as productive as the best-performing firm.

Two things might contribute to the large observed gap in terms of total factor productivity. First, there are large regional differences in productivity, with firms in East Jerusalem being far more productive than firms in Gaza—and to a lesser extent than firms in the West Bank. Unfortunately, it is difficult to disaggregate these differences further because the sample sizes become very small. Second, as

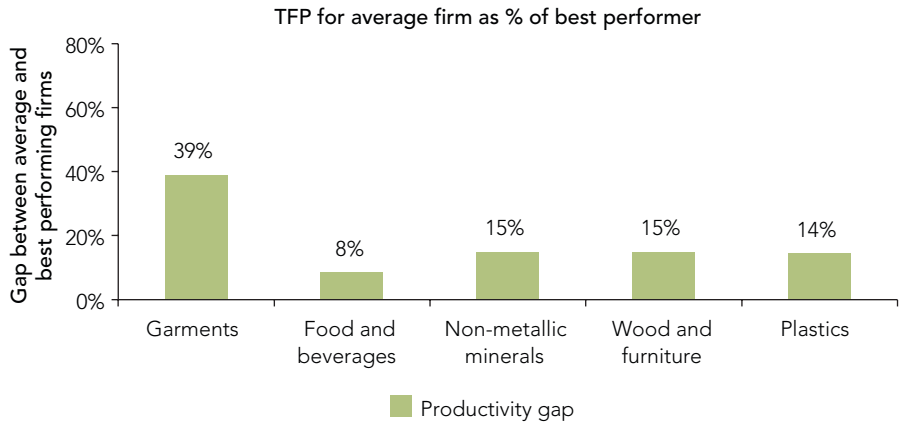
Figure A3.10: Differences in Total Factor Productivity, by region



Source: Authors’ calculation based on data from World Bank Enterprise Surveys.

Note: The coefficients are from the least absolute deviations (LAD) regressions (see appendix) for description. The numbers can be interpreted as the difference in productivity between each region and the West Bank.

Figure A3.11: Differences between Average and Best Performers



Source: Authors’ calculation based on data from World Bank Enterprise Surveys.

Note: The residuals are from the least absolute deviations (LAD) regressions. The numbers can be interpreted as the productivity of the average firm in each sector relative to the most productive firms. Only sub-sectors with at least ten firms with usable data are included in the table. TFP= total factor productivity.

noted, sample sizes are small, meaning that the differences may be exaggerated by a few outliers.

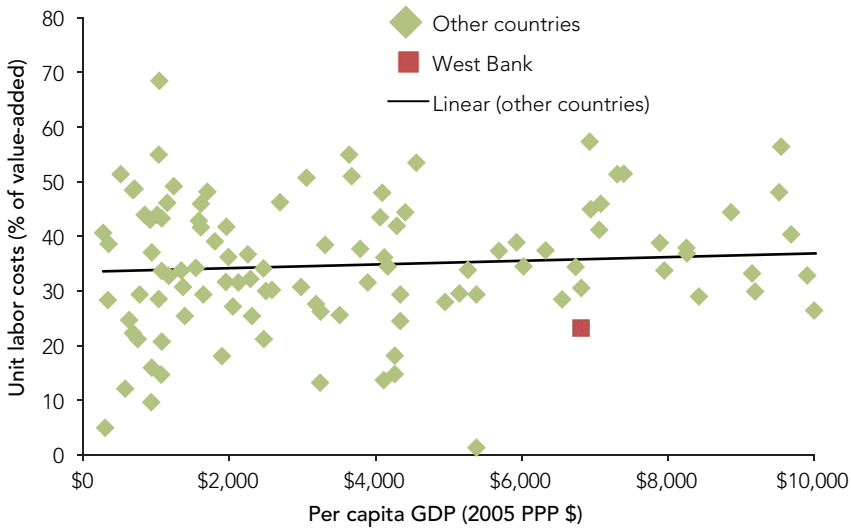
Overall, however, the large differences between the best performers and the average performers suggest that there is considerable inefficiency in most sectors. It also suggests that competitive forces might not be as strong as would be desired. If competition were more intensive, less productive firms would be forced to become more productive.

Unit Labor Costs

Unit labor costs enable the assessment of the net impact of labor costs on competitiveness. The measure used, labor costs as a percent of value-added, is an approximation to true unit labor costs (that is, true unit labor costs measure output in physical units of production rather than dollar values).¹² Unit labor costs are higher when high labor costs are not fully reflected in high productivity. When this is the case, all else being equal, firms will find it difficult to compete on international markets. Another attractive feature of unit labor costs is that they are not measured in local currency and, therefore, are unaffected by exchange rate variations. They are not perfect, however, since they do not take capital use into account. In this respect, they provide a useful complement to total factor productivity, which takes capital use into account, but does not account for differences in labor costs.

Unlike labor productivity, unit labor costs are not consistently higher in countries with higher per capita income (see Figure A3.12). Unit labor costs are not consis-

Figure A3.12: Unit Labor Costs are Relatively Low in the West Bank and Gaza Relative to Other Low- and Middle-Income Countries



Source: Authors’ calculation based on data from World Bank Enterprise Surveys.

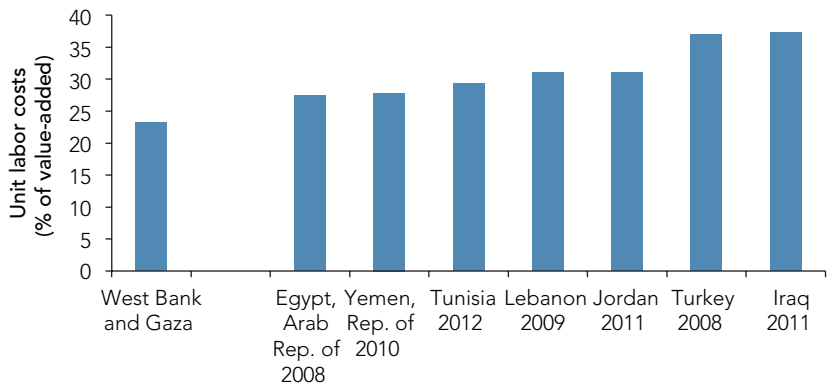
Note: Unit labor costs are the ratio of labor costs to labor productivity. See Appendix for details. Gross domestic product (GDP) is measured in 2005 constant international dollars (purchasing power parity [PPP]-adjusted). Since PPP-adjusted GDP was not available for the West Bank and Gaza, real per capita GDP in US\$ is used instead. This is likely to underestimate GDP in the West Bank and Gaza relative to its true value in PPP terms. All data points are for the median firm on each measure of performance. For presentational purposes, the chart is shown only for countries with per capita GDP between \$0 and \$10,000. Countries with GDP per capita over this amount are included when the linear projection is calculated.

tently higher in high-income countries, as is the case with other measures such as labor costs or labor productivity. Although the correlation between per capita income and median unit labor costs is positive (0.16), it is small and is not statistically significant (that is, it could be attributable to sampling variation).

Unit labor costs are low, although not exceptionally low, in the West Bank and Gaza. The median firm reports that unit labor costs are only about 23 percent – lower than in most of the comparator countries (see Figure A3.13). Unit labor costs are above 25 percent in all of the other comparator countries and are over 35 percent in several of these countries. Similarly, they are far lower than the average for countries at similar levels of per capita income (see Figure A3.12). This suggests that high labor costs do not appear to be an excessive burden on firms in the West Bank and Gaza.

There are also some differences by firm type. Although large firms are more productive than small firms, their labor costs are also higher. As a result, unit labor costs for large firms are similar to unit labor costs in less productive small- and

Figure A3.13: Unit Labor Costs are Low in the West Bank and Gaza in Relation to the Comparator Countries

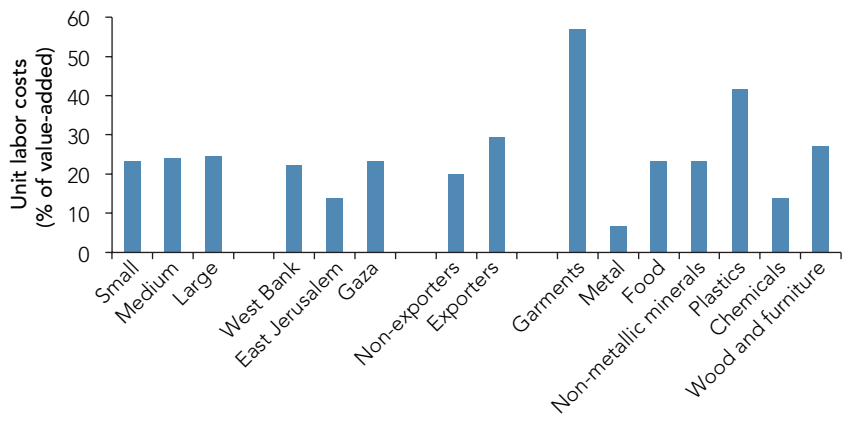


Source: Authors' calculation based on data from World Bank Enterprise Surveys.

Note: Unit labor costs are the ratio of labor costs to labor productivity. See Annex 4 for details.

medium-sized firms. Unit labor costs are also relatively lower for firms in East Jerusalem. (See Figure A3.14.) This suggests that higher labor costs do not fully offset the higher productivity of these firms. There are also differences across sectors, although these differences should be treated cautiously because of small sample sizes.

Figure A3.14: Unit Labor Costs are lower in East Jerusalem than in the West Bank and Gaza



Source: Authors' calculation based on data from World Bank Enterprise Surveys.

Note: Unit labor costs are the ratio of labor costs to labor productivity. See Annex 4 for details.

Notes

1. See Annexes 4 and 5 for a description of the methodology. Note that in the earlier (2006) ICA, values were in 2005 US\$. Changes in the exchange rate and inflation will mean dollar values in that ICA (2005 US\$) are different than dollar values in 2009 US\$.
2. See, for example, Pakes (2008).
3. See, for example, the discussion by Levinsohn (2008) on the Escribano-Guasch methodology (Escribano and Guasch, 2005; Escribano and others, 2005).
4. We restrict the data to data collected after 2006 because of concerns about comparability of data before 2006. By 2006, the survey instrument and sampling methodology had been standardized across countries.
5. See, for example, Acemoglu (2001) on institutions and the World Bank (1994) and Clarke (2013) on infrastructure.
6. See, for example, Svensson (2005) on corruption. Many papers have shown the strong link between corruption and other measures of institutional quality. See, for example, Langbein and Knack (2008, 2010).
7. Although linear projections are somewhat restrictive, results are very similar when non-linear projections are allowed. See, for example, Clarke (2012).
8. These differences are statistically significant at a 1 percent level in all cases.
9. See, for example, Clarke (2012).
10. This is referred to as the "Penn effect" or the "Balassa-Samuelson effect."
11. The productivity differences between foreign-owned firms and domestic-owned firms are not statistically significant, suggesting no productivity differences between foreign and domestic firms in the West Bank and Gaza.
12. Because of limitations related to the data collected in the Enterprise Surveys and the broad coverage of the Enterprise Surveys across different sectors of the economy, true unit labor costs cannot be calculated.

MEASURES OF FIRM PERFORMANCE

The study focuses on several measures of firm productivity. These are calculated in a uniform way in all countries with available Enterprise Survey data between 2006 and 2013.

The Enterprise Surveys collect financial data in the local currency of the country being surveyed. To make cross-country comparisons, the financial data need to be converted into a common currency in a single year (that is, to control for inflation and exchange rate differences). To do this, all values are converted into 2009 US dollars (US\$). For firm surveys conducted between 2006 and 2009 (that is, surveys with accounting data from between 2005 and 2008), data are inflated to 2009 values in local currency using the GDP deflator. For surveys conducted after 2010, the values are deflated in a similar way. The values in 2009 local currency are then converted into US\$ using 2009 exchange rates.

The values are deflated to 2009 values and then use a common year's exchange rate because of concerns that fluctuations in the value of the dollar might otherwise make comparisons difficult. However, it is important to note that since most firms in the sample sell their products primarily in local markets, exchange rates have to be close to their equilibrium values in 2009 for these comparisons to be very accurate. If the exchange rate in a given country is over- or under-valued, the comparisons will under- or over-state the actual value of the performance measure for that country.

The individual measures are constructed in the following way.

Value-added. Value-added is the value of the goods and services that the firm produces, less the cost of the raw materials (such as iron or wood) and intermediate inputs (such as engine parts or textiles) used to produce the output. Output is measured in local currency, not in physical units. We subtract the cost of raw materials, intermediate inputs, electricity and fuel in local currency from output to obtain the value-added. Firms report electricity and fuel costs separately from raw materials and intermediate inputs. Firms that do not report sales or raw materials are dropped for this measure. Electricity and fuel costs are treated as if they are zero for firms that do not report electricity or fuel costs (that is, the firms are not dropped). This is done because dropping firms that do not report electricity or fuel

costs would have a significant impact on sample size, and because electricity and fuel costs are small relative to sales and raw materials.

Number of workers. The number of workers is represented by the number of permanent and temporary full-time workers. Temporary workers are weighted by the average length of employment for these workers. So, for example, if the average length of employment for a temporary worker was 6 months, the weight for temporary workers would be $\frac{1}{2}$. For one of the comparator countries (Tunisia), data on the length of employment was not collected. Therefore, for Tunisia, the weight is set to one for all firms. Data on part-time workers is not collected in most countries (outside of Sub-Saharan Africa), and so part-time workers are omitted for reasons of comparability. In practice, where countries do have data on part-time workers, including these part-time workers does not have a large effect on relative rankings. Firms that do not report permanent or temporary workers are dropped for measures that use workers (for example, value-added per worker).

Labor productivity. Value-added per worker is the basic measure of labor productivity used in this study. It is value-added divided by the number of full-time workers in the firm. Firms that produce more output with fewer raw materials and workers have higher labor productivity.

Capital intensity. The first measure is the book value of capital divided by the number of workers. For firms that keep detailed financial accounts, this measure should be the value of capital taken from those accounts. For other firms, it will either be omitted or estimated by the manager. It is described in the ICA manual as follows:

The net book value represents the actual cost of assets at the time they were acquired, including all costs incurred in making the assets usable (such as transportation and installation) minus depreciation accumulated since the date of purchase. (World Bank 2007b).

The second measure is the sales value of capital divided by the number of workers. The manager is asked to estimate the value of the capital if it were to be sold in its current condition. Although this measure is probably closer to the true value of the capital, it has some shortcomings. In particular, when market demand for capital equipment is low, it might be difficult for the manager to give an accurate estimate. The implementation manual notes:

Ask the manager to estimate the market value if all of the equipment, land and buildings were to be sold on the open market. If the respondent states that there is no market, ask how much the respondent would be willing to pay for the capital, knowing what it can produce in its current condition. Estimate how much it would cost to buy machinery in the current market which is similar in terms of age and characteristics. (World Bank 2007b).

Firms that do not report these measures have to be dropped when calculating the respective measures of capital intensity and total factor productivity.

Total Factor Productivity/Technical Efficiency. This measure of productivity takes both labor and capital use into account. The methodology is described in detail in a separate appendix.

Labor costs per worker. The cost of labor is the cost of wages, salaries, bonuses, other benefits, and social payments for workers at the firm divided by the number of workers. The data is taken from the firms' accounts. It includes wages and salaries paid to all workers and managers – not just production workers. Firms are only dropped from these averages when they do not report labor costs (or workers).

Unit labor costs. This measure is labor costs as a percent of value-added. Although it is an approximation to true unit labor costs (that is, it measures output in dollars rather than as a physical measure of production), it can be calculated using information from the Enterprise Survey. Unit labor costs are higher when higher labor costs are not fully reflected in higher productivity.

TOTAL FACTOR PRODUCTIVITY

This appendix describes how we estimate total factor productivity for the cross-country comparisons of total factor productivity, and how we make the comparisons for total productivity for different types of firms within the West Bank and Gaza. It also presents the results from the estimation.

Methodology

Technical Efficiency (TE) or total factor productivity (TFP) is the residual from a regression of the log of output (either value-added or revenue) on labor, capital, and other intermediate inputs. Following Caves and Barton (1990), this appendix uses value-added as the dependent variable rather than sales as the dependent variable.¹ Using a formulation based upon value-added, the estimation assumes a Cobb-Douglas Production function, as follows:²

$$Y_i = A_i K_i^\alpha L_i^\beta$$

where Y is value-added for firm i , K is a measure of capital (for example, the book value or replacement value of capital), L is the number of workers, and A is total factor productivity or technical efficiency. Constant returns to scale are not imposed, allowing the model to control for differences in productivity by firm size. The higher that A is, the more output the firm produces with the same amount of capital and labor. Taking natural logs of both sides implies that:

$$\ln(Y_i) = \mu + \alpha \ln(K_i) + \beta \ln(L_i) + \varepsilon_i \quad (1)$$

where

$$A_i = e^{\nu_i} = e^{\mu + \varepsilon_i}$$

Therefore, the firm's productivity is equal to a constant, μ , and an additional firm-specific measure of productivity, ε_i . It is easy to generalize this into a more general 'augmented' production function where the error term is:

$$\nu_i = \mu + \vartheta FC_i + \varepsilon_i$$

and where FC_i is a vector of variables representing the characteristics of the firm or the investment climate that the firm faces. This implies that:

$$\ln(Y_i) = \mu + \alpha \ln(K_i) + \beta \ln(L_i) + \delta FC_i + \varepsilon \quad (2)$$

To allow productivity to be different in different countries, the regressions include a vector of country dummies (μ_c). A complete list of countries is included in Table 15. The country dummies control for country-level differences that might affect productivity. For example, firms in some countries might be more productive if infrastructure is of better quality, the rule of law is stronger, or workers are more highly skilled or better educated than in comparator countries. By comparing the coefficients on the country dummies, we can compare average levels of technical efficiency in the West Bank and Gaza with technical efficiency in other countries.³ This implies that:

$$\ln(Y_i) = \mu_c + \alpha \ln(K_i) + \beta \ln(L_i) + \delta FC_i + \varepsilon_i \quad (3)$$

Under some assumptions, equation (5) can be estimated by Ordinary Least Squares (OLS). In particular, when firm characteristics are omitted (that is, when equation (2) is estimated), the coefficients can be estimated with OLS if capital and labor are uncorrelated with the error term. This implies that any shock that affects productivity must be uncorrelated with the firms' capital and labor choices. This would be violated if, for example, managers were aware of something that affected productivity and decided to hire or fire workers or invest in new machinery and equipment. This assumption would also be violated if a firm received some technical advice from one of their suppliers or buyers that improved the firm's productivity, and then the manager decided to hire more workers to take advantage of this improved know-how.

Characteristics of the firm or the investment climate for the firm can also be directly included in the OLS regression, as long as these characteristics are exogenous. For example, if becoming an exporter makes a firm more productive (for example, through exposure to foreign markets), then a dummy variable indicating that the firm was an exporter could be included in the regression if productivity did not affect the firm's decision to become an exporter. If, for example, a firm became more productive and decided that this improved productivity meant that it could start exporting, this assumption would be violated.⁴

Rather than including firm or investment climate characteristics directly in the model, it is possible to first estimate equation (2) through OLS or another more robust estimation method, obtain estimates of TE by calculating ε for each firm from equation (2), and then regress the residuals on the firm and investment climate characteristics (for example, by estimating equation (3)). An advantage of this approach is that if panel data are available, it might be possible to estimate

equation (2) using a robust technique such as the method suggested by Levinsohn and Petrin (2003). Then, something such as 2SLS in the second stage could be used if one of the firms or investment climate characteristics were thought to be endogenous.⁵

The drawback of this second approach is that if the firm level or investment climate characteristics are correlated with the amount of labor and capital that the firm uses (that is, if the manager's knowledge about the investment climate affects the firm's use of labor or capital), then the estimates of the coefficients in equation (2) will be biased.⁶ As a result, the ϵ 's will be estimated incorrectly and the coefficients from the second stage will be biased. It seems likely that this will often be the case. Escribano and Guasch (2005) argue that "this is almost always the case since the inputs are correlated with the Investment Climate (IC) variables and least squares estimators of [equation 2] are inconsistent and biased." For this reason, estimation is done in a single step in this report.

One concern about OLS is that outliers can have a significant effect on OLS estimates. If some firms misreport their sales, capital or workers, this can affect estimation considerably. Given that many of the firms in the analysis do not report data directly from company accounts—and that many small firms in developing countries might not even keep detailed accounts—this can be a serious problem. In the West Bank and Gaza Enterprise Survey, only about 60 percent of firms report that they have audited accounts, and only about 20 percent of firms reported numbers directly from their accounts.

Outliers can be dealt with in several ways. One way is to estimate the equation with a robust estimation method such as a Least Absolute Deviations (LAD) estimator, which weights outliers less heavily than Ordinary Least Squares do.⁷ Another approach is to drop outliers. In the OLS and frontier estimation, which are less robust to outliers, we exclude outliers that report value-added per worker or capital per worker more than three standard deviations from the mean for that country. This typically excludes about 10 percent of the sample. In the West Bank and Gaza, about 13 percent of the sample is excluded from these regressions. As discussed below, however, the main results are similar in the LAD regressions, which include outliers, and the other regressions, which exclude them.

In addition to concerns about outliers, a second set of concerns have been discussed in the literature on: (i) the functional form of the error term; and (ii) whether the error term is correlated with capital and labor. There are several methods that have been proposed regarding the functional form of the error term. In particular, stochastic frontier analysis allows for two error terms, a one-sided term assumed to have a half normal distribution, ϵ , representing technical efficiency, and a two-sided normally-distributed error term, ϵ , representing temporary shocks to productivity and measurement error. The model is estimated using maximum likelihood esti-

mation. In the analysis, we use the LAD estimators as our base estimators. We also estimate the model using standard OLS estimators and stochastic frontier analysis.

In practice, estimates of country-level productivity are not sensitive to the way that we estimate the production function. The correlation between the country-level estimates of productivity from the three methods is between 0.977 and 0.986 (see Table A5.1). Thus, countries that appear more productive using one estimation method also appear more productive using other methods. In the text, we therefore focus on results using the LAD estimator.

A broader problem is that things that affect productivity might affect firm manager choices regarding capital and labor. If this is the case, OLS, stochastic frontier estimation and LAD estimation will all produce biased estimates of the coefficients. Although several methods have been proposed to deal with this, they require panel data (Levinsohn and Petrin 2003; Olley and Pakes 1996)—something that is not available for most Enterprise Surveys.

A final concern is that for analysis with firms from multiple sub-sectors of manufacturing, the analysis essentially assumes that firms use the same production technologies. Since the analysis in this chapter includes firms from more than one sub-sector of manufacturing, a more flexible estimation technique that allows firms in different sectors to use different production technologies is preferable. This can be done mechanically by including a full set of sector dummies, and interacting these dummies with the measures of labor and capital to allow labor and capital intensities to differ in different sectors.

The augmented production function then becomes:

$$\ln(Y_{ij}) = \mu_c + \sum_j (\alpha_j + \beta_j \log(K_{ij}) + \gamma_j \log(L_{ij})) + \partial FC_{ij} + \varepsilon_{ij} + v_{ij} \tag{4}$$

The coefficients on labor and capital, β and γ , are assumed to vary between sectors. Sector dummies, α , are also included to allow for systemic differences in productivity across sectors. These models are sometimes referred to as the ‘unrestricted models,’ whereas the models that assume identical production technologies are referred to as the ‘restricted models.’

Table A5.1: Correlation between Country-Level Estimates of Technical Efficiency

| | OLS | LAD | Frontier |
|----------|-------|-------|----------|
| OLS | 1.000 | 0.986 | 0.977 |
| LAD | | 1.000 | 0.982 |
| Frontier | | | 1.000 |

Source:

Note: LAD= least absolute deviations; OLS= ordinary least squares.

Some Methodological Issues

There are some well-known problems with this methodology.

1. For cross-country comparisons, value-added and capital have to be denominated in a common currency (for example, US dollars as in these examples). Because these two variables are denominated in local currency in the survey, cross-country comparisons of TE are vulnerable to exchange rate fluctuations. If the exchange rate is overvalued relative to its long-run equilibrium, then TE might look artificially high. Although this can make it difficult to interpret differences in TE between countries, it is important to note that this should not have a significant impact on the coefficients on firm-level variables.
2. The model essentially assumes that firms in the same sector in different countries use similar technologies.
3. Capital is more difficult to measure than labor for both theoretical and practical reasons. Since TE uses measured capital in its construction, it will generally be mis-measured when capital is mis-measured.
4. Ideally the measure of output would be a physical measure of output. In practice, however, it is difficult to obtain physical measures of output. Instead, most analyses including those using Enterprise Survey data use sales (that is, output multiplied by unit price) as the dependent variable. Because production is affected by price as well as by quantity, these functions are sometimes referred to as sales-generating functions.⁸ With firms producing heterogeneous products, this can be problematic if some have market power. Specifically, firms with market power that charge high prices for their output (for example, monopolists) would appear more productive than a similar firm in competitive markets that charges lower prices.⁹
5. Because estimates are calculated in a regression framework, it is less straightforward to calculate TE than labor productivity. One issue is that estimates of TE for groups of firms do not have natural units. For cross-country comparisons, TE is shown as a percent of TE in the West Bank and Gaza. For other groups (for example, exporters), differences are presented in terms of a base category (for example, non-exporters).
6. As noted by Escribano and Guasch (2005), there is no single accepted approach to estimating TE. For this reason, following Escribano and Guasch, we estimated the model in several different ways to check the robustness of the results. We therefore estimate the model in various ways, making different assumptions about the error terms (that is, we present estimates from stochastic frontier, OLS, and LAD models).
7. Recent studies have noted that inputs in the production function (labor and capital) are endogenous (Levinsohn and Petrin 2003; Olley and Pakes 1996). This can affect the estimation of TE. With panel data, it is possible to control

for this using sophisticated econometric techniques, instrumenting for inputs with intermediate inputs or investment. In this case, without a long panel, these methodologies cannot be implemented.

There are some additional problems associated with including measures of the investment climate in TE regressions.

1. The impact that different aspects of the investment climate have on firm productivity is likely to vary across countries—and results across countries have often varied in previous Investment Climate Assessments. For example, improvements in access to financing are likely to depend on how developed financial markets are, how difficult it is to obtain access to finance, how the financial sector is regulated, what informal institutions have evolved to make up for problems with formal credit markets, and many other factors. Because we are primarily interested in the effect that investment climate variables have on productivity in the West Bank and Gaza, we restrict the analysis to looking at how firm characteristics affect productivity. This ensures that we are looking at differences in productivity as they apply to the West Bank and Gaza.
2. Most firm-level variables and investment climate variables are potentially endogenous.¹⁰ The results for the firm-level variables should therefore be treated with caution and should not be assumed to be causal. For the estimates of country-level differences in productivity and within-sector comparisons for the West Bank and Gaza, we will use the coefficients from the model without additional control variables.

Several papers have discussed these issues in more depth, including Escribano and others (2005) and Dollar and others (2005).¹¹ Data is pooled for the sub-sectors of manufacturing for which enough data were collected to estimate productivity.¹²

Results

The results from the estimation are shown in Table A5.2 (see Table A5.3 for list of countries included in the regression analysis). Because the regressions include over 100 country dummies, over 10 sub-sector dummies and an additional 20 sub-sector specific coefficients on capital and labor, these are omitted from the table. The coefficients on capital and labor are the coefficients for the omitted dummy variable for the garment sector.¹³

The coefficients on the country dummies can be used to calculate the difference between each country and the West Bank and Gaza in terms of total factor productivity.¹⁴ Figures A3.7 and A3.8 in Annex 3 show the estimates of technical efficiency based on the coefficients on the country dummies.

Table A5.2: Results from Productivity Regressions, All Countries

| Column number | (1) | (2) | (3) | (4) | (5) | (6) |
|--|---|---------------------|---------------------|---------------------|---------------------|---------------------|
| Estimation Method | OLS | LAD | Frontier | OLS | LAD | Frontier |
| Dependent Variable | Natural log of value-added (in 2005 US\$) | | | | | |
| Observations | 24,297 | 26,951 | 24,297 | 17,508 | 19,519 | 17,508 |
| Workers (natural log) | 0.894*** (62.61) | 0.885*** (57.94) | 0.908*** (67.16) | 0.817*** (48.37) | 0.805*** (43.81) | 0.823*** (51.37) |
| Capital (natural log, sales value in \$) | 0.208*** (23.29) | 0.213*** (22.89) | 0.187*** (22.26) | 0.194*** (18.83) | 0.187*** (16.90) | 0.182*** (18.60) |
| Firm is exporter (dummy) | | | | 0.131*** (6.79) | 0.165*** (8.15) | 0.119*** (6.51) |
| Exporter*West Bank dummy | | | | 0.056 (0.20) | 0.140 (0.48) | 0.005 (0.02) |
| Firm is foreign-owned (dummy) | | | | 0.156*** (5.51) | 0.270*** (9.62) | 0.172*** (6.45) |
| Foreign-owned*West Bank dummy | | | | -0.269 (-0.28) | -0.430 (-0.40) | -0.657 (-0.73) |
| Firm has loan (dummy) | | | | 0.072*** (4.27) | 0.079*** (4.37) | 0.066*** (4.12) |
| Loan*West Bank dummy | | | | 0.430 (1.23) | 0.246 (0.65) | 0.352 (1.03) |
| Firm is ISO certified | | | | 0.163*** (7.62) | 0.211*** (9.51) | 0.171*** (8.47) |
| ISO*West Bank dummy | | | | -0.452 (-1.28) | -0.155 (-0.40) | -0.694** (-2.02) |
| Firm uses internet (dummy) | | | | 0.272*** (12.62) | 0.282*** (12.22) | 0.270*** (12.97) |
| Internet*West Bank dummy | | | | 0.992*** (3.73) | 0.668** (2.36) | 0.978*** (4.00) |
| Firm trains workers (dummy) | | | | 0.086*** (5.19) | 0.095*** (5.39) | 0.080*** (5.07) |
| Training*West Bank dummy | | | | 0.630 (1.40) | 0.131 (0.26) | 0.714 (1.63) |
| Constant | 6.948*** (59.48) | 6.975*** (56.75) | 8.044*** (70.97) | 6.050*** (33.60) | 6.443*** (34.32) | 7.230*** (40.36) |
| R-squared | 0.80 | | | 0.81 | | |

Source: Authors' calculations based on data from the World Bank Enterprise Surveys.

Note: T-statistics in parentheses ***, **, * means statistically significant at a 10%, 5%, and 1% level.

All regressions include a full set of country and sector dummies. The sector dummies are interacted with workers and capital (see equation 5) to allow sector-specific factor intensities. The coefficients on these variables are not presented for reasons of space. The omitted category is garments, and so the coefficients on workers and capital in the table apply to this group.

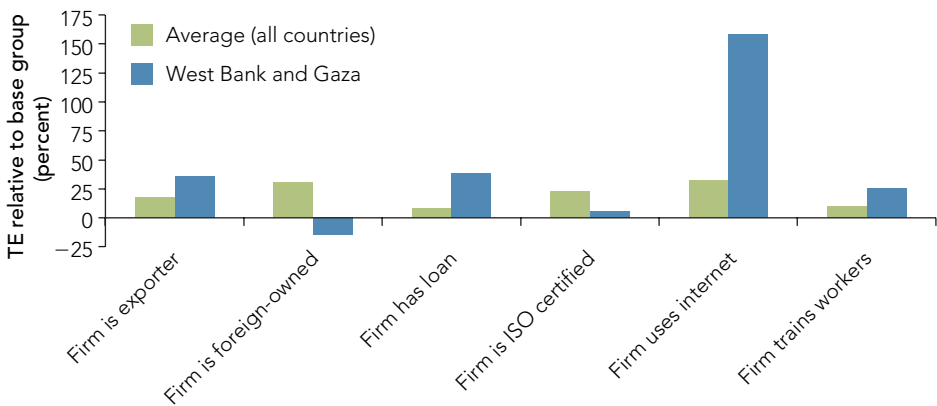
ISO= International Organization for Standardization; LAD= Least absolute deviations; OLS- Ordinary least squares.

Within country differences. The country dummies come from simple regressions without any additional firm characteristics included in the analysis (see column 2 of Table A5.2). As noted, it is possible to include additional variables to look at productivity differences between different types of firms. As seen in columns 4-6 of Table A5.2, exporters, foreign-owned firms, firms that have bank loans, firms that are ISO certified, firms with access to the Internet, and firms that train their workers are more productive than other firms (see Figure A5.1). For the entire sample, these differences are statistically significant at a 5 percent level or higher in all three regressions.

We also include interaction terms between the country dummy for the West Bank and Gaza and each group of firms. We can use this to check that similar patterns appear in the data for the West Bank and Gaza. For the most part, we are unable to reject the null hypothesis that productivity differences across groups are similar for firms in the West Bank and Gaza and firms in other regions. The one exception is firms that have Internet access—they appear to be significantly more productive in the West Bank and Gaza than firms without access than in the other countries in the sample.

Although the difference between the West Bank and Gaza and other countries in terms of productivity differences between foreign-owned firms and domes-

Figure A5.1: Differences in Total Factor Productivity, by firm type



Source: Authors’ calculation based on data from World Bank Enterprise Surveys.

Note: The coefficients are from the least absolute deviations (LAD) regressions (see appendix) for description. The numbers can be interpreted as the difference in productivity between each group and the base group (for example, the first column represents the different in productivity between exporters and non-exporters). In practice, however, the results are virtually identical in the ordinary least squares (OLS) and frontier regressions (see Table A5.2). The average coefficients are statistically significant at a 5 percent significance level. Other than for Internet access, we are unable to reject the null hypothesis that the differences are identical for the West Bank and Gaza and the average for other countries.

Table A5.3: List of Countries Included in Technical Efficiency Regression Analysis

| | | | |
|--------------------------------|--|-------------------------|--------------------------------|
| West Bank and Gaza 2013 | Colombia 2010 | Kazakhstan 2008–09 | Peru 2010 |
| | Congo, DR 2006 | Kenya 2007 | Philippines 2009 |
| Afghanistan 2008 | Costa Rica 2010 | Kosovo 2008–09 | Poland 2008–09 |
| Albania 2008 | Croatia 2007–08 | Kyrgyz Republic 2008–09 | Romania 2008 |
| Angola 2006 | Czech Republic 2008–09 | Lao PDR 2005 | Russia 2008–09 |
| Angola 2010 | Dominica 2010 | Lao PDR 2009 | Russia 2012 |
| Antigua and Barbuda 2010 | Dominican Republic 2010 | Lao PDR 2012 | Rwanda 2006 |
| Argentina 2006 | Democratic Republic of Congo 2010 | Latvia 2008 | Senegal 2008 |
| Argentina 2010 | Ecuador 2006 | Lithuania 2008–09 | Serbia 2008 |
| Armenia 2008–09 | Ecuador 2010 | Madagascar 2008–09 | Slovak Republic 2008–09 |
| Azerbaijan 2009 | Egypt 2008 | Malawi 2005 | Slovenia 2008–09 |
| Bahamas 2010 | El Salvador 2006 | Malaysia 2007 | South Africa 2007–08 |
| Barbados 2010 | El Salvador 2010 | Mali 2007 | Sri Lanka 2011 |
| Belarus 2008 | Estonia 2008–09 | Mali 2010 | St Kitts and Nevis 2010 |
| Belize 2010 | Ethiopia 2011 | Mauritania 2006 | St Lucia 2010 |
| Bolivia 2006 | Former Yugoslave Republic of Macedonia 2008–09 | Mauritius 2008–09 | St Vincent and Grenadines 2010 |
| Bolivia 2010 | Gambia 2006 | Mexico 2006 | Suriname 2010 |
| Bosnia and Herzegovina 2008–09 | Georgia 2008 | Mexico 2010 | Swaziland 2006 |
| Botswana 2006 | Ghana 2007 | Moldova 2008–09 | Tajikistan 2008 |
| Botswana 2010 | Grenada 2010 | Mongolia 2008–09 | Tanzania 2006 |
| Brazil 2008–09 | Guatemala 2006 | Montenegro 2008–09 | Trinidad and Tobago 2010 |
| Bulgaria 2007 | Guatemala 2010 | Mozambique 2007–08 | Tunisia 2012 |
| Bulgaria 2008 | Guinea 2006 | Namibia 2006 | Turkey 2008 |
| Burkina Faso 2006 | Guinea Bissau 2006 | Nepal 2009 | Uganda 2006 |
| Burkina Faso 2009 | Guyana 2010 | Nicaragua 2006 | Ukraine 2008 |
| Burundi 2006 | Honduras 2006 | Nicaragua 2010 | Uruguay 2006 |
| Cambodia 2007 | Honduras 2010 | Nigeria 2007 | Uruguay 2010 |
| Cameroon 2006 | Hungary 2008–09 | Nigeria 2009 | Uzbekistan 2008 |
| Cameroon 2009 | Indonesia 2009–2010 | Panama 2006 | Venezuela 2010 |
| Cape Verde 2006 | Iraq 2011 | Panama 2010 | Vietnam 2009–2010 |
| Chile 2006 | Ivory Coast 2008–09 | Paraguay 2006 | Yemen 2010 |
| Chile 2010 | Jamaica 2010 | Paraguay 2010 | Zambia 2007 |
| Colombia 2006 | Jordan 2006 | Peru 2006 | Zimbabwe 2011 |

tic-owned firms is not statistically significant, the point estimate suggests little in the way of productivity differences between foreign and domestic firms in the West Bank and Gaza.

Notes

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).
9. See, for example, the discussion by Levinsohn (2008) on the Escribano-Guasch methodology (Escribano and Guasch 2005; Escribano and others 2008; and Escribano and others 2005).
10. For investment climate variables, many previous studies that use firm-level data from Enterprise Surveys to look at the effect of the investment climate on various measures of firm performance control for this by replacing or instrumenting the potentially endogenous investment climate variables with region-industry averages.
11. See also comments on the Escribano-Guasch methodology by Levinsohn (2008), Pakes (2008) and Verhoogen (2008). Although the analysis is not identical to the analysis that these authors are commenting on, it shares many characteristics with it. Previous Investment Climate Assessments have used multiple firm-level observations in a single regression. In most cases, the data for the investment climate variables and many of the firm characteristics are cross-sectional. Specifically, it was only asked for a single year. In contrast, productivity data was collected for three years. By replicating the investment climate variables, which were only collected as a cross-section for each year for which there was productivity data, it was possible to run random effects panel regressions. Fixed effects could not be included because these would collinear with the investment climate variables. In this case, productivity data were only collected for a single period, making all analysis cross-sectional by necessity.
12. The econometric approach that is used to estimate TE is similar to the econometric approach used in other Investment Climate Assessments in several ways. See, for example, the Investment Climate Assessment for South Africa (Clarke and others 2007) or the Investment Climate Assessment for Turkey (World Bank 2007a).
13. To avoid problems with collinearity with the constant term, one sub-sector dummy needs to be omitted from the regression. The coefficients on the other sub-sector dummies can be interpreted as deviations in technical efficiency from the omitted sector.
14. The formula used to convert this into percentages is: $\epsilon^{\mu_c} - 1$, where μ_c is the coefficient on the country dummy for country c. See Halvorsen and Palmquist (1980) for the derivation of this formula.



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