

18.

# מדינת ישראל

משרד הממשלה

משרד

ב"ר הבנק העממי אל בלגה השטחים.  
(סיוטת שניה)  
כרך יו

17. 8. 1993

כ/8083/9

ליו, סט

מס' תיק מקורי

כ/8083/9

מחלקה



ליד שלום - דו"ח בנק העולמי יעד כדכלת  
שטחים כרך III

8083/9-A

R0004k4i

08/12/2020

תאריך הדפסה

2-111-3-11-

Document of  
The World Bank

FOR OFFICIAL USE ONLY

**REVISED DRAFT  
CONFIDENTIAL**

Report No. 11958  
(6 Volumes)

DEVELOPING THE OCCUPIED TERRITORIES  
AN INVESTMENT IN PEACE  
VOLUME III: PRIVATE SECTOR DEVELOPMENT  
AUGUST 17, 1993

Middle East Department  
Middle East and North Africa Region  
World Bank

This document has a restricted distribution and may be used by recipients only in the performance of their official duties. Its contents may not otherwise be disclosed without World Bank authorization.

## CURRENCY EQUIVALENTS

(As of January 1, 1993)

NIS 1.00 = US\$ 0.361  
US\$ 1.00 = NIS 2.764  
JD 1.00 = US\$ 1.453  
US\$ 1.00 = JD 0.688

## GLOSSARY OF ABBREVIATIONS

ADCC	Agriculture Development and Credit Company
AIC	Arab Insurance Company
BOI	Bank of Israel
BOP	Bank of Palestine
CAB	Cairo-Amman Bank
CBJ	Central Bank of Jordan
CA	Civil Administration
CPD	Central Planning Department
DRC	Domestic Resource Cost
EC	European Community
ERP	Effective Rate of Protection
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
GNP	Gross National Product
HCJ	High Court of Justice (Israel)
IDF	Israeli Defense Forces
JD	Jordanian Dinar
MO	Military Order
NGO	Non-Governmental Organization
NIS	New Israel Shekel
RC	Regional Commander
PSD	Private Sector Development
SPC	Supreme Planning Council
VAT	Value Added Tax

# Private Sector Development in the Occupied Territories

page no.

<b>Preface</b>		i
<b>Main Report</b>		1
I.	Private Sector Setting	2
II.	Private Sector Activities	8
III.	Prerequisites for Private Sector Development	14
IV.	Other Measures to Support PSD	15
V.	Prospects for the Future	23
VI.	Schematic for Accelerating Private Sector Development	25
<b>Annex I Private Sector Activities</b>		27
I.	Industrial Sector	27
II.	Services Sector	43
<b>Annex II Regulatory, Trade and Tax System</b>		53
I.	Licensing Process	54
II.	Trade Regime	57
III.	Taxation System	64
IV.	Security Procedures	67
V.	Impact of the Regulatory, Trade and Taxation System	68
<b>Annex III The Financial Sector</b>		73
I.	Financial Sector Development Since 1967	74
II.	Investment and Demand for Credit	89
III.	Recommended Policy and Institutional Changes	95
<b>Annex IV The Governance System</b>		113
I.	Applicable Law	114
II.	The Courts	116
III.	Administration	120
IV.	Economic Effects of Legal and Administrative System	122
<b>Appendices</b>		
A.	Conceptual Framework	A-1
B.	Methodology of Mission Survey	B-1
C.	DRC and ERP Analysis	C-1
D.	References	D-1



## PREFACE

1. At the request of the sponsors and organizers of the Middle East Peace Talks, the World Bank has been supporting the work of the Multilateral Working Group on Economic Development and Regional Cooperation by providing analyses of the key economic issues and developmental challenges facing the Middle East region. At its second meeting in Paris in October 1992, the Working Group requested the Bank to expand its contribution to include, *inter alia*, an assessment of the development needs and prospects of the economies of the West Bank and the Gaza Strip (commonly referred to as the Occupied Territories). In response to this request, a Bank mission visited the Occupied Territories during the period January 21-February 24, 1993. The mission comprised five teams focusing on the following areas: Private Sector Development, Agriculture, Human Resources, Infrastructure and Macroeconomics. Each team was in the field for about two weeks. The mission was led by Prem Garg who, together with Samir El-Khoury, stayed in the field throughout to provide continuity and guidance to the five teams. The staffing of the five teams was as follows:

<i>Agriculture:</i>	Gert van Santen (Team Leader) Ulrich Kuffner (Water Resource Engineer) Merle Jensen <sup>1</sup> (Horticulture Specialist)
<i>Human Resources:</i>	Fredrick Golladay (Team Leader) Maureen Field <sup>1</sup> (Education Specialist) Radwan Ali Shaban <sup>1</sup> (Human Resource Economist)
<i>Infrastructure:</i>	Alastair McKechnie (Team Leader) Ulrich Kuffner (Water Resource Engineer) Lawrence Hannah (Urban Specialist) Nail Cengiz Yucel (Transport Sector Specialist) Ted Moore <sup>1</sup> (Power Engineer)
<i>Macroeconomics:</i>	Michael Walton (Team Leader) Samir El-Khoury (Fiscal Analyst) Ishac Diwan (Macroeconomist)
<i>Private Sector Development:</i>	Albert Martinez (Team Leader) Robert Mertz (Financial Sector Specialist) Joseph Saba (Legal Specialist) Dileep Hurry <sup>1</sup> (Regulatory Environment and Tourism Specialist)

2. Mission members travelled extensively in the West Bank and Gaza, visiting municipalities, farms, businesses, industries, academic institutions, refugee camps and NGO-run facilities. Mission members also travelled in Israel, as needed, and paid several visits to Amman. The representatives of the key bilateral and multilateral donors in Jerusalem, Tel Aviv and Amman responsible for the Occupied Territories were kept briefed about the work of the mission. Close contact was also maintained with the field staff of UN agencies.

---

<sup>1/</sup> Bank consultant.

3. The Bank mission was received warmly by all sides, who took keen interest in the work of the mission and provided superb logistical and counterpart support for the field work. The main counterparts on the Israeli side were the Bank of Israel and the Civil Administration in charge of the Occupied Territories. On the Palestinian side, the main counterparts were the Technical Committees of the Palestinian Team to the Peace Conference, consisting mainly of Palestinians who are members of the bilateral or multilateral peace teams. The Ministry of Planning was the main contact on the Jordanian side. The Bank would like to thank all concerned parties, especially the Israeli, Jordanian and Palestinian hosts, for the excellent support and cooperation that the Bank mission received for this field work.

4. This report is based on the findings of the above mission. The report is in six volumes:
- o Volume I provides a summary *overview* of the key findings and recommendations of the study. After commenting selectively on the current socioeconomic situation in the OT and its evolution over time, it discusses prospects for sustainable development in the future and outlines the priority agenda of policies and programs needed to promote such development.
  - o Volume II explores the strategic choices at the *macro* level that will be faced by the OT in the future and the implications for economic relations between the OT and the rest of the region. The study looks at the current situation and its evolution over the past 25 years. The study then examines several policy choices for the future affecting the structure of development in the OT. Finally, it outlines some illustrative scenarios for the future, focussing on the consequences of current developments in the region.
  - o Volume III reviews the performance of the *private sector* (including, in particular, the industry and tourism sectors) in the OT. The study assesses the environment in which the private sector operates and its future prospects and makes recommendations for accelerating private sector development in the future.
  - o Volume IV reviews the evolution and structure of the *agricultural* sector in the OT; analyzes its current characteristics; assesses OT competitiveness in the immediate and longer term; outlines the main policy options and their implications; and provides a preliminary assessment of sectoral financial and technical assistance (TA) needs.
  - o Volume V assesses the current situation in the *infrastructure* sectors (electricity, water supply and sanitation, transport, housing and solid waste services) in the OT; identifies the major issues confronting these sectors; and outlines priorities for TA and investment needs. As local authorities are major institutions in the delivery of public services in these sectors, the study also includes a review of their current situation and makes recommendations for improving the functioning of municipalities.
  - o Volume VI reviews the current status as regards *human resource* development; analyzes options for enhancing individual welfare and labor productivity in the OT; and outlines investment and TA priorities for strengthening existing programs and for laying the foundation for later reforms.

5. It is worth highlighting two limitations of this study right at the outset. First, a number of key issues bearing upon the future development of the OT (e.g., the allocation of land and water resources, the disposition of Israeli settlements in the OT, the future status of expatriate Palestinians, the territorial issues surrounding Jerusalem and, most importantly, the nature of the proposed "self-governing" arrangements for the OT) are the subject of ongoing bilateral negotiations between the Israelis and the Palestinians. The resolution of these issues is likely to be based primarily on political and security considerations. As the Bank mission to the OT was a *technical mission*, with neither the mandate nor the expertise to deal with political or security aspects, this study does not take any positions on issues that are on the agenda for bilateral negotiations. The focus instead is on policies, institutions and investments—where optimal choices are largely invariant to the eventual political arrangements to be agreed at the bilateral negotiations. Thus, for example, while analysing, where appropriate, the economic links between East Jerusalem on the one hand and the West Bank and Gaza on the other, the report avoids making any judgements regarding the future status of East Jerusalem.

6. Second, the study has had to cope with very serious *data gaps and inconsistencies*. Much of the data on the OT are, directly or indirectly, from official Israeli sources. There are, however, serious gaps in the OT data base. A population census has not been carried out in the OT for more than 25 years. As a result, most of the demographic and labor force data are based on extrapolations and on sample surveys, the reliability of which are undermined by problems of nonresponse, especially since the onset of the *Intifada* (popular uprising) in 1987. Data on East Jerusalem and on Israeli settlements in the OT, both of which are treated as part of Israel by the official Israeli sources, are mostly unavailable. Data available on trade between the OT and Israel and on the profitability and competitiveness of the agricultural, industrial and service enterprises are also very limited. Data on the OT from Palestinian and Israeli nonofficial sources are sparse and selective. Also, Palestinian data, when they exist, are often based on *ad hoc* surveys that do not lend themselves easily to cross-sectional or longitudinal comparisons. In many instances, data differ between sources, and, even when the same source is used, there are gaps and apparent inconsistencies. Given these data problems, the report uses estimates that appear most plausible in light of the mission's field observations. In cases where the data differences among various sources are particularly sharp (e.g., population, unemployment and social indicators), the report attempts, where possible, to examine the reasons for these differences and to indicate the implications of alternative estimates for the results of the analysis.

7. In view of the limitations on the mission mandate, the data difficulties and the time and resource constraints, this study can only be considered a beginning. The analysis in the study, especially for the longer term, is necessarily incomplete; as, and when, progress is made in the bilateral negotiations, the study will need to be updated and expanded to take account of the agreements reached. Also, notwithstanding the care exercised in locating and interpreting the data from various sources, the empirical underpinnings of this study leave something to be desired, and, therefore, the conclusions of the study should be treated only as indicative of broad trends and priorities. Further, in-depth studies and project feasibility work will be required before the findings of this report could be used to make operational decisions.

8. An earlier draft of this report was discussed with the Israeli, Jordanian and Palestinian authorities by a Bank mission to the region during July 12-26, 1993. Where appropriate, the report has been revised to incorporate the comments received by the mission during the July discussions.



## PRIVATE SECTOR DEVELOPMENT IN THE OCCUPIED TERRITORIES

### MAIN REPORT

#### Introduction

1. The private sector has been the dominant economic force in the Occupied Territories (OT), accounting for approximately 85 percent of GDP in 1991. In contrast to many other economies public sector institutions play a very small role in the economy – the vast majority of productive assets are privately owned. Notwithstanding the significant role of the private sector, the economy is currently experiencing a deep crisis, with poor prospects in the short term and an unclear outlook for the longer term. While the crisis was brought about by a series of shocks starting from the early 1980s, the severity of the impact was in large part due to the past patterns of development and the existing economic structure which have three major characteristics: about a quarter of GNP was accounted for by export of labor to two areas, Israel and the Gulf countries; more than 70 percent of trade exports was to Israel, a significant portion of which was through subcontracting arrangements; and approximately 85 percent of gross fixed capital formation went into construction, primarily housing. The dependence on a few markets and on the export of labor brought about growth during the 1970s and part of the 1980s, but with demand from the Gulf countries for Palestinian labor drying up and the demand from Israel uncertain, future sustained economic growth requires a reorientation of the economy towards diversification of markets, transformation from labor to merchandise and service exports, and the development of new sources of growth. The ability of the economy to adjust would depend on the response of the private sector in increasing investment in directly productive activities.

2. This report describes the environment in which the private sector currently operates and examines the conditions under which the private sector would invest in directly productive activities. The report recognizes the unique situation in the OT, of which three characteristics are worth noting. One, security is of major concern to the Israeli authorities and this drives many of the actions described in this report. However, the major issue with regard to security in the context of private sector development is the transparency of the definition of security and the limits that circumscribe the actions that can be undertaken to maintain law and order. Two, geopolitical uncertainty is an overarching constraint to private investment. In the OT, this is exacerbated and to a large extent driven by the popular lack of acceptance and credibility of the governance system. In turn, the restrictive effects of the regulatory system are magnified as entrepreneurs view the system as lacking effective mechanisms for recourse in case of grievances. Three, perceptions drive the investment decisions of the private sector, even if such perceptions are not intended by the policies instituted. This report focuses on the private sector perceptions to the existing policies and practices, and makes no judgement on the intentions behind the policies. As such, negative perceptions would result in a critical evaluation of policies. This is the case for any private sector development report especially in economies where the regulatory climate is wide-ranging.

3. Part I describes the private sector setting, focusing on the macroeconomic framework, the financial system and the physical infrastructure in the OT; Part II examines the economic activities that the private sector is engaged in, which include industry, agriculture, construction and housing, tourism, and services; Part III provides the prerequisites for private sector development; Part IV lists the recommended accompanying measures that would encourage private sector development; and Part V

concludes with some prospects for the future. Some recommended institution building initiatives are included. Four annexes are attached to this report: (a) private sector activities; (b) the regulatory, trade and taxation system; (c) the financial sector; and (d) the governance system.

## I. Private Sector Setting

### The Governance<sup>1</sup> System

4. Palestinians in the OT are governed by a legal and administrative system that is antiquated, imposes disproportionate regulatory burdens and does not provide adequate recourse in case of property rights disputes. All policy making, legislative and regulatory authority, long-term planning, budget, material resources and infrastructure are controlled by Israelis. Furthermore, Israeli settlers in the territories are, in many respects, subject to a different system which is modern, provides incentives for investments and effective recourse for denial of property rights.
5. A prospective investor requires transparency in the definition of security and the norms for limits and accountability for interventions in the economic life of the population to maintain law and order. Under the current system, extraordinary measures with serious economic impact (mass curfews, restrictions on movement, confiscation of land and buildings, house sealings and demolitions, uprooting of trees, restrictions on land use) are taken by the authorities. The legal framework does not provide a definition of security or limits to Israel's right to pursue extraordinary measures and restrict economic activities. With all executive and legislative power in the hands of the military commanders, existing institutions provide little effective recourse to the use of economic legislation and administration for perceived security considerations.
6. There is a lack of effective civic institutions in the OT to provide the infrastructure support and implement economic policies for a market economy. In 1967, Israel retained the basic administrative apparatus of the pre-existing systems in the West Bank and Gaza. In 1981, the Israeli military established the Civilian Administration (CA) for each territory to handle social and economic affairs. The military Area Commander (AC) for each territory retains all authority for security matters and all primary legislative and executive authority. The CA's power is derivative and subordinate to the AC. The CA's chief powers are to administer a body of law and regulations through the issuance of permits and licenses, the collection of taxes and disbursement of funds. Although currently approximately 95 percent of the CA's 22,000 employees are Palestinians, all policy decisions in the CA are made by Israelis, largely guided by relevant Israeli state agencies.
7. While certain local institutions have continued to function after 1967, their powers have been quite limited. The legal powers of the municipalities are theoretically broad under the British Palestine Municipal Law of 1934 (Gaza) and Jordanian Municipalities law (West Bank), and cover building and business licensing, health, sanitation, fire, schools and markets within municipal borders. However, the powers of the municipalities and other local governments are curtailed by several factors. Except for minor tax privileges and revenue from the resale of electricity, they depend entirely on the CA for their budget, approval of the rate of taxation, and approval of municipal ordinances. The municipalities are not permitted to borrow money or collect contributions without advance approval of

---

1/ Governance is defined to be a legitimate system of allocating resources in society.



the CA. The High Planning Committee for each of the territories, composed entirely of Israelis, has the authority and has used it frequently to approve, amend or revoke all municipal zoning and planning measures. This body exerts an effective veto on all municipal decisions which impact land use, including permits to build any commercial or industrial structure. However, municipalities can grant permits within the approved zoning plan.

8. Decisions of the CA may be objected to before committees established by the CA and presided over by Israelis. However, committees' decisions are only recommendations and are unappealable. All OT residents may petition the Israeli High Court of Justice to protest an action by the AC or his agents. While such appeals have served a function in giving publicity to grievances, the process affords no recourse if the AC asserts security as the basis of its actions. In the case of local courts, judges in the OT are local Palestinians appointed by a Judges Appointment Committee composed of active or reserve status Israeli military officers. Since 1987, the local courts have deteriorated in service and effectiveness. Since the Palestinian police has resigned, there is no executive willing and able to enforce judgments of the local courts. The efficiency and standards of the judges and their staff are said to have fallen significantly.

#### Macroeconomic Context

9. The economic environment in the OT is an amalgam of policies and regulations whose combined impact is a skewed pattern of development. Five features of the policy environment are discussed below.

10. One, the OT trade with the rest of the world outside of Israel is principally governed by Israeli trade policy, which has been undergoing a process of liberalization and is expected to be by 1998 one of the most open in the world. The benefits from the trade agreements between Israel and the EC and USA spill over to the OT. However, trade between the OT and Israel is characterized by an asymmetric relationship whereby while there are no restrictions on Israeli exports to the OT, there are restrictions on agricultural exports from the OT to Israel.

11. Two, the OT economy has benefitted from the regional labor markets. Palestinians have been free to sell mainly unskilled labor to Israel and skilled labor to the Gulf. In 1987, Palestinians working in Israel accounted for 35 percent of the employed population in the West Bank and 45 percent in Gaza. There was a long run trend towards convergence of the wages in Israel and the OT, but the difference began to widen over the past few years under the dual pressure of returnees from the Gulf and lower demand in Israel. The premium on skills has virtually vanished with the rise in available labor supply.

12. Three, the regulatory regime which is a mix of licensing, taxation and trade procedures and practices increases cost of operations, imposes barriers to entry, distorts allocation of resources, and discourages modernization of technology. Combined with the strategic uncertainty of the occupation, the regulatory regime has discouraged investments, especially after 1987. However, over the past two years, there has been a relaxation in the application of many measures.

13. Four, fiscal compression has resulted in inadequate provision of public services. Spending is much lower than international norms. Total non-defence spending amounted to 24 percent of GDP (and 18 percent of GNP), compared with 37 percent for both Egypt and Israel, 31 percent for Jordan and 26 percent for a sample of developing economies. While it is still quite low with respect to

current spending, the radical differences lie in development (i.e. investment related) spending. The 3.5 percent of GDP allocated to development expenditures in the OT is a fraction of the spending levels in the other economies.

14. Five, the OT does not have its own currency or a central bank. The New Israeli Shekel (NIS) and the Jordanian Dinar (JD) are legal tender, while the US Dollar and some European currencies circulate widely as a more secure store of value. Cash seems to be the primary means of payment, and monetary savings are primarily in foreign currency (some of which is held abroad) and precious metals. In the absence of a monetary authority and an active banking system, the money supply is primarily determined by capital inflows and outflows related to foreign trade, net factor income, and net transfers. The circumstances in the OT necessitate large cash balances: cash in advance transactions predominate; large precautionary cash balances are held as shock absorbers because of the difficulties in securing short-term credit; and investment is mostly self-financed, requiring the accumulation of cash savings.

15. The above policy framework has resulted in three major characteristics of the OT economy. First, the OT economy is heavily dependent on the Israeli economy and on Israeli regulatory policies. In 1967, the economies of the West Bank and Gaza had virtually no relations with Israel. During the 1970s, a period of rapid integration of the OT with Israel occurred, with accompanying changes in the pattern of specialization and wages, and corresponding results in terms of growth. The opening up of economic opportunities brought about rapid growth during this decade. Although the rate of growth decelerated after 1980, between 1970 and 1987 GNP per capital more than doubled, with a commensurate rise in living standards, ownership of consumer durables, health and education.

16. Second, the OT economy is vulnerable to external shocks. After 1987, the decelerating rate of growth wound down to a complete halt, and turned negative until 1992. Several exogenous shocks contributed to this pattern. Being a small, open economy with little diversification of products, heavy dependence on labor exports, and restrictions on the export of agricultural produce to Israel and other products to U.S. and European markets, the OT are highly vulnerable to imported shocks from economies in the Middle East which are important markets for its labor exports. During the mid-1970s, the first oil shock led to a slowdown in Israeli growth. However, the Gulf oil boom offset the reduced demand for unskilled labor by raising demand for skilled Palestinian labor, and led to substantial transfers from expatriate Palestinians and other Arab sources overseas. The collapse of oil prices in the early 1980s led to the first period of decelerated growth and stagnation in the OT. Israeli inflation was also almost completely imported into the OT. The Intifada contributed to a reduced labor demand in Israel outside construction, and reduced economic activity in the OT due to strikes, border closures, and security-related restrictions on the movement of Palestinian personnel and goods. Jordan's withdrawal of public sector salary payments and the devaluation of the Jordanian dinar affected many in the West Bank. The Gulf war with Iraq had several adverse consequences, including border closures, increased security regulations, the expulsion of Palestinian skilled workers of Kuwait, and the loss of Arab grants. In addition to these shocks, the olive crop is prone to cyclical variations in alternate years with large aggregate effects. Furthermore, the influx of immigrants into Israel caused a decline in demand for unskilled labor, which, however, was offset by a temporary rise in demand for construction workers.

17. Reduction in vulnerability requires an economic reorientation which in turn is dependent on increased investment levels by the private sector. In 1992, expectations of a peace settlement fueled a small boom, especially in residential property, financed by drawdowns of savings of Palestinian families with household members returning from the Gulf. However, the reduction of Palestinian employment in Israel and the closure of borders between the OT and Israel has once again caused a slippage.



18. Third, the OT economy is characterized by asymmetric investment patterns and lack of endogenous productive growth. There appears to have been a preference on the part of Palestinians to stake a claim to their territory and establish their residence by investing in housing. The presence of savings due to remittances and rising incomes (during the seventies and early eighties) and the absence of alternative vehicles for investment in the form of financial intermediaries and private sector productive assets stimulated this trend. Thus over 20 percent of GDP has gone into housing — compared to one-third this level in comparable economies — while a much lower percentage (between 1 and 4 percent of GDP) has been invested in productive assets. Given a perception of political uncertainty, the relative security of housing in comparison to industry, and a rapid population growth, this pattern of investment over the past two decades is not surprising.

19. The most important, and troubling, consequence of the skewed pattern of trade and investment, given the fact that past sources of growth are drying up, is that the economy is left with a depreciated capital base thus limiting future growth. It is clear that the Palestinian productive private sector holds appreciable comparative and competitive advantages even in world markets, but these advantages have to be nurtured and stimulated by investment, supported by sound policies and a stable political context.

### The Financial System

20. At the time of the Arab-Israeli War in June 1967, there were 8 Jordanian and foreign-owned banks with 26 branches in the West Bank, and 3 Egyptian and foreign-owned banks, with 4 branches in Gaza. Those in the West Bank (administered by Jordan) operated under the Jordanian Banking Law of 1965, while those in Gaza (administered by Egypt) operated under the Banking Ordinance of 1941, established by the British mandatory authority. The Israeli military closed all Arab and foreign-owned banks immediately after the occupation, froze their accounts and transferred the cash balances to the Central Bank of Israel as deposit accounts in the banks' names. The Israeli currency was declared the legal tender in the OT and Israeli foreign exchange control regulations, far more restrictive than Jordanian regulations or practice, were applied. However, the Jordanian dinar continued to circulate as a legal currency in the West Bank (and unofficially in Gaza), and the bridges across the River Jordan remained open to the flow, albeit sharply reduced, of commerce and visitors. The Egyptian pound ceased to be legal tender in Gaza, although it continued to circulate for a few years. The Central Bank of Jordan (CBJ) assumed responsibility for the assets and liabilities of Jordanian banks, which were liquidated in an orderly manner. The Egyptian Government took no such action concerning the banks operating in Gaza, and the border with Egypt was closed to all legal commerce. Effectively, the OT were left without a formal banking system, although West Bank and Gaza residents retained access to their bank accounts in Jordan and abroad.

21. Banks. Under occupation, the Jordanian and Egyptian banks in the OT disappeared and with it any direct financial links to Arab countries, including Jordan and Egypt. Thereafter, the only banks licensed to operate were Israeli banks, which expanded through the 1970s and 1980s until they numbered 31 branches in 1984. While some of these banks served only the needs of Israeli settlers, 22 branches were located in Arab towns. There were several unsuccessful rounds of negotiations aimed at reopening the banks that had been operating in the OT at the time of the June war. These negotiations were unable to resolve fundamental political issues, including the reopening of former branches in East Jerusalem; parallel supervision of the banks of two countries still at war with each other; or technical issues regarding capital requirements, control over external deposits and legal reserves. Finally, in 1981, after several years of intense lobbying, the Bank of Palestine (BOP) was allowed to reopen in Gaza. In



1986, the Cairo-Amman Bank (CAB) reopened in Nablus on the West Bank. The BOP now has three branches in the Gaza area; the CAB recently opened its eighth and ninth branches in the West Bank. Although each bank may deal in shekels, neither is allowed to expand beyond its respective borders, i.e., West Bank or Gaza. Both banks follow very conservative lending policies and provide limited banking services to the economy. At the end of 1992, they provided credit of only \$17 million, less than 1 percent of GDP.

22. With only one Arab bank each in the West Bank and Gaza, the minimal Israeli bank presence and the absence of a business environment conducive to normal banking transactions, there is little competition in banking services at present. As a result, interest spreads are high: the margins for NIS denominated loans are 10-15 percent for Arab banks compared to 8 percent for Israeli banks, and for dollar denominated loans, the spreads are 13 percent for Arab banks and 2 percent for Israeli banks. The Arab banks also charge relatively high fees: for example, the BOP charges 2 percent per month for a bank guarantee in Gaza. In addition, the CAB and BOP are circumscribed, by the terms of the agreements licensing their operations, in the range of international services they may offer their customers. They may not send transfers directly to foreign bank branches nor open letters of credit but must deal through an Israeli bank. This places the Arab banks at a substantial competitive disadvantage, both in terms of a less flexible fee structure, which must be split with the Israeli bank, but also in terms of the time taken to complete a foreign transfer. According to businessmen, transfers through an Arab bank and their Israeli correspondent can take up to 6 days, whereas transfers done directly through an Israeli bank would take one day. Transfers via Amman are also be subject to several days' delay.

23. Moneychangers. The absence of readily accessible banking institutions, the existence of two legal currencies (dinar and shekel) in the West Bank (the shekel is the only legal currency in Gaza), stringent exchange controls and rapid inflation gave impetus to the rapid expansion of money changers after 1967 as a substitute financial sector. The number of money changers in the West Bank grew from 42 in 1967 to 196 by 1986. The larger, better-established money changers operate as small international banks, with offices in the Gulf and banking relationships in Europe and North America. Their primary services include foreign currency exchange, inward and outward money transfers and remittances and check cashing on external accounts. Prior to 1989, transfers between Amman and the OT amounted to as much as \$750 million annually. In general, the services of the money changers are more flexible, faster and less expensive than comparable bank services. For example, their margins on foreign currency exchange and money transfers can be less than 1 percent, while commercial banks may charge as much as 3 percent. Those with international networks offer money transfer by telephone or fax, with immediate credit in major financial centers, for amounts up to several million dollars, which is comparable to the service of the best Israeli banks and better than the current standard of service at Arab banks. In addition to these financial benefits, they offer anonymity and the assurance that neither specific transactions nor the size or location of a client's wealth will become known to the Israeli tax, customs or civil administration authorities.

24. Insurance. Until February 1993, there was only one local insurance company in the West Bank and Gaza, the Arab Insurance Company (AIC), headquartered in Nablus. This company was established according to the Jordanian Insurance Law in effect before 1967, but its activities are now monitored by the Israeli Controller of Insurance; it is required to conform to regulatory standards somewhere between the prudential limits set by Jordanian law and the tougher legal limits in Israel. AIC is only a modest supplier of capital to the OT economy due mainly to lack of investment opportunities. Recently, two more insurance companies were established and are currently operational.

## Physical Infrastructure

25. The present infrastructure of the OT is mostly of pre-1967 origin, and while certain improvements and changes have been made, the level and quality of the services provided are generally below those in economies with similar incomes. There is a striking dichotomy between the well developed and maintained infrastructure serving Israeli Settler Communities and that serving the rest of the OT.

26. An effective institutional structure needs to be developed for the infrastructure sector to deliver services adequate for private sector development. There are obvious limitations to international borrowing. Fiscal problems have forced municipalities, which are engaged in power distribution, to utilize power revenues to finance other municipal services. Current ownership structures do not foster efficiency and responsiveness: power and communications supply is mainly provided or controlled by municipal or CA departments. The net effect is an infrastructure sector that is inadequate in providing services, with a constraining impact on the development potential of the OT economy.

27. Electric Power. The Israel Electric Company (IEC), which is fully owned by the Government of Israel (GOI), is the main source of power supply in the OT, with power distribution systems operated by municipalities, except those supplying Israeli Settler Communities and the Jerusalem Electricity Company (JDECO) which is a private entity. Electricity consumption is low in relation to per capita income: KWH per capita in the OT is 680 in 1992 compared to 1054 in Jordan and 815 in Egypt. Actual consumption by OT consumers is significantly lower than neighboring countries due to higher distribution losses. There are still 138 Palestinian villages that either have no electricity supply or have only part-time supply from isolated diesels.

28. Inadequate investments, poor management, and lack of institutional framework and policy all contribute to the state of the electricity sector. Municipal electricity suppliers are perceived by the population as unable to achieve efficiency in operations. The regulatory system is cumbersome. The limited external funds available from the CA are highly unpredictable and do not allow for effective investment planning. A fundamental change in the institutional arrangements in the sector would be required to achieve greater efficiency and attract investments.

29. Telecommunications. The telecommunications infrastructure in the OT is underdeveloped, with the ratio of telephone subscribers to total population at 1:46, as compared to 1:15 in Jordan and 1:36 in Egypt. The system is characterized by a backlog of new connections which in the West Bank exceeds 12,500, equivalent to about one third the number of lines currently in use. As of end-1991, only 80 of 400 villages in the West Bank had telephone service. Of these, most had usually only one connection, and with poor maintenance, it was frequently out of service.

30. Poor telecommunications services render it difficult for many enterprises to transact business beyond their immediate vicinity. This causes inefficiencies, complicates trade, constrains information flow, and fragments markets. The need for efficient communications capacity is made acute by the frequency of curfews and travel bans which are likely to be imposed at short notice.

31. Roads. The existing road network serving the Palestinian community is below the level and quality that would be expected to prevail in a region with similar income levels. Recent investments in infrastructure have been made to integrate the Israeli Settler Communities with the Israeli economic and social structure, resulting in the construction of modern and high standard roads linking these settler



communities with major centers in Israel, often bypassing the Palestinian cities, towns and villages. Road networks serving solely the Arab population have suffered from relative neglect.

32. The local governments do not have the capacity to maintain, upgrade and develop urban road networks within municipality borders. It is estimated that all urban road networks are in very poor condition and need rehabilitation. In many major municipalities, traffic is extremely slow, often at a standstill during rush hours.

33. The importance of a good road network in private sector development cannot be overemphasized. Inadequate facilities dramatically increase the costs of transporting goods to markets. Market fragmentation occurs and economies of scale are constrained when road networks do not facilitate movement of goods and people.

## II. Private Sector Activities

34. This section describes the major private sector economic activities and covers the industrial, agricultural, construction and housing, tourism, and service sectors. Economic data on the private sector are summarized in the following table.

Private Sector Economic Data 1991  
(Percent)

	Share of GDP	Share of Employment	Share of Merchandise Exports
Agriculture	29.3	25.8	20
Industry	7.8	15.5	80
Construction	12.1	10.4	
Non-government Services	39.7	na	

Sources: Statistical Abstract of Israel and Mission Estimates

### The Industrial Sector

35. Compared with economies of similar income and stage of development, the OT have lagged behind in terms of contribution of industry to GDP. Despite a long history that dates prior to 1967, industry has the structure of a sector at the early stages of development, characterized by numerous small owner-operated shops with no discernable large market leaders in the major sectors. More than 60 percent of total enterprises employ less than 4 persons and only 7.5 percent employ more than 10 persons. The contribution to employment in 1991 was about 16 percent.

36. Since 1987, investments in capital stock have not kept pace with depreciation. With capacity utilization dropping to about 60 percent, industrial enterprises are financially strained, and liquidation is avoided only by severely limiting overhead and drastically cutting costs, with deleterious effects on quality and service. In addition, there have been cutbacks in critical investments in human resources and technology, thereby compromising the sector's level of competitiveness.

37. Future growth would depend on increasing levels of investment, which in turn requires a fundamental shift in perceptions of risk. The expectations of progress in the peace process combined with some liberalization in the regulatory regime resulted in higher private investment in 1992, although most of it probably went into real estate. This is consistent with international experience which indicates that private investment responds quickly with improvements in conditions of strategic uncertainty. While measures such as incentives and regulatory reform could be undertaken to encourage private investment, these are likely to have marginal results if unaccompanied by the resolution of the fundamental causes of high risk perceptions. Without progress toward a peace agreement that establishes a minimum level of security, significant increases in directly productive investments are unlikely.

38. Elimination of barriers to market access would improve prospects for the sector. The lifting of the Arab boycott would open markets that have been historically important to OT external trade. The restructuring of the regulatory regime would reduce marketing costs and permit wider contacts with export markets.

39. Assuming normal capacity utilization levels, most industries are generally competitive even at world prices, although major segments such as textile and shoes tend to be at the low end of the competitive scale. The achievement of peace would raise capacity utilization levels since the Intifada related strikes and curfews are important causes of low productivity. Peace is likely to bring about an immediate supply response with little additional investment. Longer term competitiveness would depend on high levels of investment to improve productivity and increase output, and on the ability of firms to develop core competencies such as a relatively strong human resource base and knowledge of local and regional markets – to move from factor based to skill based competition thereby achieving more enduring competitive advantage. The achievement of such competitiveness would require the fulfillment of a number of conditions that are discussed in section 3.

#### The Agricultural Sector

40. Agriculture has historically been a private sector activity with government support in terms of extensive services. Prior to 1967, agriculture accounted for over 35 percent of GDP, over 40 percent of employment, and more than half of exports; since then the relative importance of the sector has been fluctuating, with the share of GDP at 30 percent, share of employment at 26 percent, and share of exports at 20 percent in 1991. The agricultural sector has been seriously affected by the loss of some of its traditional markets, the high cost of regulation, and competition from Israeli products. Nonetheless, the sector is still viewed as playing an important role in absorbing surplus labor. Since the mid-1980s the agricultural sector has rebounded and has acted as an absorber of the surplus labor as work opportunities abroad have declined.

41. With the shifts in markets and advances in technology, many agricultural products of the OT can no longer compete in export markets and even in local markets in a more competitive environment. Most rain fed crops currently cannot compete in world markets; while technological improvements could be made, product competitiveness in markets other than local ones is likely to remain limited. However, some vegetables and fruits are grown competitively for external markets. Future sector performance will depend on the restructuring of production patterns to reflect market conditions.

42. The future contribution of agriculture to the economic development is uncertain. Key determining factors include future demand for agricultural products in the OT, future trade relations, and the competitiveness of OT production in local and foreign markets. Ultimately, water is likely to be the

key binding constraint, suggesting a relatively modest long term outlook for the potential of the sector. In the future the dualistic character of the agricultural sector will become more pronounced. One part of the sector may further evolve into a capital and knowledge intensive production system, focussed on external and local markets, economically and technologically highly efficient. The more traditional part of the sector would also improve its technology and efficiency, but would operate on a smaller scale, and be more labor intensive. While competitive in the local market, its products may not be able to compete in world markets. Absolute water shortages in the future may result in the countryside being managed as a catchment area for predominantly urban water users, in which rain fed agriculture may play an environmental as well as productive role.

43. The guiding principle in agriculture, as in the rest of the economy, should be that production should take place only if farmers in the OT can grow and sell crops competitively. The sector is particularly important for its considerable employment creation in the past; the agricultural sector needs to avoid abrupt shocks which would cause rapid declines in employment. Growth potential has to be seen in the context of resource and market constraints. Specifically, the following aspects should be considered:

- Access to markets should be improved.
- The efficiency and competitiveness of those parts of the sector with competitive potential in local and foreign market should be restored or enhanced. Improving the supply side would require creating a policy framework conducive to growth, reducing the constraining impact of the regulatory environment, improving access to natural resources and strengthening sector support services.

44. Although demand in the local market may grow due to population and income growth, improved access to external markets and improved trade relationships are critical for agriculture in the OT. Without external trade the sector would have to shrink considerably from current levels. To maintain or expand current sector production levels and to give the sector time for structural adjustment, farmers need immediate access to markets in which there is already a relative competitive edge, and in which they could sell considerable quantities of products. The market that would offer immediate and sizable opportunities for the export of OT products at present is the Israeli market. Introduction of reciprocal trading arrangements for agricultural products between Israel and the OT may replace the current irregular transfers of agricultural products, or more fundamentally, becoming part of future trading arrangements which could govern mutual access to a broad range of agricultural and other products. Shifting external economic relations to interdependence with a range of economies is also clearly desirable for sustainable development. While the competitive edge of OT products in Arab markets at present appears more modest, the OT should similarly attempt to develop reciprocal trading arrangements with selected Arab countries, especially Jordan.

45. The OT needs improved governance or, specifically, a realistic agricultural policy; an effective public sector institution; selected public support services and infrastructure, like an export control and food safety service; a service to facilitate the transfer and generation of agricultural knowledge; and infrastructure to facilitate improved local and export marketing, like wholesale markets. Such a policy should, eventually, cover those aspects of agricultural operations which cannot be performed well by the private sector, or for which public regulation is essential. However, priority may be given to determining the future role of the public institutions, in terms of providing sector support



services, market information, quality and product safety regulations, trade and tariff policies for inputs and outputs and strategies to enhance sector competitiveness.

46. The private sector in the OT is dynamic and capable, and public sector resources, financial as well as administrative, are likely to be scarce, at least for some time to come, suggesting a private sector involvement in what traditionally are public sector activities, like agricultural extension, education and research.

47. Enhancing the potential of the sector requires the creation of a legal and regulatory environment that supports private sector initiative. Improving competitiveness through the removal of the most constraining regulations and practices, particularly regulations restricting movement of products and people within the OT and across borders, the perceived insecurity of property rights and access to water and land should have high priority and would result in tangible increases in improved production and reductions in costs.

### The Construction and Housing Sector

48. Since 1980, between 10 - 11 percent of Palestinians working in the OT have been engaged in the construction industry. Construction contributes significantly to the economy, accounting for just over 18 percent of GDP in 1990. Compared to economies in a similar stage of development, the OT have a much higher proportion of investment in housing and a much lower proportion of investment in industry. There are many factors that contribute to this high level of investment in construction activity, not the least of which is the poor climate for investment in industry and other productive sectors.

49. The urban housing industry is characterized by strong demand and restrictive supply resulting in high relative prices for new dwellings - median new house price to median income is a multiple of 7 to 8 times annual income, a level that is at the upper end of the range for market economies. While the housing output per thousand population is similar to those in comparable economies, the ratio of investment in private building and construction (only a small portion of which is commercial production) for the OT is about three times more - 20.3 percent versus 7.35 percent of GDP for similar economies. A disproportionate share of economic resources are being used for housing in the OT.

50. High prices are the result of distortions in the input market for housing and land. Many building materials are imported from Israel where many items are priced well above levels in neighboring countries. The restrictive regulatory environment results in approvals for permits taking as long as 18 months. Overall supply of urban land has not increased because municipal boundaries have not expanded significantly since 1967 despite an almost doubling of population, although there are indications that certain boundaries will be expanded in the near future. Restrictions make it virtually impossible to build outside municipal boundaries despite the existence of buildable land. Finally, the lack of fully documented titles and an efficient and complete registration system have further reduced land supply.

### The Tourism Sector

51. The tourism industry is a potentially significant growth industry in the OT, drawing on a long tradition and substantial expertise in catering to the pilgrim traffic to both the Christian and Islamic religious shrines. The industry is mainly based in East Jerusalem, since the most important religious sites

are found in this part of the city. Mission estimates of demand for tourism range between 500,000 and 1 million tourists on an annual basis, which is adequate to maintain a viable tourism industry.

52. Despite the fact that the market size is sufficient to allow both the Israeli and Palestinian tourism industries to flourish, significant disparities exist in the size of the two industries. Between 1967 and 1992, the number of travel agents in the Palestinian industry has declined from 47 to 36, while the number of Israeli travel agents has grown from 35 to 436. Similarly, the number of Palestinian tour guides has declined from 206 to 70 during the same period, while the number of Israeli guides has grown from virtually zero to 4,300. There are currently around 1,100 Israeli operated tour buses, while only 108 buses are run by Palestinian tour operators. The hotel industry also exhibits a similar trend - between 1967 and 1992, the total capacity of Palestinian hotels has remained stagnant at around 2,000 rooms, while the total capacity of Israeli hotels increased six-fold, from around 5,000 rooms to over 31,000 rooms.

53. There are several reasons for the relative stagnation of the Palestinian tourism industry, despite the experience and skill endowments of Palestinian entrepreneurs. Physical facilities are in poor condition in East Jerusalem and other sites. Neighborhoods have an impoverished look, and are unlikely to serve as tourist attractions in their present condition, given the high visibility of military security posts in the immediate vicinity. Perhaps more so than other industries, the negative impact of the regulatory system has crippled the tourism industry. For example, certification of tour guides involves passing competency exams written in Hebrew. Although a few aspirants did take these exams, it appears that no new Palestinian guides have been certified during a 25 year period. As a way around this barrier, some potential guides are seeking training in theology, since "spiritual leaders" have in recent years formed a new entrant to the guide business at the religious shrines.

54. Stringent licensing requirements for travel agents, including the posting of high security bonds, have effectively barred new entrants while some erstwhile operators have exited through bankruptcy. Palestinian tour operators and travel agencies operate under restrictive conditions. They are denied access to airport facilitators who could receive visitors on their behalf (since airport security prohibits them from meeting arriving flights). Since they have no access to state-sponsored marketing and promotion, and do not merit attention equal to Israeli tour operators in dealing with the national carrier, Palestinian operators have to depend on word-of-mouth referrals among European and US Church groups.

55. The Palestinian hotel industry is cost competitive but is in need of considerable renovation. The administration of the licensing regulations have effectively deterred both entry and expansion in East Jerusalem. Hoteliers have had to contend with both high Arnona (property tax) claims and differential treatment compared to Israeli establishments. Given the stagnating condition of Palestinian hotels, many Palestinian workers with excellent skills now form a large percentage (as high as 40 percent according to Palestinian reports) of the Israeli hotel industry.

56. The natural segmentation of the market into religious and recreational tourism creates a situation where both Palestinian and Israeli tourism industries are in a position to utilize their own competitive strengths without diminishing the other's opportunities. The two segments may overlap but are sufficiently distinct to enable each side to prosper on its own. So long as Palestinian tour operators are permitted access to Jerusalem, the administrative barriers to entry and expansion of hotels are eliminated, Jordanian re-entry regulations are relaxed, new Palestinian tour guides are once again given

certification, and some modest support is available for renovation of physical locations and assets and training of personnel, Palestinian tourism could become a significant industry in the OT.

### Social Services

57. Many services of a social nature that in many countries are in the public sector are in the OT provided by the private sector. While this situation provides the basis for efficient service provision, an effective institutional framework is required to ensure quality. Because many of these services have aspects of a public good nature, public sector involvement is necessary. The lack of public administration capacity in the OT prevents the development of an effective institutional framework.

58. It has been estimated that at least half of the health services in the OT are provided directly by or contracted through the private sector. The increased commitment to primary health care and the need for private Palestinian health providers to assume responsibility for emergency services in the absence of public sector provision have played a key role in the expansion of private services. That the industry is mainly in the private sector provides a strong basis for establishing an institutional framework and organization that maximizes cost effectiveness and efficiency.

59. Education at the post secondary level is operated by the private sector; all eight universities are private. Virtually all short term training provided to individuals and institutions is private. Most private education is heavily subsidized by donors, although increasingly universities and private training institutions are expanding their capacity to offer fee-for-service short term training to the private sector, and many educational institutions at other levels are exploring mechanisms to reduce dependency on external donors.

### Supporting Services

60. The transport industry is completely in the hands of the private operators and consists mainly of passenger bus companies, shared taxis, and trucking operations. Many of the operations are small, one unit businesses, suffering from an aging fleet and a precarious financial condition. The freight industry is not organized and lacks modern terminal facilities, particularly refrigerated storage for agricultural products. The controls and regulations imposed on the industry, coupled by lack of credit facilities and high cost of spare parts, have put many of them under financial duress; in recent years, several enterprises have left the industry creating a vacuum, particularly in passenger services.

61. Marketing and distribution services have not developed to support private sector activities. Most of the operations are small retail shops and distributors covering very limited geographical areas (a town or village). Export marketing capacity is almost nonexistent, and imports are typically done through Israeli distributors and agents. This undeveloped state of marketing and distribution services has resulted in market fragmentation, lack of access to technology, and poor diffusion of information.

62. Accounting and auditing professions have not developed such that currently, there are only a few fully accredited professionals in the West Bank, the rest being allowed to practice on the basis of minimal one year training. Accounting and auditing standards are yet to be modernized to provide relevant, timely, and accurate information to investors, managers, financial institutions, regulators, and tax administrators. The organization and regulatory framework (including licensing and supervision) for the professions would have to be worked out in order for these services to be provided in an effective manner.



### III. Prerequisites for Private Sector Development

#### Introduction

63. Future economic growth in the OT will depend on the performance of the private sector which has exhibited initiative, innovation, and resourcefulness under adverse conditions. Unleashing this private sector potential and attracting private investment require the establishment of certain prerequisites. Meaningful investment in the OT is unlikely without a fundamental alteration of risk perceptions and an improvement in the property rights regime. Recent closures of the West Bank and Gaza only confirm negative risk perceptions. Significant progress in the peace talks is a necessary condition for sustained private investment in the OT.

64. The challenge for the transition is substantial, early progress toward a legal framework that gives private investors the confidence to go forward. Such a framework would need to establish publicly accessible and relatively stable rules for the authoritative allocation of resources and property rights and a belief by the population that the rules will be enforced fairly and consistently over time. This should provide the basis for developing a set of measures that would provide the potential private investor with a supportive business environment. Obviously, the ideal will not be achieved overnight. However, substantial progress is needed for a private investor to take risk. This involves the restructuring of the governance system.

#### Restructuring the Governance System

65. Private sector development requires as a critical condition the transformation – in the context of the peace process – of the existing governance system to one which is widely accepted by the population to be legitimate and supportive. This implies a system that protects property rights, defines a fair mechanism for economic exchange, and establishes acceptable and enforceable means of adjudicating disputes. Reforming the current system will involve a complex process of disengagement, restructuring and institution building. First steps in the reform would be to address two principal obstacles to the establishment of an effective governance system. One, there should be clarity and transparency in the definition of security, limits on actions that can be taken by particular authorities based on security, and recourse for those damaged by breach of those limits. Two, while the private sector should take the lead in production and commerce, public institutions are required to set rules facilitating property rights and economic development, enforce the rules and provide services for the maintenance of civil life. These institutions, to be effective, must have credibility and be accountable for meeting the needs of the population that they serve. As part of the peace process, crafting such a structure for the OT will require careful design of principles and procedures to impart credibility and substance to the new administration.

66. Once issues discussed above are resolved, significant assistance would be required in institution building. Management training, information systems, accounting, budget and tax skills would all have to be developed rapidly. External assistance could play a significant role.

#### Rebuilding the Legal System

67. Assuming some progress toward resolution of the issues discussed above, priority attention should be focused on the modernization and harmonization of the legal framework for business

activities and property rights disposition. A comprehensive diagnostic study should be undertaken to survey existing legislation and implementing procedures and practices. This survey would form the basis for recommendations to the appropriate authority as to (a) the body of local law agreed to be applicable at a particular time and (b) reforms, changes, amendments and procedures for harmonization between the West Bank and Gaza. While the universe of legislation to be reviewed is broad, it should include all laws, Military Orders and related secondary legislation affecting the definition, registration, transfer or hypothecation of real and personal property; civil, commercial and companies codes, including bankruptcy; banking, insurance and financial laws; tax codes; investment and competition.

68. Two areas of law, tax and town planning, have been at the center of past contention and now offer the opportunity of reform and the building of confidence measures between the parties. The business legislation, commercial and civil codes require a complete review. Given time and resources, the OT would benefit significantly from complete redrafts. The company procedures are cumbersome, time consuming and overly bureaucratic. The number of corporate forms should be increased and greater flexibility offered in classification of shares and management arrangements. Modern corporate models include The Netherlands Companies Code, recent revisions to the Jordanian, United Arab Emirates and Egyptian codes and models being considered for the new Central Asian states.

69. The OT would benefit from a well organized, technically modern commercial, e.g. companies and securities, registration system. Such a system is generally familiar in the region and affords a source of much needed information for both the general public as well as the business community.

70. Finally, the local courts need substantial restructuring to inject confidence into a revitalized private sector. Training, including substantial technical assistance could begin immediately. Enforcement measures must be undertaken by the municipal and other authorities.

#### IV. Other Measures to Support PSD

71. There are other measures that would support private sector development in the OT. For many of these measures, actions could be undertaken even under the existing political and security situation. However, maximum effectiveness could be achieved if these measures are undertaken in conjunction with the establishment of the prerequisites discussed above.

##### Improving Access to Markets

72. The Jordanian and Arab markets are traditionally, culturally, and geographically important to the OT. Prior to the occupation, Jordan (East Bank) was the major trading partner, accounting for about 45 percent of exports of the West Bank, 80 percent of which were in agricultural goods. The Arab boycott and the regulatory and security restrictions on trade with Jordan have impeded access to Jordanian and other Arab markets. Two major structural shifts have occurred: one, the ascendancy of Israel as the major trading partner (both imports and exports) of the OT; and two, the dominant share of industrial products in OT exports. Because OT exports to Israel have been mainly in industrial products not produced and exported to traditional markets, improving market access to Jordan and other Arab countries should provide opportunities that would result in trade creation, rather than trade diversion. The proximity of neighboring countries should also provide opportunities for the OT service sector, especially construction and repair work. The improved access to markets combined with upgrading of

OT capability could make OT services (as opposed to simple provision of workers) competitive in regional markets. Thus, the lifting of the Arab boycott and the elimination of many of the restrictive procedures related to trade should result in greater export opportunities for the OT.

73. For the agricultural sector, the problem with traditional markets has been less an issue of access (agriculture is typically exempt from the boycott) but more of loss of competitiveness as other countries, such as Jordan, improved its agricultural productivity. However, certain OT agricultural products are competitive in the Israeli market, and are in fact being exported through informal channels. The opening of Israeli agricultural markets to OT goods would have significant positive impact on OT agriculture, especially in the Gaza area, by both increasing production and eliminating rents from illegal trade.

74. Maintaining continued access to the Israeli, EC and US markets will have major implications for the economy, particularly in the transitional period. The ambiguity as to whether the OT will continue to be eligible for special trade concessions from the EC and the US after a political settlement is achieved must be resolved as rapidly as possible.

75. Access by Palestinian tourist operators to Jerusalem would accelerate the development of the OT tourist industry. Ease of movement of people across borders, including the relaxation of Jordanian restrictions, would promote tourism activity in the region.

#### Restructuring the Regulatory Regime

76. The regulatory regime generates increased costs of operations, imposes barriers to entry, and distorts allocation of resources. As important, the lack of transparency of the regulations and the discretionary manner in which these are imposed create an unstable environment which deters investment in either expansion or new projects, thus also impeding modernization of technology.

77. Despite some relaxation of business licensing policy in the past 18 months, most businesses reported continued difficulty in obtaining licenses. Some entrepreneurs in the past have waited as long as 10 years without receiving approval to commence operations, with the average wait, according to Palestinian businessmen, reportedly at 6 years. Recently, the average wait, according to Palestinian businessmen, has improved to 6 months. While the CA authorities state that the approval process is mechanical, Palestinian businessmen claim that the process remains too discretionary, and that not all proposed projects are being approved. Forms are usually to be filled in Hebrew, requiring the entrepreneur to sit in the office of the CA local headquarters and plead the case before an official who will actually "fill out" the form.

78. With respect to external trade, Palestinian businessmen claim that several forms and certifications are required to obtain an annual import/export certificate. The procedure could take as little as one week or be delayed by several weeks. In addition, individual import licenses are required on a per transaction basis for imports from nations without formal trading relations with Israel and for "sensitive commodities" which include processed foods, agricultural inputs, and textiles. Licenses were often denied on the grounds of "the manufacturing situation in Israel," although this may be a situation that is also faced by Israeli importers. The recent trade liberalization in Israel has replaced quotas with tariffs; currently, about 26 percent of product categories require licenses. Testing for compliance with Israeli product standards is required for 35 percent of product categories, and can be a source of trade restriction.



79. The clearing of goods through the ports and the transportation of goods over land bridges to Jordan are often expensive and time-consuming. As many as four kinds of checks, including product testing, may be required for imported goods, and since the size of each shipment of Palestinian imports tends to be small, the unit cost impact is relatively large. There is also the risk of damage and pilferage while goods are waiting the security clearances. This has led many OT businessmen to use Israeli agents for imports.

80. Exporting by road to and through Jordan is subjected to extensive security checks. Lorries that pass over the bridges to Jordan have to be in stripped down condition. Both the exporter and the driver need to obtain several approvals (mainly relating to taxation and police "good conduct" compliances). Clearances regarding income tax and the VAT are essential. Trucks crossing into Jordan often wait days in Jericho before they are able to cross the bridges, which creates problems, especially for produce for export to countries beyond Jordan. Vehicles crossing into Jordan must return that same day or be impounded on their way back into the OT. The vehicles are released only after an inspection, for which the driver must bring a mechanic to take apart the vehicle as requested by the Israeli inspector. It should be noted that regulations that effect exports to Jordan originate from both Jordan and Israel.

81. Various security measures restricting movement exercise a significant constraint on economic development. These include the issuance of permits for movement of people and vehicles, the imposition of curfews, restrictions on travel abroad, and the recent border closures. Strikes and demonstrations by the Palestinians have also acted to inhibit development.

82. Much of the restructuring of the regulatory regime could be started even prior to the peace agreement. Regulations could be made transparent by publishing and circulating them. Trading arrangements could be made more cost effective by allowing entry of modern transport vehicles to ply the OT Jordan route, which may require an agreement with the Jordanian government. Security checks at the bridges to Jordan could be streamlined, such as by utilizing conveyor systems to transport goods across the bridges, and various clearances could be eliminated. The impact would be reduction in costs of doing business. With respect to various other security measures that affect the movement of people, the establishment of peace should alleviate the need for many of these.

#### Restructuring the Tax System

83. The main taxes imposed on Palestinians in the West Bank and Gaza are income tax and value added tax. Commencing in the late 1970s, several key changes occurred in the CA's income tax administration which led to considerable tension which continues. First, the time given to a taxpayer to pay upon assessment, appeal or determination of appeal was reduced by half or more. Second, under pre-existing law, income tax other than that deducted at the source was assessed annually and in arrears. In 1978 such assessments were made monthly and based on the income tax assessed the previous year or based on the tax assessor's view of what that tax could or should have been paid irrespective of the current year's actual income.

84. A continuing source of complaints is the CA's "best judgment" method of tax assessment. For both the VAT and income tax, a taxpayer is obliged to keep books of account in accordance with the detailed regulations. When this taxpayer fails to keep such books, the CA tax assessor may refuse to accept the taxpayer's tax return and treat the taxpayer as having not filed. In that event, the assessor may determine the tax due on a "best judgment" basis. The CA tax assessors point out that "best judgment" is the method that also applies in Israel and is not arbitrary but controlled by guidelines. However, there

are no guidelines developed specifically for the OT. The tax assessors use guidelines provided by the Israeli Income Tax Commissioner based on models developed for the higher income Israeli economy. Once the assessor has made a "best judgment" assessment, the taxpayer has the burden of proof in the Objections Committees that the amount is incorrect. There is no appeal of the Committee's decision. The best judgment assessment typically includes fines, interest and penalties.

85. Consequences of failure to keep books according to the CA's standards and to pay taxes are severe. The CA Inspectors have the right to impose fines for a range of offenses. Late payment is punishable with a fine of 0.4 percent of the value due every week until paid. Further penalties are added for failure to pay fines or for a violation of more than 15 other matters listed in amendments to MO 1263(1988). In addition, the tax assessor may temporarily confiscate a taxpayer's property, including property in the hands of a third party, for non-payment of taxes, fines, penalties, without a requirement for any court order or higher administrative review. Finally, under MO 1262(1988) 23 different CA services or licenses are "contingent on the production of evidence which in the opinion of the official, indicates that the applicant has done everything required of him, by all tax laws, and has paid all the tax which he owes at that date." However, this MO has not been applied in the West Bank for over a year and is applied in Gaza only for licenses to work in Israel.

86. Over the course of the Intifada, the tax enforcement methods employed by the CA have included night time raids, roadblocks, conditioning of services on payment of third party arrears, confiscation of identity cards, attachment and sales of inventory, business equipment and capital machinery. The result is significant damage to existing business and a disincentive to new investment. The tax regime in the OT has placed significant burdens on a population which does not accept the current taxation system as legitimate and which in most cases is not prepared for the imposition of sophisticated bookkeeping rules on small, family-owned businesses.

87. In 1991, in conjunction with several liberalizing measures, the CA acted to simplify the tax regime and provide incentives for investments in Palestinian areas. The 1991 reforms reduced the number of tax brackets from 11 to 5, reduced the upper tax bracket of 55 percent to 48 percent and made minor changes in deduction rates.

88. The investment reform measures basically provide a tax holiday to an "approved enterprise" for income from an "approved investment" (in both cases as approved by the CA's new Investment Center). The tax holiday is for three years from the tax year in which the enterprise had chargeable income, as determined by the Director of the Investment Authority appointed by the Head of the CA. The provisions grant the Director broad discretion in maintaining and revoking the approval status of an enterprise or an investment for noncompliance of conditions. The MO (Article 29) also grants the Director or his designee, the right to receive, on demand, all documentation and evidence relevant to the implementation of the MO. The MO also permits the Director broad discretion to cancel the holiday and assess all the taxes, fees and duties up to an amount that would have been paid if no holiday had been given, either with interest in arrears or by an addition of 25 percent whichever is greater. Several OT private firms said the new investment incentive is not attractive because it grants too much discretion, particularly for retroactive assessment, to the Director who answers to the Head of the CA. The reform measures are on their face encouraging but their impact is limited by the perception of unpredictability. More important, the investment reform measures do not address the fundamental sources of perceived high risk.

89. From the viewpoint of the private sector, there are a number of areas of tax reform that need attention. First, the current rates for personal income taxes, despite recent reductions, are still higher than in Israel or Jordan. This requires a review of the existing structure and rates of taxation in relation to its fiscal objectives and incentive effects. Second, the administration of the tax system needs a complete overhaul. This includes the establishment of transparent rules and enforcement capability for tax assessments and advance payments of income taxes, the creation of a credible and efficient institutional mechanism for settlement of tax disputes, and possibly simplification of procedures and forms for small business. The role of the accounting and auditing professionals should also be defined. Third, the credibility of the taxation system is to a certain extent dependent on perceptions on the benefits from taxes and efficiency with which public funds are utilized. Recent publication of the OT budget by the CA is a step in the right direction in this regard. Even prior to a peace agreement, reform of tax administration could be implemented. In the longer term, the tax system should be reviewed including the development of tax administration capacity.

#### Restructuring Land Use Policies

90. The high cost of industrial space for Palestinians puts economic development in the OT at a severe disadvantage. In both Hebron and Nablus, there is need for expanded industrial space. Much of the industry is currently crowded within residential areas, often with housing built over one or two shop floors. In Nablus, an industrial zone has been approved by the SPC and funds allocated. In both Gaza and the West Bank, since the development is to take place within the existing municipal boundaries on private plots (Palestinian development on any land other than private registered land, i.e., state land is not permitted), the cost of the land in the zone is \$150,000 per dunam (Gaza) which is discouraging to new business and not sufficient incentive for much existing small industry to relocate.

91. The planning process has severely constrained residential and commercial real estate markets. Owners of cultivated land and land for which no deed was issued prior to 1967 are unable to transfer or divide land legally (or pledge it or transfer it by inheritance) since the CA authorities require proof of a deed to effect the transfer. Since the land settlement process, especially in the West Bank, was only partly completed by 1967 and then suspended by the AC, a significant amount of land is still unregistered, about 60 percent in the West Bank and 30 percent in Gaza. Many Palestinians cannot obtain deeds and thus cannot legally subdivide or present a parcellation plan. In practice, Palestinians rarely try to subdivide their land fearing the AC will challenge their title and confiscate their land. The result is that in case of death or where children subdivide a parent's land, the new owners' ownership rights are ambiguous at best. They cannot get a valid building permit. The choice is to stay in multiple use, overcrowded buildings or build without a permit. Faced with such dilemmas, many just go ahead and build anyway. But they face dire consequences - demolition of their building (whether home or business or often both) if the authorities learn of the unauthorized building and choose to order it demolished.

92. Subdivisions have been halted even where deeds are available. Within municipalities, the local councils have the right to develop parcellation plans to facilitate subdivision. These plans cannot be executed without approval of the CA Central Planning Department (CPD). However, in mid-1988, the CPD stopped its approval of any parcellation plan until the applicant submitted further detailed plans, none of which the CPD had approved as of February 1, 1993. The result, in several large towns (Ramallah and Hebron), there has been complete cessation of legal development.



93. Other land use restrictions are considerable and include requirements for permits to plant trees or certain crops. As with all requirements for permits, the process is complex and discretion is left to the CA employees. There are no mechanisms for forcing a decision and frequently the process drags on for years.

94. Some steps could be taken to improve the situation, including: (a) reactivation of the land registration system; and (b) establishment of an acceptable dispute resolution mechanism. The resolution of the issue of land settlement and state land is part of the peace process.

#### Developing the Financial Sector

95. The development of the financial system in the OT requires significant reform in several areas. The objectives of financial reform are to encourage entry, promote competition, establish a level playing field, instill confidence in the financial system, and improve financial intermediation. Necessarily, perceptions of risk and progress in the peace process play a critical role in determining the nature and speed of development of the sector.

96. The major area of reform is the replacement of the existing patchwork of banking laws and regulations that are unevenly applied depending on whether the bank is Israeli or Arab, and whether the Arab bank is in the West Bank or Gaza. The direction of reform should be the establishment of a unified set of consistent laws and regulations that would be uniformly applied to all banks in the OT. Current framework under discussion would eliminate some of the distortions but would not achieve the objective of uniformity.

97. Liberalization of entry -- both new institutions and expansion of existing ones -- would accelerate development of the financial system. The current negotiations between BOI and CBJ are expected to authorize the reopening of all banks that were operating in the West Bank in 1967, and as many as four Jordanian banks are expected to open immediately, thus introducing competition. To further encourage broader access to financial services, existing banks should be permitted to open new branches in all parts of the OT. Currently, CBJ does not allow Jordanian banks to operate in Gaza.

98. The utilization of credit will not expand until a mechanism is found to enhance the value of existing, but unused, collateral. One measure would be to introduce the use of chattel mortgages on movable property, such as equipment and working capital. While this is common practice among Israeli banks, the Mortgage Law in Jordan apparently prohibits the acceptance of movable assets as collateral by Jordanian banks without physical possession, for which the procedures are not yet fully developed. Moving now toward greater similarity in collateral practices between Arab and Israeli banks would place Arab banks in a more competitive future position.

99. Another significant step would be a mechanism to tap the single greatest store of personal wealth in the OT, real property. Throughout the Middle East, land and housing are the most commonly used forms of collateral to secure credit. Even though Arab-owned banks are now operational, Palestinians have been unwilling to pledge land and buildings as collateral, out of fear that the property will fall in Israeli hands. This attitude seems unlikely to change, even with the reopening of Jordanian banks, so long as the OT are under military occupation. While various mechanisms could be established to create a trustee/custodian that is less likely to be under Israeli control, the basic problem is the uncertain property rights regime and lack of credible process of adjudication.

100. Given the current weaknesses in the banking system and the need for institutional capability to mobilize funds for longer term lending, the establishment of an investment bank could provide a mechanism for financing investment projects. The investment bank should be well structured and strongly capitalized, and should have the necessary skills for risk assessment. This would require significant technical assistance and possibly links with similar institutions elsewhere. The bank should be owned and controlled by the private sector, and would benefit from foreign participation.

101. For the past six to seven years, the credit institutions established by Palestinian and external donor agencies have provided funding for a broad spectrum of economically viable projects, needy people and disadvantaged groups within Palestinian society. The generally poor loan recovery experience of the past few years has caused some of these institutions to re-examine their approach to the management of their business. Some have contracted with the Cairo-Amman Bank and the Bank of Palestine to handle loan administration. However, the interest rates charged are still subsidized, and, while there are political objectives to these programs, this subsidized lending might have a negative impact on credit discipline in the OT economy, even though the programs are small in aggregate.

102. Significant institution building efforts would be required for the development of the financial system. While the design of the legal and regulatory framework would depend on the result of the peace agreement, several steps could be undertaken immediately to review the design options and to start training regulators. Existing Arab banks would benefit from technical assistance in the form of skills development in areas such as risk management and bank operations, and technology upgrade to enable banks to provide responsive service at competitive costs.

#### Upgrading Physical Infrastructure

103. The quality of the physical infrastructure – electrical power, telecommunications, and road network – is fundamental to unlocking private sector potential. Efficiency is enhanced and markets work better with a higher level of infrastructure services. Upgrading the currently deteriorating state of physical infrastructure in the OT should therefore receive priority attention.

104. While the investment requirements for enhancing infrastructure services can be easily identified, an effective institutional framework is difficult to design and implement in the context of the current governance system in the OT, which is widely perceived by the Palestinian population to lack accountability to its needs – ultimately, it is the CA that makes the final decisions on infrastructure plans, financing, and regulations. The local governments that deliver most of the current infrastructure services suffer from limited control over resources and investment decisions, and poor management. However, even in the best of circumstances, local governments are an inefficient delivery mechanism for managing public utilities. While commercialization through the creation of separate organization forms would provide a basis for autonomy and accountability, ownership and control by the public sector would not provide the most effective mechanism for achieving commercial and efficiency objectives.

105. Privatization of the utilities should be the instrument for achieving the objective of enhancing efficiency in telecommunications and electric power services. This would necessarily require an effective regulatory framework, the characteristics of which are described in the Infrastructure Report. However, because of large investment requirements that would take several years to recover, the establishment of prerequisite conditions is necessary to attract private sector investment. While short term measures could be undertaken to improve current performance of public utilities, fundamental reform could occur only under conditions of peace and credible governance, which would make possible the



development of an institutional arrangement where private ownership and control of public utilities operate under an effective regulatory framework in providing efficient services to the population.

#### Improving Human Resource Base

106. Despite the relatively high level of educational attainment of the Palestinian population, there is a need to ensure that the human resource base keeps pace with the changing market. There are signs of paucity of skilled technical personnel, despite relatively high levels of unemployment. Increased investment in productive activities requires a supply of trained and trainable work force and managers. Reorienting the economy needs a parallel restructuring of the educational and vocational system.

107. The educational system in the OT is organized according to the Egyptian model in Gaza and the Jordanian model in the West Bank with different objectives and separate examinations. The CA supervises all primary and secondary educational institutions. Services are provided by the CA, UNRWA, and a small number of private organizations. The strong commitment to education by the Palestinians is reflected in the very high enrollment ratio in primary schools.

108. Vocational education and technical training are provided by the CA and UNRWA. After 1967, Israel established vocational training centers to prepare workers for employment in the Israeli economy. The CA determines the curriculum of vocational and technical schools, including those run by UNRWA and private organizations. Courses in areas which may pose security risk, such as communications, are prohibited. Employers have not been involved in setting training policy. Vocational and technical schools are seriously under funded, and face restrictions on importations of equipment. As a consequence, facilities are inadequate and equipment is often obsolete.

109. The 8 universities in the OT – 6 in the West Bank and 2 in Gaza – which were opened after 1967 were completely closed from the beginning of Intifada until 1992 due to security concerns. Universities are established with private funding, and are under the supervision of the Council of Higher Education, which is composed of representatives of the colleges and universities and elected leaders from the education sector. There are 20 community and teachers' training colleges in the West Bank and 1 in Gaza. Because of difficulty of access caused by problems with passes and travel permits for both faculty and students, there has emerged considerable duplication among universities of courses and departments. Because of lengthy closures during the Intifada, many universities now face serious funding problems. Several have been unable to pay faculty salaries for several months at a time, and as a result have had to cope with faculty strikes. Libraries, laboratories, and computer facilities are seriously deficient. Textbooks and educational materials are in short supply.

110. Certain fundamental reforms in the educational system are needed. It is imperative that the curricula be examined. The qualifications of educational personnel in almost all positions need to be strengthened. In addition, facilities have to be rehabilitated and upgraded. The current official practice of limiting access to library materials and censoring textbooks should be reviewed. The present policy of not granting permits to build, extend and update school premises for private institutions and UNRWA centers should be relaxed. The institutional framework for the educational system could be developed by building on the current private sector involvement in the sector.

111. To meet changing conditions in the job market, the vocational education system should be developed towards providing relevant courses and programs, whose design should involve specialists and prospective employers. Community colleges should upgrade and recruit staff to provide more

specialized and technically advanced education. Greater stress should be placed on the development of mid-level technicians to bridge the gap between craftsmen and highly specialized engineers.

## V. Prospects for the Future

112. In developing a strategy for future development, the OT can take advantage of three major advantages. First, the private sector has a long history of entrepreneurship under difficult conditions, and given the right environment should be able to respond to market signals and compete in world markets. Second, the stock of human capital is still considered to be of high quality relative to the region. Third, there are substantial financial resources in the diaspora that could be tapped given the right conditions.

113. For increased and sustained private investment in the OT, fundamental risk perceptions linked to the occupation should be changed. This could occur only in the context of significant progress in the peace process which should result in the evolution of a credible and supportive governance system. However, the achievement of peace and restructuring of governance would have to be accompanied by measures that would support private sector development in a manner that maximizes use of scarce resources. These are summarized in the matrix below.

114. There are several reform measures that could be implemented even before the components of the peace agreement are known and are not dependent on the outcome of the peace process. The licensing processes could be further streamlined, certain tax practices inimical to business development could be reformed access to foreign markets could be improved, entry of Arab financial institutions could be liberalized, and certain regulations relaxed. Several short term measures could also be implemented in upgrading the physical infrastructure and improving the delivery of training and education. These measures should result in an immediate supply response through increases in capacity utilization and greater efficiency of operations.

115. For the medium and long term, the major challenge would be the building of institutions that would support private sector development. Actions could be undertaken immediately to start the process of institution building, including design and organization studies and possibly training. Some suggestions for technical assistance programs are:

- Modernization and Harmonization of Legal System (\$0.5 million). The current legal system has its roots in the pre-1967 laws. Jordanian law, for example, has moved forward since then to support a private sector oriented economy. Modernizing laws and harmonizing those of West Bank and Gaza would provide the private sector with a sounder legal basis to do commercial transactions.
- Development of Public Administration Capacity (\$3.0 million). The structure of a new administrative entity would have to be developed and capacity established. The 20,000 plus Palestinians now working in the CA would provide the nucleus for such an entity. Among others, important to the private sector would be the design of systems of tax administration, customs administration, judicial system and land registration offices. This includes the establishment of an information base for use by investors and lenders. Furthermore, training programs would have to be developed and implemented for public administrators.

- Regulatory Framework (\$0.5 million). Regulations would be necessary in the following areas, the design of which requires careful study: banking and insurance system, securities markets, professions, and health and safety.
- Financial System (\$1.0 million). The development of financial infrastructure would require studies in the following areas: payments and clearing system, accounting and auditing systems, supervision capacity, training and technology.

# Schematic for Accelerating Private Sector Development in the Occupied Territories

Policy Reform	Actions	
	Short-term	Medium-term
Regulatory Reform	Speed-up publishing all regulatory procedures in Arabic	Lift restrictions on movement of goods and people  Eliminate business license requirements
Ensure access to markets		Ensure continued free trade with EC and EFTA, and seek a preferential trade agreement with US  Establish symmetric trade relations with Israel in agriculture  Normalize trade relations with Arab countries and enhance trade relations with Jordan
Develop legal framework	Review all laws relating to commerce towards harmonization and modernization	Develop and implement market-friendly commercial laws
Develop financial system	Eliminate barriers to entry and expansion  Establish payment clearing system  Develop chattel mortgage	Establish independent regulatory authority  Create an enabling legal framework for financial system
Restructuring Land Use Policies	Reactivate the land registration system	Establish acceptable dispute resolution mechanism
Improving Human Resource Base	Revamp vocational training  Involve employers in the design of courses to a greater extent  Relax regulations on access to books and educational equipment	Strengthen qualification of teachers  Rehabilitate educational facilities

Policy Reform	Actions	
	Short-term	Medium-term
Upgrading Physical Infrastructure	<p>Immediate investments in improving roads, telecomm and electric power services</p> <p>Commercialize municipal utilities</p>	<p>Develop a regulatory framework for utilities</p> <p>Explore mechanisms for private provision of public services</p>
Reform Tax System	<p>Reform of income tax reporting and compliance provisions</p> <p>Transparency in determining tax liability</p> <p>Reform tax assessment practices with possible simplification for small business</p>	<p>Review taxation structure</p> <p>Establish tax administration capability</p>



## ANNEX I PRIVATE SECTOR ACTIVITIES

### Introduction

1.1 The private sector in the OT accounts for more than 85 percent of GDP and GFCF. Unlocking private sector potential is the key to future growth and development, and understanding the private sector should provide clues as to which conditions are necessary for its development. This annex describes the characteristics of the industrial and selected non-government service sectors, all of which are driven and dominated by private sector initiative. The structure, behavior and performance of these sectors are described and analyzed in the context of the environment and conditions in which the private sector operates. The agricultural, infrastructure and health and education sectors, which have significant private sector participation, are described in other companion reports.

### I. INDUSTRIAL SECTOR

#### Characteristics

#### Contribution to GDP

1.2 Compared to other economies with similar income levels and at the same stage of development, the share of industry to GDP in the OT has been consistently low. Over the past 25 years, the share of industry in GDP has not exceeded 10 percent, while the comparable figures in 1990 were 33 percent for Mauritius, 37 percent for Singapore, and 30 percent for Lesotho. The share of industry to GDP for low- to middle-income countries increased from 30 percent in 1965 to 37 percent in 1990, with the average for East Asian and Pacific countries reaching 45 percent. The growth patterns of relative contribution of industry to GDP in the OT were not consistent during the period, and there were differences between the West Bank and Gaza. During the first five years of the occupation, the share of industry in the OT in GDP increased, from 5.4 percent in 1968 to 6.9 percent in 1971. The case of Gaza was dramatic and more sustained, with industry share of GDP in Gaza increasing from 2.0 percent in 1967 to 5.4 percent in 1972 and peaking at 12.0 percent in 1978 as Gaza industry caught up with the rest of the OT during the integration of the economy with Israel. From 1980 to 1987, the share of industry in GDP for both the West Bank and Gaza was stable and, in fact, increased slightly, but after 1987, the share of industry in GDP dropped as plants operated at significantly lower capacity due to both the Intifada strikes and a more restrictive regulatory environment.

Table 1.1: Contribution of Industry to GDP  
(Percent)

YEAR	WEST BANK	GAZA	OT
1965/66	6.6	4.4	
1968	8.2	3.1	6.7
1969	8.7	4.0	7.4
1970	9.4	6.0	8.3
1975	8.0	10.1	8.0
1980	6.3	9.9	7.3
1985	7.7	9.1	8.1
1986	7.6	12.6	8.7
1987	7.6	13.9	9.2
1988	6.5	11.2	7.7
1989	6.0	11.5	7.5
1990	5.9	12.2	7.4

Source: Statistical Bulletin of Israel, various issues.  
World Development Report, various issues.

1.3 The licensing process partly explains the low contribution of the industrial sector to GDP, although licensing should be viewed in the context of the larger issue of uncertainty stemming from the geopolitical factors and lack of credibility in the governance system. Prior to 1991, many investors often did not bother to apply due to restrictive licensing procedures. The regulatory climate affected both expansion and new entry, resulting in the stunted growth of the sector. The regulatory and taxation system creates distortions in the entrepreneur's opportunity set, forming disincentives to investment, growth and modernization by imposing sustained and onerous restraints to the free flow of trade and investment; straining the day-to-day liquidity of operations; and aggravating a systemic paucity of capital. The majority of entrepreneurs clearly perceived severe restrictions under the regulatory system and in conjunction with the volatile security situation have developed a marked aversion to risking capital. It should be noted that over the past two years, efforts have been made by the CA to restructure the regulatory and taxation system, but it is too early to determine the impact of these initiatives.

1.4 The mission survey<sup>1</sup> of industrial sector showed low real growth rates since 1987. Between 1975 and 1985, assets and sales of the survey sample grew in constant dollar terms between 2.0 percent and 3.0 percent per year. Between 1987 and 1990, the industrial sector experienced zero or negative growth, nullifying earlier gains. In 1991 and 1992, a positive, though minimal, growth trend has re-emerged. Growth indices reported by entrepreneurs who participated in the survey are shown in Table 1.2.

Table 1.2: Entrepreneurs' Estimated Growth Trends  
(Index Numbers 1975=100)

	1975	1980	1985	1987	1990	1992	% per year
Market Demand	100	125	165	175	185	200	4.20
Total Assets	100	115	122	117	102	106	0.35
Sales Revenues	100	118	120	110	95	106	0.35
Profitability	100	125	150	85	75	102	0.13
Invested Capital	100	115	165	117	102	106	0.35
Training Expenses	100	111	124	82	91	100	0.00

Notes: Mean figures (rounded off) reflect constant dollars.

Standard deviations ranged from 5 to 25 percent.

Source: Mission Survey.

### Investment

1.5 Lack of investment has constrained sector growth in recent years. Based on the mission survey, invested capital, which is the major source of investment given the absence of debt financing, has grown by only 0.35 percent per year in real terms during the period 1975-1992, although it grew by 5.1 percent per year from 1975 to 1985. Subcontracting accounted for much of the growth during the 1975-85 period. Since 1987, there has been a reduction in both invested capital and assets resulting from a combination of factors that include Intifada strikes, curfews, entry barriers, a restrictive regulatory and taxation climate and nonexistent financial intermediation.

### Legal Form

1.6 The main legal form utilized by the industrial sector is sole proprietorship. Among registered firms, sole corporations or one-man companies are predominant. In the West Bank, 67 percent of registered firms are sole corporations, about 30 percent are private joint-stock companies and less than 3 percent are public shareholding companies. Private joint-stock companies are popular in the chemical (67 percent), paper (68 percent) and plastic (70 percent). The public shareholding companies are in the

<sup>1/</sup> See Appendix B for the methodology.



food (two), textile (one), chemical (four), mineral (three) and building materials (one). Most of the private and public shareholding companies are located in Ramallah and Jerusalem. There are two main reasons for this distribution in legal forms. One, the size of most of the industrial establishments does not warrant the costs attached to company formation and registration. Two, the incentive to avoid the regulatory environment drives entrepreneurs to organizational forms that facilitate both flexibility and informality.

#### Size and Concentration

1.7 The total number of industrial enterprises in the OT were 3,688 in 1991, of which 1,978 were in the West Bank and 1,710 were in Gaza. The size of the establishments remained small, with more than 60 percent employing less than 4 workers and only 7.5 percent of enterprises employing more than 10 persons. About 43 percent of all establishments are owner-operated shops. The average revenue per establishment is \$10,747 in the West Bank and \$5,140 in Gaza. Establishments employing workers have an average revenue per establishment of \$19,751 in the West Bank and \$7,930 in Gaza, while the corresponding figures for owner establishments not employing workers are \$580 in the West Bank and \$821 in Gaza. The predominantly small size of enterprises is notable in that after more than 25 years of industrial evolution, there has been no emergence of an industrial structure common to market economies. Some of the above figures, which are based on the Israeli BCS, have been disputed by certain authors who believe that the sector is larger than is commonly perceived.

1.8 The generally small size of industrial establishments is explained by several reinforcing factors. The propensity to avoid dealing with the regulatory regime drives entrepreneurs towards operations that enable them to work in a flexible and informal manner, which is possible in small establishments. In addition, the lack of a supportive financial system and the regulatory and taxation regime limit the ability to expand operations. Finally, the perception of high political risk, but with some expectation of future autonomy for the OT, motivates entrepreneurs to hold investments as options for the future, rather than develop them by making additional major investments now.

Table 1.3: Industrial Establishment by Number of Employees, 1991

Number of Employees	WEST BANK		GAZA		TOTAL	
	Number	Percent	Number	Percent	Number	Percent
1	559	28	387	23	946	26
2 - 3	669	34	719	42	1,388	38
4 - 7	485	24	417	24	902	25
8 - 10	80	5	95	6	175	4
11 - 20	103	5	71	4	174	4
21+	82	4	21	1	103	3
TOTAL	1,978	100	1,710	100	3,688	100

Source: Statistical Abstract of Israel, 1992.

1.9 Although Gaza experienced a 71 percent increase in the number of establishments, from 1,000 in 1967 to 1,710 in 1991, there was a decline in the total number of establishments in the OT between 1967-1991. The West Bank experienced a 51 percent decline from 4,029 in 1968 to 1,978 in 1991. The decline in the number of enterprises in the West Bank occurred during two periods. From 1968 to 1978, there was a 42 percent decline in the number of establishments as part of the adjustment to the occupation. However, from the period 1978 to 1987, the number of establishments was stable. The period 1987 to 1991 saw a further 20 percent decline in the number of West Bank establishments, from 2,463 to 1,978, as a result of the Intifada. A survey<sup>2</sup> of enterprises in the West Bank concluded that, in 1989, 82.6 percent of enterprises employing 8 or more people and 77.8 percent of enterprises employing less than 8 people were established during the period 1967-1989. There has been a dynamic process of exit and entry in response to changing economic and political environment, although the choice of industrial activities where entries occurred were influenced by the licensing process and subcontracting practices.

Table 1.4: Number of Industrial Establishments  
(1968-1991)

YEAR	WEST BANK	GAZA
1968	4,029	1,000
1978	2,332	1,370
1985	2,494	1,628
1987	2,462	1,793
1991	1,978	1,710

Sources: Statistical Abstract of Israel, various issues.

1.10 Despite the large number of small producers, there is little or no direct competition among them. In the mission survey, most respondents gave their perceptions of the level of competition as "not much" and reported that there is unmet demand in the market. Furthermore, no market leaders or signs of industry consolidation and oligopolistic formation are in evidence. In a few industries (cigarettes, soft drinks, and cardboard packaging), the mission was informed that there were single firms that accounted for 25-50 percent of the market. In most industries, concentration at the 4-firm level is estimated to be in the 10-20 percent range. This is due to individual firms operating as niche players catering to a limited number of customers, which in turn may be partly explained by poor support services such as distribution and transport. The existence of a large number of such niches and the absence of strong competition point to a primitive form of industrial structure in which strategic groups (oligopolies, market leaders and market followers, and up-market and middle-market firms) have yet to form. Industries thus exist in an immature condition, almost as embryonic industries in the first years of operation, despite their existence

<sup>2/</sup> Abu-Shokor et al, Industrialization in the West Bank.

for some 25 years. However, in the leather and textile industries, some direct competition is beginning to emerge.

### Employment

1.11 Total employment in the industrial sector is 18,376 persons, of which 5,981 are also owners of establishments. Industrial employment is about 15.5 percent of total employment. Total industry wages amount to US\$2.8 million out of total estimated industrial revenues of US\$30.0 million. The average daily wage is higher in West Bank (US\$10.30) than in Gaza (US\$8.40). The paternalistic attitude of owner-managers enables workers to get paid even during strikes and curfew.

1.12 Because of a lack of external training facilities, employers are forced to do most of the training of personnel in-house. Respondents to the mission survey point to a lack of resources as the main reason for the deficient training of workers. Another reason cited was the lack of access to the latest methods and technology. Competition from other countries for trained Palestinian personnel has also been mentioned as exacerbating the current lack of qualified workers.

### Products

1.13 The types of manufacturing subsectors where investments have been made have not changed over the past 25 years, with food processing, textile, clothing and leather accounting for a significant portion of total production. New enterprises have sprung up in the same subsectors, initially with subcontracting arrangements with Israeli firms.

Table 1.5: Distribution of Industrial Establishments by Subsector  
(Percent)

Subsector	WEST BANK		GAZA	
	1965	1991	1960	1991
Food, Beverages & Tobacco	26.6	12.3	11.0	6.8
Textiles & Leather Products	13.5	20.5	62.0	33.3
Wood & Wood Products	17.5	18.1		18.8
Nonmetallic Minerals	5.6	13.3	3.5	15.4
Others	36.8	35.8	23.5	25.7
TOTAL	100.0	100.0	100.0	100.0

Sources: Statistical Yearbook of Israel, 1992; Abu-Shokor et al, Industrialization In the West Bank; Okasha, Field Survey of Gaza Industry.



## Behavior and Performance of Industrial Firms

### Markets and Marketing

1.14 The occupation resulted in a structural shift in markets for industrial production. Prior to 1967, the West Bank and the East Bank constituted one market with the free flow of goods between the two areas. The occupation resulted in restrictions on trade with Jordan and, over time, caused the redirection of trade towards Israel. Initially, subcontracting was the major mechanism to gain entry into the Israeli market, especially for the textile, leather and building material industries. Although subcontracting activities have declined as more firms have started to sell directly to target markets, Israel is still a significant buyer of Palestinian products. A 1989 survey<sup>3</sup> for the West Bank indicates that 55 percent of industrial firms employing eight or more employees, and 33 percent of industrial firms employing less than eight employees, sell some portion of their output to the Israeli market. The mission survey estimates the Israeli market to be about 20 percent of industrial production, but more pronounced in textiles, shoes and building materials. The major market for Palestinian firms remains the domestic market, with more than 90 percent of industrial firms that employ eight or more employees selling to West Bank and Gaza markets as the primary market. Only a limited number of firms in the West Bank view the Jordanian and Arab markets as their primary markets, although about 16 percent of West Bank firms surveyed<sup>3</sup> in 1989 did some exports to these markets, mainly for products such as soap and building materials.

1.15 Based on a survey<sup>4</sup> done in 1990, the Gaza industries rely primarily on Gaza (61 percent) and the West Bank (13 percent) as markets for their production. The Israeli market accounts for only 13 percent of Gaza industrial sales, down from 21 percent prior to the Intifada. Arab markets account for 6 percent and other markets, primarily European, account for another 7 percent.

1.16 The primary channel of distribution in the OT is direct sales to customers, which is practiced by almost 80 percent of those surveyed<sup>3</sup> in 1989. About 95 percent of the smaller firms (less than eight employees) use direct sales. The result of this practice is the concentration of sales to a limited geographical area, which, to a certain extent, reduces the impact of competition and introduces inefficiencies. The development of marketing skills and distributions systems for both export and domestic markets would introduce greater efficiency and would help promote exports and market diversification.

### Subcontracting

1.17 Subcontracting with Israeli firms has been a major activity in the industrial sector. Based on the mission survey results, the principal reason for entering into subcontracting was the lack of market access, which was provided by the Israeli firm. However, having commenced subcontracting, the principal reason for continuing to do so was the lack of working capital to sustain the same level of operations.

---

3/ Abu-Shokor et al, Industrialization in the West Bank.

4/ Okasha, Field Survey of Gaza Industry.

1.18 Palestinian subcontractors exhibit several characteristics that distinguish them from other industrial establishments. First, subcontractors have a higher average capacity utilization (68 percent compared to 56 percent for the broader sample). Second, competition was considered by subcontractors to be "fair" to "high" in contrast to the "low" competition reported by the sample firms. Third, subcontractors had better trained workers and spent an average of 5 percent of sales on training, compared to 2 percent for the sample. Fourth, in terms of financial structure, subcontractors have a significantly lower proportion of working capital in the balance sheet (5-7 percent versus 10-15 percent) and higher operating profits (25 percent versus 12-17 percent). Fifth, the subcontractors have generally better technology and more modern equipment than similar firms in the OT. Finally, major subcontractors have grown rapidly compared to the rest of the industrial sector and have, in many cases, expanded capacity several times over.

1.19 There are several reasons for the better performance of the Palestinian subcontractors. First, the linkage with Israeli firms gives subcontractors easier access to markets and technology (at least at the start of the subcontracting process). Second, the nature of the operations reduces the financial requirements, primarily through a need for less working capital. Third, the processing of operating and import licenses is reportedly smoother. Finally, the subcontractors (compared to direct exporters) have more cash to plow back into operations, as discussed in the Annex II.

Table 1.6: Comparative Analysis, Subcontractors vs. Other Firms  
(Percent)

	Subcontractors	Sample in Survey
<b>Annualized Growth Rates</b>		
Assets	19.3	0.3
Sales	20.8	0.4
Profits	2.4	0.1
Capital	19.3	0.4
Training Expenditure	3.5	0.0
<b>Performance</b>		
Capacity Utilization	68	56
Downtime	20	25-44
Operating Profit	25	12-17
Working Capital (Percent of Total Assets)	5-7	15-20
Perceived Competition	Fair/High	Low

Source: Mission Survey.

## Financing

1.20 The typical balance sheet and income statement derived from the mission survey is shown in Table 1.7. The absence of debt in the capital structure of most businesses, and the low level of working capital is noteworthy. Generally, family savings were the sole source of start-up capital, and although this may reflect preference for family ownership and control, the absence of a financial sector exacerbates the situation. The income statement shows a relatively high proportion of imported raw materials, significant level of taxation in relation to income and net losses. Given that sales and assets have grown at the same rate over a 17-year period, one can assume that asset turnover has a value of about 1 percent. Assuming that assets are financed by equity, average ROE lies in the region of negative 15 percent to positive 10 percent.

Table 1.7: Financial Statements (Percent)	
Modal Balance Sheet	
Fixed Assets	80 - 85
Owner's Equity	100
Working Capital	15 - 20
Debt	0
Total	100
Median Income Statement	
Revenues	100
Raw Materials	
Imported	20 - 40
Local	13 - 27
Labor	
Skilled	2 - 19
Unskilled	4 - 26
Overhead	2 - 4
Transportation	3 - 5
Operating Profit	12 - 17
Finance Charges	0 - 1
Taxes	
Direct	6 - 9
Indirect	5 - 11
Net Profit	(15) - 10

Source: Mission Survey



## Raw Materials

1.21 A majority (about 80 percent) of industrial firms rely on imports of raw materials. This requires import procedures that minimize time delays and cost. In addition, manufacturers need to be aware of outside developments on products, technology and prices to ensure informed business and managerial decisions. The role of distribution agents is crucial in this process, as are the smooth flow of information and the unrestricted movement of people. The current trade, regulatory and taxation regimes prevent manufacturers from maximizing opportunities in the procurement of raw materials. Current tariffs on imports from low-cost "third countries" are still high (see Annex II). The licensing process introduces additional cost through higher transaction and inventory costs. Security procedures at the port delay the release of imports and result in losses and damage. Restrictions on travel reduce access to information.

## Technology

1.22 While there are pockets of high technology firms producing quality products, the technology level in the industrial sector is generally less advanced. The subcontractors have adopted higher technology compared to other domestic firms, due in no small measure to direct contact with more advanced Israeli firms. There are several factors that constrain the adoption of better technology. The nature of the business environment, which is characterized by constant stoppages and low capacity utilization, prevents the maximization and proper use of high technology. A lack of financing was also mentioned as a constraint in the utilization of better technology. Finally, regulations that restrict the movement of people and hamper the free flow of information affect technology levels.

## Management

1.23 Owners are very active in the management of the industrial establishments. The owner-managers of the larger enterprises are generally well travelled and well educated, many having received technical training abroad. Because of the relatively small size - in terms of employees - of the industrial establishments, a paternalistic environment is evident, with the owners in close touch with almost all employees. There is, however, the absence of a professional managerial class, which would be necessary if firms expand into larger and more sophisticated operations.

## Capacity Utilization

1.24 Based on the mission survey, capacity utilization varied between 40 percent and 70 percent across firms in the sample, averaging 56.4 percent. Some 25 percent to 44 percent of capacity is underutilized because of downtime that is directly related to strikes produced by the Intifada and the curfews imposed by the Israeli authorities. The remaining 15 percent to 26 percent of capacity is underutilized largely as a result of problems associated with administrative and procedural delays produced by the regulatory regime.

## Effect of Intifada

1.25 While the Intifada has resulted in a decrease in industrial output, there have been significant structural changes, primarily the shifting of domestic demand to locally produced goods. A

survey<sup>5</sup> made in 1989 in the West Bank noted that about half of the respondents employing eight or more indicated an increase in demand after the Intifada, notably in food, plastics, chemicals and minerals. On the other hand, only 14 percent of the respondents employing less than eight workers experienced a demand increase. A similar survey in Gaza<sup>6</sup> in 1990 estimated an increase in the share of the domestic market (the West Bank and Gaza) in industrial output from 65 percent to 73 percent. The Intifada-related strikes average about 40 days per year and the consequent curfews, another 10 days per year. This exacerbated the situation in the industrial sector and resulted in the negative growth from 1987-90 and the minimal growth in 1991 and 1992 (per survey results).

#### Effect of Arab Boycott

1.26 The Arab boycott has constrained access to additional markets. This is especially the case for the historical trade in building materials and food products and, possibly, in textile and leather. The domestic content requirement tends to increase costs, and the verification process introduces delays. The existing share of Arab markets in industrial sales is small-- less than 10 percent of output for West Bank producers and less than 7 percent for Gaza producers.

#### Impact of Infrastructure on Private Sector Development

1.27 The inadequate and antiquated nature of the infrastructure in the OT seriously constrain private sector development. It also serves to depress the general level of economic activity, retarding the development of markets and trading patterns. The limited network of main and feeder roads has served to dramatically increase the cost of transporting goods to markets. This is particularly true with respect to perishable agricultural products and has produced two unambiguous results: (i) it has increased dependence on imports as local markets are disrupted and local producers are driven out of business by high transport costs; and (ii) it has prevented the development of economies of scale within the OT and retarded the development of major trading centers.

1.28 The underdeveloped state of the telecommunications infrastructure in the OT renders it difficult for many enterprises to transact business beyond their immediate vicinity. Few residents possess their own phones, and entire villages have been left off the national grid. This has caused inefficiencies in economic relations and complicated trade. It has similarly affected the capacity of the productive private sector to sustain current activities and to expand their operations, particularly under existing security restrictions where curfews and travel bans are likely to be imposed at short notice and up-to-date information is vital.

#### Business Support Services

##### Support Systems

1.29 Industrial Parks. The lack of space and infrastructure services has resulted in the rush towards the establishment of industrial parks. Industrial parks are one way of solving the overarching deficiencies in the power and telephone services by enabling specific connections to be made between the

---

5/ Abu-Shokor et al, Industrialization in the West Bank.

6/ Okasha, Field Survey of Gaza Industry.

utility company and the industrial parks. However, industrial parks tend to be expensive, mainly because of land prices. Moreover, industrial parks bring to focus the issue of land ownership and property rights.

1.30 Marketing and Distribution. The underdevelopment of marketing systems and distribution channels reduces competition and affects efficiency by limiting the capability of manufacturers to expand markets. The development of the trade sector requires an enabling environment that includes an appropriate legal framework, especially with respect to contracts and collateral; an efficient financial system; good communication systems; and workable transport systems.

1.31 Training. While the firms interviewed in the survey place a premium on training, the cost of training and the lack of external training programs result in underinvestment in human capital. Because of small firm size, in-house training programs are expensive. Closer ties with educational institutions would help generate dividends.

1.32 Financial. To a certain extent, the moneychangers provide certain basic financial services at competitive cost. However, the financial system needs to provide a wider array of services to support further development of the industrial sector. This includes more financial instruments to enable firms to manage risk better, engage in foreign and domestic trade and expand operations. Capital markets development is necessary if the industrial sector is to go beyond small, family-owned firms.

1.33 Product Testing and Standards. The ability to manufacture products of consistent and acceptable quality requires the capacity to perform quality control and an awareness of standards. In certain cases, product testing equipment may be too expensive for a single firm. An independent organization that could attest to product specifications and quality is necessary to provide credible information to consumers, especially for export markets. Independent product testing which is being performed in conjunction with Bir Zeit University, is in its infancy and will take time to establish in the market place. However, health, safety and environmental standards and concerns still need to be addressed. To address this institutional weakness, the CA is training three people to provide product testing in the OT.

### Institutional Support

1.34 Chambers of Commerce and Associations. Each major town has a chamber of commerce, which is considered a semi-public agency and performs tasks such as providing exporters with certificates of origin. In addition, various associations of industrialists have been organized. The current effectiveness of the chambers and associations in terms of assisting industrialists seems to be limited and is circumscribed by the lack of funds. Nonetheless, these organizations are of potential importance in providing support to the private sector, given the absence of public agencies. The role of the chambers and the associations should be better defined and made more effective in providing support to the private sector in such areas as: regulations, information on business opportunities, skills development and advocate for the private sector.

1.35 Learning Institutions. The importance of learning institutions in private sector development cannot be understated: they provide industry with trained and trainable workers and managers, participate in cooperative research and assist in the development and diffusion of technology. In the OT, the role of learning institutions assumes greater importance; however, for these institutions to be effective, closer ties with the private sector are necessary.



1.36 International Agencies. International agencies provide not only social services to some segments of the population, such as refugees, but they also support technical assistance for certain aspects of development, such as training. The lack of local counterpart institutions makes the effective delivery of technical assistance difficult. Furthermore, technical assistance should be provided in the context of some kind of strategic agenda, which is lacking due to the absence of institutional mechanisms for decision-making. Nongovernment Organizations (NGOs) provide a significant amount of resources and assistance. How best to utilize NGOs in industrial development would have to be determined.

### Competitiveness of Palestinian Industry

#### Static Efficiency

1.37 An analysis of the long-run domestic resource costs<sup>7</sup> of a sample of 18 firms indicates that most Palestinian industries are potentially competitive at free market prices. The implication is that even with a more liberal trade regime, industry should be able to compete, so long as the costs related to the regulatory regime and the low capacity utilization resulting from the Intifada and curfews are eliminated. It should be noted that this analysis is static and would have to be taken in conjunction with the analysis of dynamic efficiency.

1.38 The low competitiveness of the textiles and footwear is due to two factors. One, there still exists some protection from low-cost producers in the form of high tariffs against "third countries," though effective protection is lower due to competition from EC and US producers, which are not subject to tariff barriers. Two, OT producers compete on the basis of price in products that are essentially indistinguishable, or where consumer preference is mainly based on price. Future competitiveness in the textile and shoe industries would be based on superior skills and organization applied to the production of products that distinguish themselves in the market. However, it should be noted that some individual players in these industries are highly efficient. Every Palestinian industry contains pockets of efficiency, which often consist of firms whose outputs are contracted to Israeli firms.

---

7/ See Appendix B for methodology.

Table 1.8: Competitiveness Analysis

<u>Sector</u>	<u>Competitive</u>		
	<u>High</u>	<u>Medium</u>	<u>Low</u>
Stone Cutting	X		
Textile			X
Clothing		X	
Shoes			X
Plastic		X	
Soap	X		
Food			X

Source: Mission Survey.

Dynamic Efficiency

1.39 The potential efficiency of Palestinian industry at the firm level has not been translated into dynamic performance at the aggregate level. There are four principal causes for this anomalous situation. First, there is a largely political element in the downtime and underutilization of capacity experienced by Palestinian industry. As long as political risk is perceived to be high, it is unlikely that entrepreneurs in general will be motivated to invest resources to expand businesses. Second, the regulatory environment, especially in the context of the fragile geopolitical stability, engenders perceptions of a high degree of unpredictability and volatility in the minds of entrepreneurs. As a consequence, a high-risk premium is placed on new investments, and this discourages the influx of capital into the economy and fosters some capital flight into Jordan and other countries. Third, the regulatory system creates impediments and bottlenecks to the free flow of goods, services, personnel and information. This acts as a further disincentive to expanding operations. Finally, given the plethora of security restrictions that go along with a military occupation, it is difficult for new technology, in the form of sophisticated machinery, to pass through to the OT. This further intensifies the pressure to refrain from a technological enhancement of operations.

1.40 Because of the four interrelated reasons cited above, an incentive is created for the entrepreneurs to maintain existing facilities in the OT without expansion. To use a currently prevalent analogy that applies to the real investments of business firms, entrepreneurs are motivated to hold investments as options for the future, rather than develop them by making major investments. So long as a perception of high risk prevails, entrepreneurs will perceive a positive option value in deferring new investment. The sunk cost of existing investments keeps future options open at limited risk: i.e., if and when political conditions improve, existing businesses will enjoy first mover advantages over new entrants at no extra cost. A similar behavior is observable in applications for new licenses, where entrepreneurs apply for several licenses in advance, not with the intention of commencing operations, but in the hope of creating options for use in a more politically stable future.

1.41 The only progress that occurs during this period takes place internally in the form of the refinement of manufacturing skills through experience. This is by no means a necessarily undesirable state of affairs. In fact, it actually encourages Palestinian firms to develop and strengthen competencies while they wait for better times and could eventually lead to an enhanced comparative and competitive advantage for the sector as a whole.

#### Comparative/Competitive Advantage

1.42 The comparative and competitive advantage of Palestinian firms lie in three distinctive or core competencies: (a) their ability to use the limited technology and facilities at their disposal to achieve efficiencies in manufacturing; (b) their ability to learn by doing and to disseminate knowledge and skills (on a small scale) among their workers; and (c) their intimate knowledge of their immediate markets including linkages with customers and suppliers operating in those market niches. Unlike the more common factors of production, these competencies are mobile across industries and, in the case of the first two competencies, also across markets.

1.43 The Palestinian industrial sector in particular, and the private sector in general, is likely to be insulated from shifts in factor prices in the long run since it is endowed with competencies that would enable it to adjust to difficult situations. To a great extent, this can be seen in its survival through several years of occupation. Some enterprises arrange for a limited amount of high quality training for their employees. Commensurate with the small scale of operations, some businesses have fairly sophisticated technology, e.g., computerized sewing machines, automated textile equipment, personal computers, fax machines, close circuit TV monitors, etc. They have also adopted enlightened employment practices such as guaranteed wages despite downtime due to curfews and strikes.

1.44 Mainly as a result of good mid-level technology and learning abilities, some firms have performed well as subcontractors. Bedran Ltd. of Tulkarem has sales of around US\$10 million per year and makes global branded products such as Arrow shirts, Liz Claiborne apparel and Calvin Klein fashions. Other firms, such as those in the leather and shoe industries, have progressed from subcontracting to meeting local and export demand through their growing knowledge of the market. Soft drink and cigarette manufacturers often have a well-defined domestic market for their branded products. Other manufacturers, such as Silvana (a confectioner from Ramallah), have developed new products that have significant market shares in Israel. Shark Electrodes of Hebron has a long-standing technical alliance with Oerlikon, the leading Swiss manufacturer. Haddad Ltd. of Jeneen (a producer of diesel ploughs) has used its competence in low cost manufacture to gain a major share of the Israeli market for its product.

1.45 Firms such as those described above are likely to develop into the industry leaders of the OT over the medium term, provided that the regulatory environment and political climate is sufficiently stable to encourage entrepreneurs to make investments in enhancing their technology, utilizing and expanding their capacity and diversifying into competence-related new businesses. These industries are likely to generate a momentum that could drive a fairly rapid development of industries.

1.46 As a rule, industrial development proceeds through a phase of factor based competition to a phase of skill-based competition and, finally, to a phase of innovation-based competition. The sooner an industry arrives at the second and third stages, the more likely it is to gain a relatively enduring competitive advantage. The Palestinian private sector differs from that of the stereotypical developing economy in which industries are protected against imports and are dependent on low-cost labor as their



sole source of comparative and competitive advantage. While labor is the primary source of comparative advantage, industries in the OT also show evidence of skill-based competition and, to a lesser extent, innovation-based competition. Being regulated under the occupation, Palestinian firms have had to work within numerous logistical and fiscal constraints that impose high transaction costs on ongoing operations. Although they have been protected against imports from the Far East under Israel's current trade regime, they have had to compete in the OT markets against imports from the EC and US, as well as against Israeli products. The policy of licensing a large number of entrants in industries judged to be of low importance to Israeli industry has raised the level of competition in some Palestinian industries; however, the nature of this competition is indirect since many firms are insulated because they operate in small market niches in the OT.

1.47 As a result of these conditions, the more efficient players reflect an encouraging amount of entrepreneurial ingenuity in devising efficient operating processes within the constraints imposed by regulations under the occupation. Most firms have learned to manage with limited inventories of essential supplies and spare parts. Despite the limited facilities at their disposal, they have managed to develop design capabilities and branded products and are capable of turning scarce inputs of sometimes dubious quality into products that are fairly reliable and of good quality. This competence applies to both consumer products, such as clothing and leather goods, as well as intermediates (equipment and supplies) produced by machine operations. These modest, though non-trivial, innovative capabilities should enable Palestinian firms to hold their own in the OT against producers in the Middle East and, in some items, against imports from the US and Europe.

1.48 It should be possible for firms in the textile and leather/footwear industries to further develop their repertoire of operating skills and innovative competencies. In 1998, when the current tariff protection against imports from the Far East is slated for elimination, firms that have made the transition from factor based competition to skill based competition - including marketing skills - will be better positioned for success in the new climate. Firms manufacturing branded products would probably be able to complete the transition to innovation-based competition and are, therefore, likely to perform well under the new conditions.

## Conclusions

1.49 To achieve its full potential, the private sector would need support from the public sector over and above the removal of regulatory barriers. This calls for the active, though arm's length and nondistortionary, participation of the public sector in creating conditions that would encourage firms to develop technology and learning; the provision of institutions to assist firms to gain intelligence and access to foreign markets; and measures to stimulate competition within all industries. Transforming core competencies to dynamic efficiency requires, in addition to a supportive regulatory regime, the improvement of infrastructure and support services and the establishment of enabling institutions. The current structure, conduct and performance of industry are driven by the existing environment, which is not conducive to dynamic growth. To attain dynamic efficiency, Palestinian industry must improve factor conditions, specifically by adopting appropriate technology, enhancing skills, and improving management and marketing practices. This requires greater investment by firms, which in turn necessitates conditions that would enable entrepreneurs to develop a longer-term view and gain access to markets and resources. Because all elements of the business environment are linked, the elimination of constraints to private sector investment would have to be fundamental and wide-ranging, and it would have to be combined with the establishment of supportive infrastructure, services, laws and institutions.

## II. SERVICES SECTOR

### Introduction

1.50 In most countries, the service sector was one of the most rapidly growing segments of the economy during the 1980s. In fact over the 20-year period 1968-1988 in the US, the service sector (including construction, wholesale and retail trade, professional and financial services and education) represented the only areas of growth in employment shares. In that same period, for example, the employment share for low-skill, medium-skill and high-skill manufacturing in the US decreased by 39.5 percent, 38.1 percent and 21.6 percent, respectively. This growth of the service sector was characterized by increases in both high-income jobs requiring higher levels of education (e.g., in the professional and financial subsectors) and the lower stratum of employment (often part-time, temporary) paying low wages and no benefits. At the same time as the service sector was expanding in the US and Europe, it was expanding in Israel, the primary trading partner with the OT. During the decade of the 1980s, the only economic branches in Israel in which there was job growth were in the service sector (e.g., commerce, financing and business, personal and other services).

1.51 The contribution of the service sector (excluding construction) to GDP amounted to over 50 percent in 1991. Of this public and community services amounted to 11 percent and other services to 40 percent. Employment in the service sector amounted to about 49 percent of total employment in the OT.

### Tourism

#### Importance to the Economy

1.52 Tourism has been an important segment of the Palestinian economy for some time, and it is a potentially significant industry in the OT, drawing on a long tradition and substantial expertise in catering to the pilgrim traffic to both Christian and Islamic religious shrines. There are currently severe restrictions on the growth of the industry. For example, the capacity of Palestinian hotels has been frozen since the occupation. At present, 36 Palestinian tourist agencies are in operation, a decrease from the 46 in operation in 1967. Although 300 Palestinian tourist guides worked in the West Bank in the early 1970s, only 50 are currently active.

1.53 Although precise figures are difficult to obtain, it is estimated that tourist expenditures in the West Bank and Jerusalem approximated \$90 to \$100 million in 1989. However, the area is subject to dramatic shifts in tourism resulting from political instability. For example, from August 1990 to the summer of 1991, the period covering the Gulf War, the tourism sector lost approximately US\$100 million, including hotels, travel agencies, tourist transport companies, handicraft manufacturers and restaurants. Yet, tourism has important potential for the economy of the OT, as it does in other developing economies. According to a 1989 report in *The Economist*, "tourism earned poor countries about \$55 billion in 1988, according to UN estimates. That makes it their second biggest earner of foreign exchange, after oil (\$70 billion)." *The Economist* predicted in 1989 that spending on international tourism, exclusive of fares, would increase by about 5 percent per annum, in real terms, until the year 2000. *The Economist* also pointed out that, in contrast to manufacturing, which is faced with protectionist



trade barriers (and the need for often significant expenditures on new technology), tourism creates many jobs and does not face such barriers.

1.54 In spite of the limitations imposed on the Palestinian tourist industry, the potential for contribution to the Palestinian economy is significant. However, because the tourism industry has been severely constrained, the need to invest in both human resources and institutional development in the area is great. While training programs, including courses ranging from hotel management to archeology, are available through the Notre Dame Center and the Bir Zeit University, the opportunities for employment in Palestinian tourism are minimal, in part because of the paucity of capital investment.

### Demand

1.55 Tourists can be divided into three broad segments: (a) Christian groups in package tours arranged by a sponsoring church in their home country through a Palestinian travel agent; (b) non-Arab Islamic pilgrims completing the Haj (Arab muslims do not travel to the OT); and (c) recreational tourists. This last segment includes Palestinians living abroad (e.g., those residing in the Middle East primarily Jordan and Egypt, Europe and North America) and vacationing in the West Bank (typically at Ramallah) and Gaza. Recreational visitors from Europe and the US and internal tourists constitute the mainstay of the Israeli tourism industry, while religious Christian and Islamic segments, which amounts to 35 percent of the Palestinian industry's custom, is the latter's most important segment.

1.56 Based on figures provided by the Jordan Society of Tourist and Travel Agents, approximately 30,000 tourists, most of whom were US and European travelers, crossed from Jordan to the West Bank each year between 1987 and 1989. According to Israeli statistics, just over 20,000 tourists crossed into the OT from Jordan in 1991. Another estimate of the potential demand for Palestinian tourism may be obtained from the number of visitors to the Al-Aqsa Mosque in the Old City of Jerusalem. According to the custodians of the mosque, the number of visitors rose from 87,000 in 1989, through 90,000 in 1990, to an estimated 370,000 in 1991. Official Israeli estimates put the figure of Christian tourists entering through Israel to either visit Israel or the OT at 630,000 in 1991. Estimates obtained from a variety of sources as part of our survey suggest that given political stability, the Palestinian tourism industry can expect to receive between 500,000 and one million tourists (both religious and recreational) on an annual basis generating income from the entire tourism sector of between \$250-300 million (based on Palestinian estimates). There is, thus, adequate demand to sustain a viable tourism industry in the OT.

### Sites and Facilities

1.57 For the most part, tourism in the area is concentrated in Jerusalem, with a secondary concentration in Bethlehem and one or two operators in other areas. The tourist industry in the OT, including hotels, travel agents and tour operators and tour guides, handicraft manufacturers and retailers and restaurants catering to tourists, has been severely constrained since the occupation. However, tourism continues to hold unique competitive advantages, despite several years of decline in the face of a restrictive regulatory system and the rapid growth of the Israeli tourism industry supported by the Israel Government Tourism Office (IGTO) and El Al, the national airline. Table 1.9 lists locations that have, at one time or another, been tourist sites of some prominence.



1.58 Over time, many tourist attractions in the OT have fallen into disrepair. Archeological sites are poorly maintained if at all. The few discotheques, nightclubs and casinos that once operated in the West Bank have shut down.

Table 1.9: Major Tourist Sites

<u>Locations</u>	<u>Description</u>	<u>Pilgrimage Sites</u>
Jerusalem	Islamic	Dome of the Rock, Al Aqsa Mosque (requirements as part of the Haj)
	Christian	Church of the Sepulchre, Stations of the Cross, Garden of Gethsamane, Church of the Ascension
	Jewish	The Wailing Wall, King Solomon's Temple
Bethlehem	Christian	Church of the Nativity
Hebron	Islamic/Jewish	Abraham's Tomb
<u>Other Attractions</u>		
Jericho	Dead Sea and temperate Winter resort	
Ramallah	Temperate Summer resort	
Gaza	Mediterranean beach resort (potential)	

#### Hotels and Restaurants

1.59 The hotel and restaurant industry in the OT is cost competitive in comparison to Israeli establishments, but it is in need of considerable renovation. Israeli regulations have deterred entry and severely limited expansion. According to Palestinian accounts, on the one hand, plans for the construction of new hotels and the expansion of existing hotels is routinely denied. On the other hand, according to the CA, only two applicants have ever asked for a license to build a new hotel; while the CA maintains that both were approved, at least one of the applicants asserts that approval was received for the management of the hotel, not for its construction and operation. Reportedly, plans for a third hotel in Ramallah are currently being negotiated. It is undeniable, however, that the growth in this segment of the industry has been slow at best (see Table 1.10). According to the Arab Hotel Association, the number of Palestinian hotels in Jerusalem has decreased from 40 in 1967 to 35 in 1992.

Table 1.10: Hotel Growth, Occupancy and Tariffs

	PALESTINIAN		ISRAELI	
	1967	1992	1967	1992
<b>Jerusalem</b>				
Hotels	40	35	30	32
Rooms	2,005	2,099	1,193	5,361
Occupancy (%)	-	46.20	-	63.80
Tariff 4 Star (\$)	-	59.00	-	70.00
Tariff 3 Star (\$)	-	43.00	-	62.00
Meals 4 Star (\$)	-	16.00	-	12.00
Meals 3 Star (\$)	-	15.00	-	10.00
<b>All Locations</b>				
Rooms	2,250	2,377	N/A	31,400

Source: Arab Hotel and Restaurant Association, 1993.

### Travel Agencies and Tour Operators

1.60 Prior to 1967, Palestinian travel agencies in Jerusalem held licenses from worldwide travel services such as Thomas Cook and Cox & King, and had branches throughout the Middle East and in many cities in Europe and the United States. Several had a long history of arranging tours of the Holy Land. The negative impact of regulatory restrictions introduced after 1967 has crippled the tourism industry. The main requirements for a license for travel agencies are threefold: that the agency employ four or more employees; that it be located on the ground floor of the building; and, most pertinently, that it furnish a license fee or bond of \$350,000. New entrants were effectively barred by this last requirement, while some existing travel agents exited through bankruptcy. Meanwhile, Israeli travel agencies have mushroomed (see Table 1.11).

Table 1.11: Travel Agents, Tour Guides and Tour Operators, 1967 and 1993

	Travel Agents		Tour Guides		Tour Buses	
	Palestinian	Israeli	Palestinian	Israeli	Palestinian	Israeli
1967	47	35	206	Nil	20	-
1992	36	436	70	4,300	108	1,100

Source: Arab Tourism and Travel Agents Association, 1993.

1.61 Palestinian travel agencies appear to operate in a vacuum, effectively cut off from opportunities to expand (or even maintain) their services in the age of global, computer-based marketing of travel services. For example, they are excluded, *de facto*, from promotions and trade fairs arranged by IGTO and El Al and are prevented by airport security regulations from meeting their arriving clients. Although similar restrictions apply to Israeli travel agents, it is possible for them (but not Palestinian travel agents) to hire airport facilitators for this purpose. El Al and IGTO also reportedly discourage tourists and foreign travel groups from patronizing Palestinian travel agents, who, with no access to state-sponsored marketing and promotion, must depend on word-of-mouth referrals among European and US church groups.

1.62 Tour operators who own tourist buses have fared much better than tourist agencies that do not own their own transportation fleet. This group differs from other firms in our sample in that it shows some reliance on debt financing for its fleets. Its buses are in good condition, although it has been troubled by liquidity problems and fleet size has shrunk.

1.63 In the case of tourist guides, those in service in 1967 were required to undergo six months training in Jewish tourist attractions, at an effective cost of \$10,000; most of them fulfilled this requirement. For new guides, however, certification involved passing competency exams written in Hebrew. Although a few aspirants did take these exams, it appears that no new Palestinian guides have been actually certified during a 25-year period. As a way around this barrier, some new guides are attempting to gain credentials in theology since "spiritual leaders" (i.e., theology students) have in recent years formed a new entrant to the guide business at the religious sites. The number of Israeli tourist guides has grown rapidly, but the aging group of Palestinian guides has registered attrition.

#### Tourism-Related Industries

1.64 Palestinian handicrafts have contributed greatly to both the economy in general and to charitable associations, which have produced handicrafts as a means of income generation for their health and social service programs. Several societies that serve handicapped Palestinians also use the production of handicrafts for sale to tourists as a component of their occupational therapy programs, irrespective of the amount of income generated.

1.65 The dominant Palestinian handicrafts are those made of mother-of-pearl and olive wood, tiles, glassware and needlepoint cloth. The handicrafts are sold to tourists through retailers and church-based or charitable associations in Bethlehem and Jerusalem. The handicrafts industry faces the VAT and advance tax restrictions similar to other industries, but almost all of the small crafts enterprises have serious cash flow problems that exacerbate the problem. Moreover, they are limited in their ability to maintain productive operations because of considerable - in some cases, dramatic - fluctuations in demand. Because of restrictions on export, these small craft enterprises are not able to turn to this outlet for their goods, as are Israeli firms producing handicrafts. Several handicraft enterprises have recently organized a cooperative that, acting on its own initiative, has obtained funding from European donor organizations and participated in trade fairs in Europe during the past two years.

#### Cost Impact of Restrictions

1.66 The more prevalent administrative restrictions facing the industry are licensing and land permits. Twenty-five tourism companies were surveyed and the results indicate that the cost impact of



licensing was about 7.5 percent of sales and for land about 12 percent. These results tend to be somewhat higher than the results of manufacturing, trade, and construction companies. In other words, proprietors of firms in the tourism industry perceived a strong negative impact on their annual business performance arising as a result of these two sets of regulations and their related administration. In the case of licensing, the major elements reported consist of a perceived stringency in licensing requirements for tour guides, the stipulation of an expensive cash bond or bank guarantee to open or maintain a travel agency, and a perceived reluctance on the part of the administration to license new hotels or expansions of existing hotels. In the case of land, many respondents reported the confiscation of lands on which hotels were being constructed by them, and the perceived unwillingness on the part of the administration to allow hotel construction within the existing zoning system, even if vacant land was owned or purchased by Palestinian hoteliers.

### Potential

1.67 The Israeli tourist industry - including hotels, archeological and religious sites, state-funded public relations and promotion, education and the training of guides, support for public and private sector transportation and the national airline - has been subsidized and supported by the Government since the founding of the State of Israel. Moreover, the supporting physical infrastructure (roads, communication, water and sanitation and electrification) is in excellent condition, and sites are well maintained. However, the actual and potential demand for tourism in the area is so high that both Israel and the OT could utilize their relative competitive advantage - if there is an even playing field. The two markets overlap but are sufficiently distinct to enable each side to prosper on its own. So long as Palestinian tour operators are permitted to operate in Jerusalem at the Christian and Islamic religious sites, and nontariff barriers to entry and expansion are removed, the Palestinian industry will be able to grow.

1.68 The tourism industry still possesses the basic factor endowments with which to succeed given tourist sites of religious value to pilgrims, sizeable demand and a good, albeit limited, foundation of skills and experience. However, existing guest facilities require renovation, and capacity needs to be expanded. The industry needs to be freed from regulatory pressures, to expand training to meet competition on an equal footing, and marketing and promotional exposure to enable it to widen its base of customers. Given these inputs, there is no reason to doubt its competitive viability.

### Recommendations

1.69 Because the important sites are in Jerusalem, the viability of the Palestinian tourist industry depends on unrestricted access to Jerusalem. Restrictions on the movement of people between Jerusalem and the OT should be liberalized. In addition reasonable access to airports should be provided to Palestinian tour agencies to enable them to meet clients. Regional cooperation and agreements would also be beneficial, especially to ease movement of people across borders; open competition in the tourist trade; promote tourism; ensure infrastructure development; and create acceptable standards.

1.70 Infrastructure planning is necessary to ensure that the potential for tourism is developed. The liberalization and rationalization of licensing would help in this process. Hotels and restaurants would need building permits, the requirements for which should be transparent and fair and the processing of which should be mechanistic and nondiscriminatory. This would require set standards on building codes, zoning, health, safety and the environment. Licensing policies for tour guides and agencies should foster competition on an even playing field.

### Construction

1.71 Since 1980, about 10 percent of Palestinians working in the OT have been engaged in the construction industry. Construction contributes significantly to the economy. There are many factors that contribute to this high level of investment in construction activity, not the least of which is the poor climate for investment in industry. Compared to countries in a similar stage of development, the OT have a much higher proportion of investment in housing and a much lower proportion of investment in industry. Geopolitical instability, the uncertainty relating to the occupation, and the regulatory regime have much to do with the allocation of investment resources.

1.72 The relatively high investment in housing has encouraged related activities in the industry, especially in the building materials, wood and furniture, and electrical sectors. There is also demand for professional services in engineering and architecture. While there are several contractors, there are only five major ones who are capable of doing projects requiring substantial investment in equipment and significant working capital.

1.73 The construction industry is linked to activities in the housing sector, another private sector activity, which is treated at length in the infrastructure report.

### Marketing and Distribution Services

1.74 In the domestic market, producers typically use direct selling to retailers or customers as the primary method of distribution. Small producers selling to a few retailers and small retailers selling within a small geographical area have resulted in market fragmentation, thereby reducing the impact of competition. The development of a wider distribution network of wholesalers and retailers has been constrained by lack of financial resources for working capital, storage facilities and transport equipment; poor communications systems; inadequate road and transport systems; and an ineffective legal system. The future development of an effective marketing and distribution system would depend on the establishment of an enabling environment covering the above areas. It should be noted that access to information, suppliers and markets is also critical. Policies that encourage the unrestricted movement of people and the free flow of information would benefit the development of marketing and distribution systems.

1.75 Imports and exports are typically done either directly by manufacturers or through Israeli agents. Palestinian businessmen engaged in foreign trade suffer from an inherent bias in favor of Israeli traders due to the regulatory and taxation system (see Annex II). The restructuring of the regulatory regime and taxation system should provide impetus to the development of the Palestinian foreign trade sector.

### Information Services

1.76 Information has been accepted as an important element in achieving efficiency and competitiveness. Firms make decisions on the basis of information on markets, technology and competition. For this reason, information services have been a fast growing segment of the service industry and have been associated with advances in both telecommunications and computing. In the OT, fragmented and localized markets have obviated the need for more sophisticated information services. As development occurs and firms expand production and markets (including export) at a higher level of

technology, the information service industry would have to grow in response to growing demand. This requires adequate telecommunications capacity and trained manpower.

1.77 The use of computers in data and information storage and analysis is limited, although expanding. A number of computer engineers (trained in the US or European countries) have initiated the development of computer software (e.g., for accounting and finance, project management, word processing and translation) and have trained (or are planning to train) industrial managers and line personnel in the use of computer-assisted manufacturing equipment. The latter efforts are being coordinated with or sponsored by the UNDP and Beir Zeit University.

1.78 The development of computer software is seen by a number of Palestinian economists (as well as computer engineers) as having important potential for investment in the near future, as it is not dependent on extensive capital investment. As of 1989, some 40,000 independent software firms existed worldwide. According to a World Bank report, the large variety of niche markets for accounting, banking, word processing, data and information storage and retrieval; for the general public and specialized groups; and for computer-assisted manufacturing, and the fact that the industry is still largely labor intensive, bodes well for entry into the market. However, according to this same report, successful entry requires:

- Some capital investment (many of the newer companies are backed by multinational corporations)
- Access to new developments in telecommunications; hardware and software and manufacturing processes; and market trends,
- Long-term management commitment (difficult to obtain in such a volatile sociopolitical environment),
- The ability to market the product(s) through traditional promotional vehicles and through telemarketing.

1.79 Although, at present, the OT is severely restrained with respect to virtually all of the above, the removal of restrictions would provide an opportunity for Palestinians to compete in this service sector.

1.80 The need and demand for data and information in both the public and private sectors is almost limitless and provides an opportunity for entrepreneurial activity with relatively small investment. This service subsector can also utilize knowledge and skills at a variety of levels and in a variety of disciplines, including for example, administrative and secretarial staff as data entry clerks, software engineers and academic researchers (for analysis and interpretation of data). The public sector can play a prominent role in increasing the stock of information by collecting and disseminating government statistics, publishing regulations, requiring the disclosure of financial statements for public companies, disseminating information on standards and requiring information disclosure on products as they affect public health and safety.



### Accounting and Auditing

1.81 The accounting and auditing professions have deteriorated to the point where, in the West Bank, only 6 of about 58 practicing accountants have received formal certifications either from Israel or abroad. The rest are allowed to practice on the basis of minimal, one year training. In addition, accounting and auditing standards are yet to be modernized to provide relevant and accurate information to both management and investors and creditors. A complete revamp of the accounting and auditing standards, rules and practices is needed if the private sector is to grow beyond small, workshop-type operations. A formal financial system and good taxation administration requires acceptable financial information certified by qualified accountants and auditors. A system of training, certifying and regulating accountants and auditors would have to be put in place.

### Conclusions

1.82 The service industry has already achieved a level of importance in terms of both employment and value added. Further development of the sector would increase its ability to absorb surplus labor, support improvements in efficiency of industrial and agricultural operations through marketing, information and training services, and enhance the role of markets by providing access and reducing market fragmentation.

## ANNEX II

### THE REGULATORY, TRADE AND TAXATION SYSTEM

2.1 This annex describes and analyzes the regulatory, trade and taxation system in the OT. In order to assess the impact of the system on the private sector, three types of surveys were carried out during the mission, in addition to numerous interviews, both structured and unstructured, with the private sector and Israeli authorities. It should be noted that different accounts exist as to the procedures and requirements, not only between the Israeli authorities and the Palestinian businessmen, but also among the Palestinian businessmen themselves. However, there is a common thread in the perceptions of the private sector concerning the regulatory and taxation regime, as well as the corresponding impact on investment and growth.

2.2 The regulatory, trade and taxation system is largely made up of three sets of regulations as follows:

- Business licensing, land zoning and building permits (Licensing Process)
- Export, import and Israeli product standards procedures (Trade Regime)
- Direct and indirect taxes (Taxation System)

2.3 It is also affected by security procedures affecting the movement of goods, vehicles and personnel (Security Procedures).

2.4 Regulations impact the conduct of business both jointly and individually. At each and every stage of operations, business enterprises must face the cumulative impact of multiple regulations since the administration of the regulatory system invariably tends to link regulations together. Thus, even if licensing policy is at present being relaxed, other regulations, such as taxation, can unobtrusively, but equally effectively, restrain new entrants.

2.5 Another consequence of this linked manner of administration is that it is difficult to separate out different application procedures. Business licensing, building permits, import licenses and other clearances often coalesce into a single, complicated mass of procedures. Not only do these procedures cause inordinate delays and, hence, impose cost sanctions on businesses in the private sector, they also constitute a definite strain on liquidity and financial solvency. In fact, the source of the competitive distortions that the system produces may be identified with the imposition of this financial burden.

2.6 Discussions with the CA indicate that in the past year there has been an attempt to simplify the administration of the regulatory system. Indeed, some relatively well-established Palestinian businesses report confirmation insofar as obtaining timely clearances and refunds (e.g., duty drawback) are concerned. However, there is wide discretion accorded to the officials actually administering regulations, which can be highly discriminatory at certain times or in certain cases. Thus it is possible for an official to apply all the conditions pertaining to a regulation for some applicants, or during some period of time, and to waive most requirements for other applicants. The field survey findings clearly speak to the restrictive nature of the administration of the regulatory system. The most persistent restrictive effects are summarized in Table 2.1.

Table 2.1: Restrictive Effects of the Regulatory System

Regulation	Impact	Industries Affected
Licensing	Barrier to entry	New industries
Land/building permits	Entry/expansion barriers	All industries
Export/Import	Delays; carrying costs; constraint to modernization of plant and equipment; manufacturing industries needing to renovate plant; traders importing products for local demand	Industries with high import costs
Advance Income Tax Procedures	Working capital shortages; capital outlays needed to replace confiscated assets; hinders routine expansion/growth	All industries
VAT Rebates/ Customs Procedures	Working capital shortages; erosion of price advantage due to carrying costs; barrier to expansion/entry	Exporters
Security	Carrying costs; advantage to Israeli clearing agents	Importers; Exporters to and through Jordan

2.7 In addition to these constraints, Palestinians also lag significantly behind other economies with respect to adaptation of modern technology. Few Palestinian industries have modern equipment and production technologies; fewer have access to the data and information required to compete in an open market.

2.8 With the exception of some limited development in individual companies, there is no research or development capacity in the OT; such capacity is essential in the design and adaptation of new technologies for appropriate and effective use and has been the foundation of economic progress in the rapidly progressing Asian countries. The use of newer technologies is limited, in part, as a result of Israeli restrictions on the importation of equipment, import costs of equipment and the lack of awareness of new technological developments. Recent visits by Palestinian economists to Japan, European countries and elsewhere may improve this awareness, but economic and business interchange is still minimal.

#### I. Licensing Process

2.9 The licensing of private sector companies and operations is controlled by the CA offices under the two different military commanders in the West Bank and Gaza Strip. Based on extensive interviews with Palestinian businessmen and economic associations, since December 1988, more than 20 different licenses have been identified as being required for the opening or expansion of manufacturing plants and service industries, or for the export or import of goods. Most of these licenses require proof



of payment of taxes and other fees, which requires businessmen to obtain stamps from 7 to 10 different CA departments. The procedures have also been reported to be arbitrary and highly dependent on the individual official in whom the authority for a specific license rests. No complete description of the various licenses is available. A compilation of English translations of all Israeli military orders relating to economic activity in the OT has recently been prepared by the CA, but even these would not necessarily include licensing procedures and requirements that technically do not require specific military orders to impose.

### Licensing Procedures

2.10 Despite some relaxation of licensing policy in the past year, most businesses reported difficulty in obtaining licenses. Some entrepreneurs have waited as long as 10 years without receiving approval to commence operations, with the average for those eventually receiving licenses reportedly 6 years. During the past 18 months, the average wait, according to Palestinian businessmen, has improved to 6 months. Forms are usually in Hebrew, so quite often the entrepreneur has to sit in the office of the CA local headquarters and plead the case before an official who will actually fill out the form.

2.11 In the West Bank, obtaining a license to engage in a business requires two steps - at the municipal level and at the Israeli authority level via the CA. Approval by the municipality involves the submission of an application, which has no set format, accompanied by an architectural plan if the business is to be set up in an industrial zone. At this stage a problem arises because in most towns no industrial zone exists, or the existing zone is completely built-up. The municipality is usually loath to part with its own land for the purpose, while the CA seems to keep the question of land grants pending indefinitely. Given the shortage of industrial land, prices tend to stay artificially inflated, e.g., \$150,000 per dunum in Ramallah and Gaza.

2.12 Municipal approvals usually take a few weeks and are rarely denied. Approval from the CA requires obtaining at least three clearances (stamps or certificates of compliance), in addition to the Health Department clearance, proving: (a) payment of income tax; (b) payment of the value-added tax (VAT); and (c) no record with the local police. If the business is being established outside an industrial zone, further approvals are required from: (a) the GOI's Custodian of Absentee Property; and (b) the Archeological Department. After obtaining clearances, the entrepreneur may have to register the partnership (which is treated like an Ottoman association) or the company with the Registrar of Firms.

2.13 In Gaza, the number of stamps required reportedly rises to as many as 12, pointing to a more stringent application of the licensing process compared to the West Bank. Approvals have been required from: (a) the military governor; (b) the Land and Property Office; (c) the Transportation Department; (d) the VAT Office; (e) the Income Tax Office; (f) the Department of Statistics; (g) the Legal Department of the CA; (h) each of the three port authorities separate clearances; (i) the Police; (j) the Ministry of the Interior; (k) the Health Department; and (l) the Education Department. While businessmen have different versions of which combination of approvals is required, tax (income and VAT), security and police clearances are almost always required.

2.14 Since each office is open only for a limited time each week, the lines are long, and each scrutiny takes several days. Clearances received earlier on sometimes lapse by the time the later ones are received and have to be applied for afresh. Over and above this arduous procedure, the issuance of licensing is discretionary. Alternatively, partial or modified approvals may be granted.

### Impact of Recent Efforts at Liberalizing Business Licensing

2.15 There was a relaxation of the business licensing process in 1991 and 1992. According to the CA, 42 licenses were applied for in 1990 but none were approved; however, 95 out of 114 applications were approved in 1991, and 71 out of 112 applications were approved in 1992. According to the CA, 65 new factories established operations in 1991, and 25 new factories did so in 1992. Many of these factories were approved under the law for capital investments and foreign investment procedures. Data from Palestinian sources give much lower figures for Palestinian businesses. Of the 67 licenses granted in 1991 in the West Bank, 32 are in operation; of the 17 licenses granted (out of about 300 applications) between October 1991 and October 1992 in the Gaza Strip, 10 are operating. To determine the perceptions and attitudes of the investors, 19 businessmen who recently received licenses were surveyed and interviewed, 16 in the West Bank and 3 in Gaza. Certain conclusions were drawn from the interviews. First, it is the reinforcing combination of the liberalization move and expectations of progress in the peace process that provided the impetus to many businessmen to request licenses to establish factories. The relaxation of the licensing process and the establishment of the Encouragement of Investment Act created a signal that, in tandem with the peace talks, caused businessmen to reevaluate their strategies. Second, many of the those who sought and received licenses did so to legalize existing businesses that are operating without licenses. Third, many regard the receipt of licenses and the establishment of businesses as options; hence, some hold on to licenses without establishing businesses or those establishing businesses do so on a minimal scale. Fourth, a third of those surveyed perceived significant unmet demand and, therefore, did not see competition to be a problem. Fifth, a majority of those surveyed did not believe that there was a relaxation of the other elements of the regulatory regime. Sixth, the Encouragement of Investment Act has marginal value in the sense that the amount of financial incentives do not offset the more fundamental problem of high perceived risk.

### Licensing of Professions

2.16 The legal and accounting professions operate in a no man's land. Formal licensing applies only to those candidates who have passed the proficiency examinations in Israel, which are conducted in English and Hebrew. Requests for an association of auditors in the OT have met with refusal by the authorities on the grounds of redundancy. As a consequence, these professions exist at two levels. There are a few professionals holding foreign certification (typically Jordanian or US), and the majority practice on the strength of little more than a year of semi-formal training.

### Licensing of Vehicles

2.17 The trucking business is severely restricted because of limits on the number of trucks licensed. Initial licensing fees and costs amount to around US\$1,000. In a similar way, the taxi business is also restricted. New licenses are not available. The initial cost of purchasing a license for a cab is US\$60,000 (which largely comprises a free-market premium since the official fee is in the region of US\$5,000). The passenger bus business also faces some difficulties, mainly in the form of an inability to afford new buses. Since the Israeli regulation requires buses to be no more than 15 years old, Palestinian bus operators may be forced to exit the market as their fleets age. These buses do not operate in Israel since special permits, which are not easily obtained, are required. For private cars, the registration excluding compulsory insurance costs run to around NIS 98 per month. According to Jordanian regulations, all trucks crossing the bridges are required to have been registered before 1967. In practice, this means that the trucks are at least 25 years old, energy inefficient and lacking the modern refrigeration necessary for the transport of agricultural products.



## II. Trade Regime

### Evolution of Trade Policy

2.18 Overview. The international trade policy regime facing the OT is the same as that facing Israel. In recent years, Israel has undergone a liberalization process that could be divided into three phases. The first phase, roughly from 1962 to 1977, was a period of considerable, but gradual, trade policy liberalization. The second phase, from the late 1970s to the early 1980s, initially consisted of a pause in the thrust of the trade liberalization program and then a partial reversal in 1983-85 as growing macroeconomic instability resulted in policy interventions, including increased quantitative restrictions on imports. The third phase, from 1987 to the present, was the reinstitution of the trade policy liberalization program intended to make the economy more efficient by reducing distortions and relying more on market signals. Important additional measures were instituted in September 1991.

2.19 Preferential Trade Arrangements. To improve market access for Israeli products and to stimulate competition and efficiency, the GOI signed free trade agreements with the European Community (EC) in 1975 and the United States (US) in 1985. A similar arrangement for the EFTA countries became effective in January 1993. The transition to a free trade agreement has been completed, insofar as the EC and EFTA are concerned, while the transition on the USA free trade agreement is scheduled to end in January 1995. However, trade barriers still apply in the case of most agricultural goods, in the form of quantitative restrictions, tariffs and compensatory levies. Presently, Israel still applies MFN tariff treatment to imports from the US for a wide range of products, including food products, communications equipment, shoes, paper products, chemicals and electrical machinery. By 1995, except for agricultural products, there will be no restrictions on trade between Israel and the US and the EC.

2.20 In order to remove differential trade policies with different trade partners and to institute complete, rather than partial, trade liberalization, a program was implemented effective September 1991, to reduce tariffs to a maximum of 12 percent over a seven-year period. In the early phases of the program, quantitative restrictions on imports are replaced with tariffs, some at very high effective levels. Under this program, Israel will have a very open economy by 1998.

Table 2.2: Tariff Reform Program

DATE	Maximum Tariff (Percent)
September 1991	350
September 1992	110
January 1993	75
January 1994	60
January 1995	48
January 1996	36
January 1997	24
January 1998	12

Source: Bank of Israel and State Revenue Administration Annual Report, 1992.



2.21 Impact of Trade Agreements on the OT. The preferential trade arrangements generally apply to imports and exports by the OT through Israeli ports. With respect to EC trade, the OT can import and export directly under the same preferential trade arrangements as Israel. However, with respect to US trade, the OT do not enjoy FTA preferences. While export markets in the EC, and to a limited extent in the US, became open to the OT, there has been a diversion of imports from the third countries that are the lowest cost suppliers. Additionally, the OT producers are accorded protection from the third-country competition in both the Israeli and OT markets, especially in the textile and leather sectors, at least until 1998.

#### Import Policy

2.22 Quantitative Restrictions. Except for mainly agricultural products, quantitative restrictions have been largely removed. In September 1991, a discretionary import licensing system was replaced with an automatic licensing procedure. In September 1992, the system was further streamlined, leaving only some agricultural commodities and food products subject to quantitative restrictions. However, a list of restricted countries exists, and imports from certain countries require special permission.

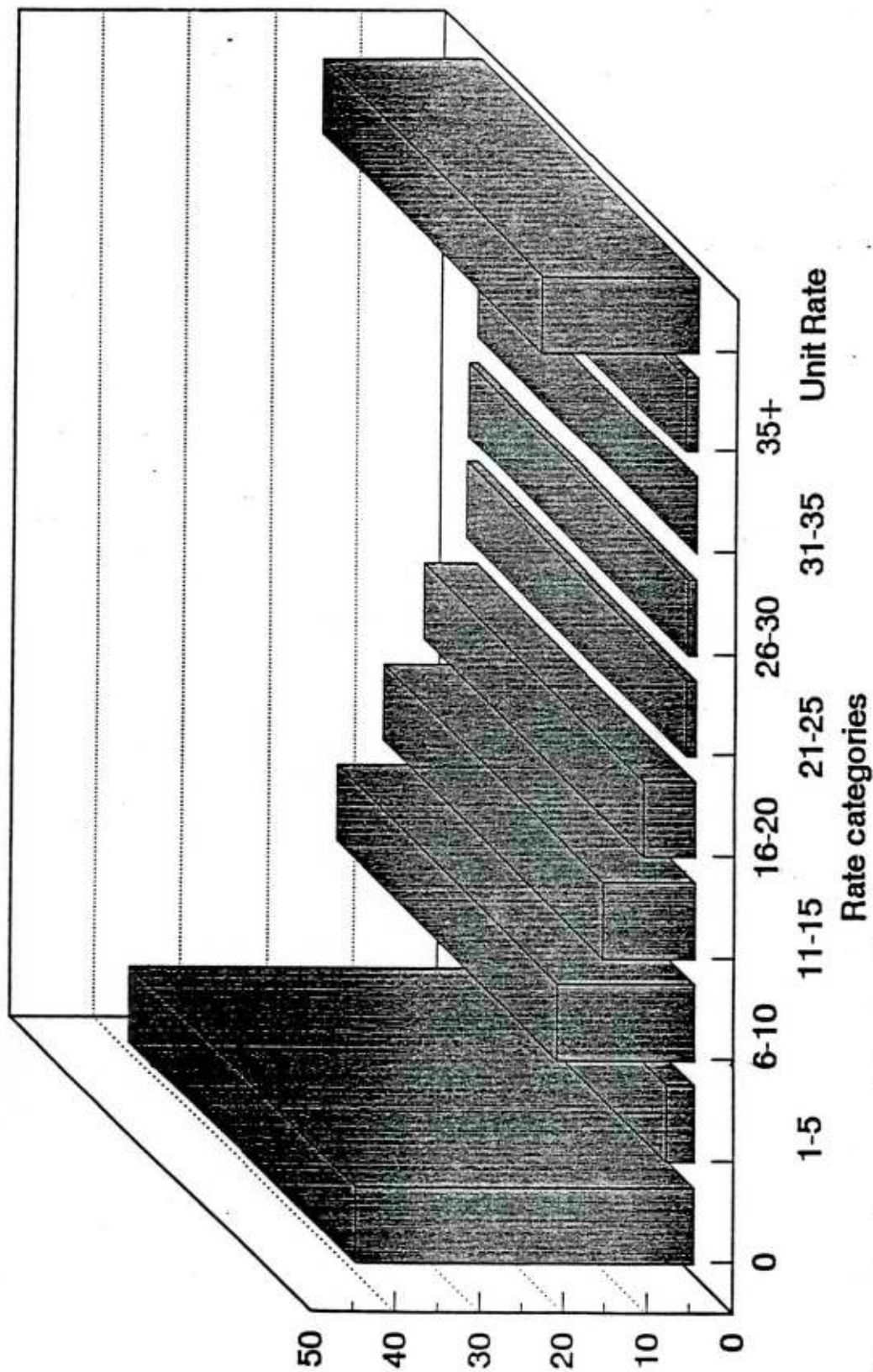
2.23 Purchase Tax. Purchase taxes are de facto excise taxes, which affect both imported goods and domestically produced goods, but not equally so. Until early 1993, the purchase taxes for many domestically produced goods were, in practice, exempted. In addition, imported goods are subject to a higher effective purchase tax rate because of the way in which they are calculated. The purchase tax basis for competing imports is the CIF value of imports, plus all customs duties, plus an arbitrarily assigned mark-up (called TAMA) designed to reflect an increase to wholesale prices. This tax has been applied to imports from all origins, irrespective of the existence of preferential trading arrangements. Because of complaints from trading partners under those free trade agreements, some changes in TAMA were introduced in 1991, reducing it to a basis of actual mark-ups. For products that are not produced in Israel, the TAMA is not included in the calculation of the purchase tax, which is levied on the CIF Import value. The purchase tax rates vary from 5-100 percent, except for cigarettes, for which the rate is 240 percent. In general, the purchase taxes apply to consumer goods.

2.24 Customs Duties. Import taxes consist primarily of an ad valorem tariff and, in many instances, a specific tariff. Table 2.3 gives the distribution of tariffs. The import weighted average realized tariff rate for all import taxes in 1991 was 11 percent. This average rate, however, understates the rate applicable to third countries, i.e., those countries not included under preferential trade arrangements but accorded MFN treatment. Taking the ad valorem and specific tariff equivalents together, the current maximum rate is 75 percent; this rate applies to sensitive products such as textiles, garments and wood products. Many combined tariff equivalent rates exist in the 30-50 percent range.

2.25 Import Licensing and Standards. Import licensing is required for 26 percent of the products and standard testing for another 35 percent of the products. The rationale for import licensing is questionable, and the benefits from standard testing depend on whether it is being utilized as a nontariff barrier. While both apply to Israeli and OT residents, in practice, the implementation is more rigorous for the OT with the licensing requirement potentially linked to other elements of the regulatory regime, specifically taxation and security control.

Table 2.3:

**Israel, Rates of Customs Duties, 1991**  
**Percent of Products subjects to Tariffs**



Source: Based on computations from Israeli customs and tariffs data, 1991.

2.26 Effective Rates of Protection. Effective rates of protection were estimated for certain commodities and are listed in Table 2.4. Textile weaving has a relatively high ERP at 39 percent, with footwear following with 14 percent. Otherwise, effective rates of protection are generally low. This could be explained by competition imposed by EC and US products, which reduces the effective protection from third countries to the extent of the price differential between EC/US and third country products. Soap, clothing, marble and building materials are export commodities.

Table 2.4: Effective Rates of Protection

Industry	ERP (Percent)
Food Processing	6
Vegetable Oil	-14
Footwear	14
Textile Weaving	39
Textile Yarn (acrylic)	6
Clothing	5
Plastics	7
Soap	0
Concrete Building Materials	7
Marble/Stone Cutting	-3
Glass	0

Source: Mission estimates.

2.27 The implication from the ERP analysis is that liberalizing third-country trade would have little impact for most industries. Textile weaving and, to a lesser extent, footwear would have to compete in products with greater value added and differentiation. Greater competition would force existing firms to examine the basis of their competitiveness, forcing them to move to skill based competitiveness rather than simple factor-based competitiveness.

#### Arab Boycott<sup>1</sup>

2.28 The Arab Boycott has a significant impact on trade, given the historical and cultural links between the OT and Arab countries.

2.29 Arab states have boycotted Israeli-made goods and services, as well as companies that do business with Israel since 1945 when the Arab League was founded. Each Arab state is responsible for its own boycott rules and regulations and for maintaining the list of companies it refuses to deal with.

<sup>1/</sup> This section is based on the Congressional Research Service, The Library of Congress, November 1992.



2.30 Under the Arab League resolutions, Arab peoples, states and companies are prohibited from buying or selling to Israel or Israelis (the primary boycott). The prohibition covers purchases of any goods, services, or merchandise manufactured in Israel; products containing components manufactured or processed in Israel; and any products transshipped through Israel. Arabs are prohibited from entering into any contracts, commercial transactions, financial operations or trade relations with Israelis, and they may not transship goods for Israelis. Arabs may not deal with non-Israeli companies or subsidiaries that deal with Israel (the secondary boycott). Finally, Arabs may not deal with companies that, in turn, deal with companies on the secondary boycott list (the tertiary boycott). Under Arab League recommendations, Arabs should demand certificates of origin on all goods acquired from all suppliers to ensure that they do not inadvertently purchase Israeli made goods or products with Israeli components, or deal with companies in the secondary or tertiary lists. Arab League regulations outlined in the resolutions are not binding on the 21 member-states, but they often have been used as models for laws passed by individual countries. The Arab League maintains a boycott office in Damascus, Syria, to coordinate member boycott activities and issues advisories on boycott situations that, in its view, demand attention from its members.

#### Export and Import Procedures

2.31 The following modalities have been distilled from a variety of actual cases, no two of which were precisely identical. Currently, the following forms and certifications are required to obtain an annual import/export certificate:

- Application for a branch sector (e.g., textile industry) "Recognized Importer" certificate
- Certificate of compliance from the CA's local income tax office
- A similar certificate from the VAT office
- Certification of good conduct from the Bureau of Social Services
- Certification of good conduct from the local municipality
- Certification of good conduct from the police
- Certification of good conduct from the Property Registry Office.

2.32 These clearances are usually obtained as part of the licensing procedure, but renewals on an annual basis mean repeating the above procedure in its entirety. The procedure can take as little as one week or be delayed for several weeks.

2.33 In addition, individual import licenses are required on a per transaction basis for imports from nations without formal trading relations with Israel and for "sensitive commodities," including processed foods, agricultural inputs and textiles, particularly from third countries, such as those in the Far East. Licenses were often denied on the grounds of "the manufacturing situation in Israel," but recent trade liberalization in Israel has replaced quotas with tariffs. Certification of compliance with Israeli product standards is required for certain products specified in the Israeli Customs Code.

2.34 The procedural modalities for importing sensitive commodities (assuming the availability of a license) include the submission of the following forms to the Office of Trade and Industry: (a) annual "Acknowledged Importer" certificate; (b) "Application for Import License" in triplicate; (c) "Submission of Order for Import/Export of Goods in Accordance with License" in six copies; and (d) income tax and VAT clearance stamps on the application.

2.35 For security reasons, it is difficult to import electrical goods and appliances, including machinery. Thus, firms are faced with the cost trade off between going through a very complicated approval procedure for new plant and equipment (with the possibility of machines being damaged when dismantled as part of the security check at the port) or making do with used, and possibly outdated, Israeli equipment.

2.36 The Israeli authorities have explained that, in recent months, the import and export procedures have been streamlined so that only a limited number of commodities require licenses. This has been confirmed by a few of the larger enterprises (such as the cigarette company and the vegetable oil company), but most businessmen simply deny that the situation has changed. The absence of formal and transparent rules, and the perception that such rules could be radically revised suddenly and without notice, has prevented a change in the mind-set of businessmen in response to changes in Israeli policy.

#### Customs Procedures

2.37 The clearing of goods through the ports and the transportation of goods over the land bridges to Jordan are often expensive and time-consuming activities. There are reportedly four kinds of checks, to which goods imported by Palestinian firms are more susceptible than goods imported by Israeli firms:

- A physical customs check, to verify shipment content against accompanying documents
- A comprehensive customs check, to verify shipment, content, price and documentation numbers - this may form an audit of shipments chosen at random; it is possible for goods to be confiscated if discrepancies are found
- A security check, which is conducted only at specified times by a specialized Police team - this check is performed most scrupulously for goods being imported by Palestinians. There are reports of loss (2 to 3 percent of the shipment) and damage during checking and dismantling of goods (10 to 20 percent of the shipment). Security checking is paid for by the importer, in addition to demurrage relating to delays as long as two or three weeks, that are outside the importer's control
- At the discretion of the Customs officer, samples may be sent to the Israeli Standards Institute to ascertain compliance with national product standards. This may take as long as six months; usually costs several times more than the price of the item in question; and is sometimes required for consecutive shipments of even standardized products imported from a single foreign vendor (e.g., European or US firm).

2.38 Since the size of each shipment of Palestinian imports tends to be small, the costs of security checking and testing have a relatively high impact on the landed cost of imports. Clearing agents' fees are in the region of .05 percent of the landed cost, while bank charges paid by Palestinian firms are usually twice those paid by Israeli firms (1.25 percent versus 0.65 percent, but sometimes as high as 5 percent).

### Exporting Through Jordan

2.39 Exporting by road to and through Jordan is subjected to extensive security checks. Lorries that pass over the bridge to Jordan have to be in stripped down condition. Both the exporter and the driver need to obtain up to seven approvals (mainly relating to taxation and police "good conduct" compliances). Clearances regarding income tax and the VAT are essential. A marble exporter reported that it is customary for each lorry to pay 1 percent of the value of the shipment as income tax (deducted at source, as it were).

2.40 The delay involved in security checking is particularly costly to exporters of produce since their cargo is perishable. Transportation often becomes the major factor determining the viability of exports, as a result of the costs associated with security checking. As one exporter explained, "it is 60 miles by road from Plastics to the bridge and 60 miles from the bridge to Amman; the first journey costs US\$1,000 per vehicle, while the second costs only US\$60." The shipping cost for a lorryload of 800 cartons or 600 boxes of citrus fruit is shown in Table 2.5.

Table 2.5: Cost of Exporting Citrus To Jordan  
(US\$)

	Description	Cost
Shipment Value	1 lorry load (800 cartons of 600 boxes of oranges - 12 tons by weight)	1,800.00
COST:		
Department of Agriculture Export fee	per ton basis	60.00
Firm's income tax deducted at source*	per ton basis	48.00
Driver's income tax deduction**	per ton basis	50.00
Fees (specific to exports to Jordan)	per truck/entry	117.00
TOTAL		275.00
Percentage of shipment value		15.3%

\* Assumes producer is also shipper; agriculture is exempted from income taxes.

\*\* Drivers mark up their usual charges by this amount.

2.41 Palestinian exporters of agricultural products face various other problems, such as the unavailability of refrigerated containers suitable for the export of Palestinian agricultural products. Exporters are, thus, forced to airfreight their produce, which costs 55 percent of the selling price of the goods, effectively removing their competitive edge.

2.42 Trucks crossing into Jordan often wait days in Jericho before they are able to cross the bridge, which creates problems, especially for produce for export to countries beyond Jordan. Vehicles crossing into Jordan must return that same day or be impounded on their way back into the OT. The



vehicles are released only after an inspection, for which the driver must bring a mechanic to take apart the vehicle as requested by the Israeli inspector.

2.43 The economic cost of the taxes, duties and other fees charged to the Palestinian entrepreneur is high, both because of the fee structures themselves and as a result of the delays in inspection, approval and shipment. The stringency of the procedures on trade with Jordan are driven by both security concerns as well as the controls relating to the Arab boycott. It should be noted that many of the procedures were established by the Jordanians. The simplification of procedures is dependent on the normalization of Jordanian trade, which in turn is dependent on the normalization of political relations among the countries concerned.

### III. Taxation System

2.44 Palestinian entrepreneurs are subjected to a variety of taxes. These consist of the following types of taxation: (a) an Income tax, (b) the VAT levied at a flat rate, currently 17 percent; (c) taxes on unused land and a property transfer tax; (d) customs duties, the Galilee tax, a Purchase tax, excise duties; (e) social security tax, deducted at the source in Israel; and (f) various other taxes, such as vehicle registration taxes and a tax on travel via the bridges to Jordan.

#### Income Tax and Value-Added Tax

2.45 Income tax is levied through both personal and corporate taxes. No tax is levied on capital gains, agricultural income (except exports of agricultural produce) or dividends. Companies must deduct tax at the source from the salaries of their employees. Personal income is taxed through a progressive structure that begins with a rate of 8 percent for income over NIS 4,800 and rises to a top bracket of 48 percent for incomes in excess of NIS 37,800 (US\$14,265). Differences exist in the incidence of personal taxation between Israel and the OT. Based on the exemptions, deductions and allowances available to an employee with a spouse and five children, Palestinians come into the tax net at NIS 7,200 (i.e., NIS 600, or US\$226, per month). The comparable figure for Israeli citizens is NIS 20,000 (NIS 1,667, or US\$629 per month), given the personal tax credits available. Common complaints are that: (a) taxation is on the high side, and no subsidies, grants or other assistance (e.g., home finance assistance) are available to Palestinians; (b) social, civic and public works benefits are either non-existent or at a very rudimentary level compared to Israeli citizens; and (c) Palestinians come under the tax net at a lower level than both Israeli and Jordanian citizens.

2.46 Table 2.6 compares the incidence of personal taxation for Palestinian and Israeli residents. This computation is based on information provided by the CA and tax, surtax and credit points data in Kesselman & Kesselman<sup>2</sup> (1992). It is assumed that a Palestinian business person with a spouse and five children is being compared with an Israeli business person in identical circumstances. It is estimated that two thirds of the Palestinian population do not earn more than NIS 20,000 per year.

---

<sup>2/</sup> Kesselman & Kesselman, Guide to Investment in Israel, 1992/93 edition.

Table 2.6: Effective Incidence of Personal Taxation  
(NIS)

Income Level	Tax on Palestinian Income	Tax on Israeli Income
12,000	592	NIL
15,000	1,072	NIL
20,000	2,080	108
24,000	3,360	1,150
50,000	14,638	9,439
100,000	38,638	33,054
200,000	86,638	85,129

2.47 Corporate income is taxed at a flat rate of 38.5 percent in the West Bank and 37.5 percent in Gaza. Business losses can be carried forward for six years. A recent military order offering incentives to investment allows new businesses to pay tax at the lowest rate assessed in the first six years, for three of the six years, provided the business has a start-up investment of US\$100,000 in the West Bank and US\$20,000 in Gaza. However, given the loss-carrying-forward provisions, this incentive is of marginal value.

2.48 The VAT is levied at a flat rate of 17 percent on value added - the difference between purchase and sale invoices, the same as in Israel. The VAT was instituted in 1976 and does not apply to agricultural produce and exports. The legality of the imposition of a VAT has been challenged by the Palestinians all the way to the Israeli High Court with the decision made in favor of the Israeli authorities.

#### Tax Administration

2.49 By far the most serious problems in the taxation system arise from its implementation by the CA. Since 1989 by Palestinian accounts there has been an increase in the severity of the implementation of the taxing statutes. Since only 24 percent of the residents of the OT come under the tax net, this might explain some of the zeal with which taxation is enforced. At the same time, it points to the undue hardships faced by a small, and productive, section of the population.

2.50 In addition to tax clearances being required at all stages of the regulatory system, the first issue that strikes an observer is the presumption of evasion that underlies tax collection efforts. Proper books of account are required and then ignored - in favor of the income tax officer's best judgement, which is usually based on Israeli standards of profitability without regard to extenuating circumstances, such as the absence of subsidies, higher input costs and the lower capacity utilization of Palestinian businesses.

2.51 Since 1989, Israelis have replaced Palestinian tax collectors who have resigned. Criminal prosecution is provided for and applied frequently. Confiscations of assets, conducted via military search and seizure operations without any advance notification, have been documented. The appellate procedure has been reduced to a quasi-military tribunal (the "Objections Committee") with recommendatory authority. The Supreme Court may be appealed to on only questions of due process, not on substantive

points of statute interpretation although some recent cases point towards a shift in this situation. Valid questions of law, such as the allocation of costs between revenue and capital expenditure or the distinction between income and contributions to equity capital or long-term debt, cannot be addressed by the system in its present form. Some 55 major amendments to the tax laws have been made by military orders, of which 10 have been unnumbered. In all cases, notification and publication is in Hebrew and, thus, not communicable to assessees, even through the municipalities and legal profession.

2.52 The collection procedure itself is excessively harsh. As in the case of citrus exporting, income tax is collected in advance of receipt of income on a presumptive basis (in this case, the tonnage being exported). The VAT is collected in five installments a year, while income tax is collected in six bi-monthly installments. At the beginning of each year, the amount of income tax thus payable in advance is determined by applying a percentage or indexed increment to the previous assessment. This advance tax is usually between 5 and 10 percent of the *invoice value of presumed sales* (based on the tax collector's best judgement, usually of similar Israeli firms) but has been reported to reach 33 percent in some cases. Given the low rates of profitability, it is fair to conclude that the advance payment of taxes places a stringent constraint on liquidity and the wherewithal of normal business growth.

2.53 In practice, an assessee whose previous year's loss has been accepted and certified by the tax authorities is required to pay 5 percent of sales rate. Thus, the loss-carrying-forward provision in the law is completely vitiated by the advance payment procedure. Assessee's are entitled to appeal to the Objections Committee if the advance tax demanded exceeds the previous year's figure by at least 40 percent. Abatement of the rate does not result, however; so, in practice, a process of negotiation occurs between the assessee and the tax collector. In addition to the advance payment of the tax, up to 25 percent of the invoice value is deducted at source by Israeli firms that purchase products from Palestinian firms.

2.54 Prompt income tax refunds and duty drawbacks/VAT refunds on exports (within 15-60 days of a claim) are provided by law but are reportedly a rare occurrence (save for the occasional well-established firm with good records). This is because a Palestinian assessee's tax account is kept permanently open, and refunds are credited against future tax dues. The legal justification for this is as follows. An assessment, once completed, cannot be reopened later than five years after that year. However, years whose assessments are not completed remain open indefinitely. By simply not completing an assessment, or by completing an assessment every other year, a tax account can be kept open ad infinitum, and reassessments can reach back to 1967. VAT accounts, similarly, remain open for usually 7 to 10 years.

2.55 Additionally, during 1990, the tax authorities frequently revised tax assessments for previous years, then demanded payment in one lump sum for the previous years for which assessments had been revised (up to five years). While this is normal procedure for tax authorities (e.g., in the US the statute of limitations is seven years, although tax audits for corporations are usually within three years), this delayed review is perceived by some as a form of harassment. Furthermore, the authorities reportedly often claim that Palestinian companies owe far more in taxes than the Palestinians and their accountants, some of whom are Israeli, maintain could possibly be the case. A procedure of bargaining for the taxes due is then carried out, with the Palestinian entrepreneur in the final analysis paying more than he, his accountant and lawyer believe can be justified. This process is reportedly similar to that in Israel. Reportedly, many businesses, which have not been operational for some time (as long as three years) or which have been only minimally operational, have, in the past year, received very high tax bills for that same period.



#### IV. Security Procedures

2.56 Security procedures are necessary given the current situation in the OT. However, these result in heavy costs to businesses and to the economy. This section describes the security measures imposed.

2.57 Travel restrictions (including curfews and pass and permit requirements) impede physical arbitrage and substantially reduce access to information for both marketing and development. It is commonly asserted that local Palestinian markets are highly fragmented. The fact that travel restrictions appear to many Palestinian entrepreneurs to be random events limits the ability to, or interest in, forward planning for production and marketing: a curfew may be announced suddenly; a truck driver may be detained; a cargo delayed; or a road closed suddenly.

2.58 Israeli regulations concerning the travel and movement of people and goods include: (a) short-term and extended curfews; and (b) the requirements for passes and permits for the movement of individuals from one village to another, from one region to another and between the West Bank and the Gaza Strip. These regulations impede the movement not only of goods and services, but also the transfer of knowledge, information and skills necessary for economic development.

2.59 Curfews are imposed by the military commander of either the West Bank or the Gaza Strip. These are imposed due to security considerations arising from escalating violence or specific threats such as the Gulf War. They may be imposed generally on the area, or on certain localities specifically, for 24-hour periods or for evening hours only (e.g., 8.p.m. through 5 a.m.). The curfews, which have lasted from 1 to 45 days, take a particularly serious toll on farm activities, often applying to entire villages and interfering with the timeliness of farm operations such as harvesting, pruning and land preparation. For extended curfews, Israelis provide passes to certain merchants such as those engaged in agricultural trade.

2.60 During curfews, factory and business owners continue to pay overhead and must meet debt obligations even when production lines have ceased operation. During the Gulf war, three Bethlehem factories reported losses of US\$500,000 in the first two weeks of curfew alone. These losses resulted from foregone production, the inability to fulfill already placed orders and the spoilage of goods in storage. During periods of curfew, factory owners are often not able to facilitate arrangements for permits for their workers to travel, nor for the movement of raw materials imported from Israel, nor for the local or export marketing of products. At one point during the Gulf war, production for most manufacturing facilities reportedly fell to 10 percent of capacity. Examples of extended curfews are those imposed on Gaza following the violence related to the deportation of some 400 Palestinians in December 1992 and the recent curfews in the West Bank related to escalating violence.

2.61 All types of enterprises have been affected by extended curfews, although those engaged in agricultural production and distribution have asserted that they are more affected than those engaged in manufacturing processes.

2.62 Security restrictions also apply to the movement of personnel. Special permits are needed for West Bank residents to visit Gaza at certain times, or for Palestinians to visit East Jerusalem. Businesses with multiple locations are particularly affected. A permit may be issued for, say, two weeks at a time, but half that period may lapse during the application procedure itself. Frequent curfews also

impose restrictions on the simplest of business activities, such as visiting the bank in Israel to cash a cheque.

## V. Impact of the Regulatory, Trade and Taxation System

2.63 The regulatory, trade and taxation system has various effects on industry structure and competitiveness. It may create barriers to firm entry or expansion; it may impact profit and cash generation through taxation; and it may engender various perceptions in the minds of entrepreneurs, so as to favor some types of business investments over others. Our survey of 75 Palestinian businesses in the industrial, construction and trade sectors indicated that, by and large, the private sector - despite its over 25-year history - exists at the embryonic stage of fragmented, proprietary businesses, with industries characterized by basically small firms. A high degree of homogeneity was found across businesses and industries in the sample, both in terms of their structure and in terms of their responses to survey questions concerning operating restrictions. The low rates of capacity utilization can be attributed to both the Intifada and to the security restrictions under which firms must operate.

2.64 These conclusions are based on several findings. First, the high level of taxation expenditure and the net losses reported in the median income statement are consistent with a regime in which a large proportion of available profits are taxed out of the hands of businesses. Second, the narrow range of industries, falling mainly in the low to moderate technology category, is highly suggestive of the presence of strong institutional barriers to entry. Finally, the perceptions of business owners with respect to the operating restrictions imposed upon them are uniformly strong and consistent across the sample. These perceptions are summarized below.

2.65 Expansion Disincentives. The main reasons cited by the surveyed firms for not raising capacity during the past two decades were "political risk" and "cash shortages." A risk-averse element exists, but this may be understandable. Some firms reported that they were forced to turn away business for want of a license and a shortage of cash.

2.66 Export/Import Restrictions. Although most respondents claimed that an export market was a "definite" possibility, given assumptions of political stability and the removal of constraints, and projected an increase in revenues (both domestic and export) averaging 500 percent (standard deviation = 150 percent) over five years, all reported severe external restrictions on their ability to compete. The most salient of these restrictions were the administrative/procedural, or unofficial, barriers to exporting, which are skewed in favor of Israeli exporters in ways to be discussed later. The main form of Palestinian exporting is indirect and is effected by means of production subcontracted by Israeli exporters. The high cost of exporting by land (e.g., agricultural produce from Gaza to Jordan) was also cited as a secondary problem by the sample firms.

2.67 A commonly reported operating restriction was dependence on Israel for raw material inputs, or on Israeli sources for material imported from Europe, averaging 65 percent of total raw material costs (standard deviation = 18.5 percent). Only a few (< 10 percent) firms reported imports from Arab countries. There are two reasons for this low percentage. It is often cheaper to buy from Israel than from the Arab countries. Further, given the Arab embargo on Israeli products, countries such as Jordan insist on a high local content to ensure that products imported from the West Bank and Gaza are not Israeli goods trying to break the embargo. Palestinian manufacturers who export to Jordan must import a high percentage of their product inputs from Jordan in the first place. In other words, the few

firms that import from Jordan are likely to be those who will re-export their production. Given the costs and difficulties posed by Israeli security procedures in bringing goods in by road from Jordan, the number of such importers/re-exporters is likely to be low. Palestinian businesses are, thus, faced with a regime that makes it difficult for them to export to Israel as well to Arab countries. Nor did we find firms in Gaza using imports from Egypt. The most salient import restraints reported by the sample related to the cost of dealing with delays and security procedures.

2.68 Overall Restraints on Business and Trade. The three most commonly reported constraints, which received the highest weight by the sample were: (a) the paucity of capital; (b) the advance payment of income tax; and (c) the licensing procedures for new businesses. Other restrictions, such as those relating to building permits and the acquisition of land, or those relating to the transportation of finished goods and exports/imports via Israeli clearing agents, were reported more selectively. Some firms cited the incentives and subsidies offered by the Israeli Government to Israeli firms as reasons for their own inability to be cost-competitive. The first two restrictions - capital paucity and advance taxes-are closely related. These were almost unanimously reported by the sampled firms. Further confirmation of the first restriction came from responses to a question identifying success factors, in which the highest ranked response (averaging 10 on a 10-point scale) was "we had our own capital."

#### Cost Impact of Regulations

2.69 Estimates were made of the cost impact of the more prevalent administrative restrictions by asking respondents to estimate the effect of these restrictions in two forms: as opportunity costs expressed as a percentage of revenues lost or as real costs in terms of increased expenditure directly related to particular restrictions. Consistent with responses discussed earlier, the absence of credit and the advance payment of income tax figured prominently in these cost estimations. For example, respondents estimated that if they did not have to tie up cash in advance tax payments, they might have the working capital to boost sales by as much as 17 percent and save up to 5 percent of sales in administrative overhead. Business licensing barriers, restrictions on transportation and importing and the issue of land allotment and building permits also imposed cost burdens on the day-to-day operations of businesses. The cost impact, stated as a percentage of sales, varied from less than one percent to over 15 percent, according to estimates given by the sample of 75 firms (excluding tourism)<sup>3</sup>.

---

<sup>3</sup> See Annex B for methodology.



Table 2.7: Average Cost Impact of Restrictions/Regulations

Restriction/Regulation Imposed	Average Rank	Cost Impact as Percent of Sales			
		Lower Revenues	Increased Expenses		
			Material	Labor	Overhead
Credit	9.3	14.9			
Advance Tax	9.0	17.4			5.2
Licensing	6.0	6.3	0.6		
Import	6.3		5.4	2.5	
Transport	5.6	2.7	3.1		
Export	5.0	12.0			
Land	4.6	10.0			

2.70 The subcontractors also reported operating restrictions that included a shortage of capital and advance tax. This group also added the restriction (ranked 8 on a 10-point scale) that direct exports were not viable, as a direct consequence of the administration of the regulatory system and the asymmetries caused by the incentives and subsidies available to Israeli firms. Further, the subcontractors held a significantly lower proportion of current assets (mainly inventories of materials and finished goods) than the rest of the sample. Finally, the sample reported its major strengths in terms of capabilities that relate more closely to their perceived regulatory pressures or institutional deficiencies than to straightforward competition-related matters. The two highest ranked reasons put forth to explain their own success/survival were the following: "we had our own capital" (mean rank = 10) and "the ability to adjust to the administration" (mean rank = 7).

#### Distortion of Industry Choice Opportunities

2.71 The taxation and regulatory system creates asymmetric choice opportunities for Palestinian industry through a mix of artificial incentives/disincentives. The four most salient distortions are discussed below.

2.72 Inefficient Sourcing of Inputs. The system creates a disincentive to the efficient sourcing of imported inputs. Palestinian firms have stated that, for many types of products, buying Israeli production involves a premium of at least 30 percent over free market prices. However, businesses are often compelled to buy from these sources because the landed cost of alternatives can sometimes grow prohibitively high as the result of extraneous costs. For example, after taking into account the risk that every shipment of Basmati rice might have to undergo costly standards testing, the importer decided it was "cheaper" to buy the Israeli alternative.

2.73 Disincentive to Modernization of Technology. In the case of capital goods, the cost differential translates into Palestinian businesses being compelled to buy second-hand, outdated machinery from Israel, instead of using modern equipment and technology. The high probability of receiving no approval for importing new equipment, or an inordinately delayed approval with deleterious consequences to the commencement of the project, and the high probability of imported machinery being dismantled and damaged during security checking, are strong disincentives to modernization. The spillover effect

is also felt in the training of personnel. As a rule, training tends to keep pace with the technology level of equipment in an industry. The resulting dependence on outdated equipment, in addition to protecting Israeli firms from new or strengthened Palestinian competitors, widens the gap between the two regions by allowing skill development in the OT to lag behind, despite the generally high level of literacy and higher education of the population. The effect, of course, is an overall deceleration of industrial development in both regions since the existence of a strong competitor next door is likely to motivate a strong industry within the country.

2.74 Disincentive to Investment and Growth. Coupled with the absence of a banking sector and any form of long-term finance, the problems associated with tax administration tend to discourage investment involving payback periods beyond the very short term. This finding should be juxtaposed alongside our somewhat contradictory finding (see Chapter III) that the financial sector is liquid. Our conclusion is that adequate cash exists in the economy for businesses to continue operations at current levels, but not for growth.

2.75 Businesses are mostly still at the small, proprietary stage of development. Significant growth has not occurred over the past 25 years. Individual questionnaire responses show that efficient firms are faced with closure as a result of advance tax requirements, delayed VAT refunds and consequent capital shortages. For a firm trading on a profit margin of 5 percent in competition with Far Eastern suppliers for global markets, delayed refunds equivalent to 17 percent of its added value can rapidly price it out of the market or force operations to a halt for want of working capital. One successful textile exporter, for instance, is reported to be facing liquidation as a consequence of being drained of working capital through the non-refund of VAT over a two-year period. The removal of the tax administration barrier should go a long way towards allowing capital formation through a retention of profits and towards encouraging private capital to emerge from hiding as soon as political stability and public confidence are restored.

2.76 Favoring Subcontracting Over Direct Exporting. Within the existing system, there is a strong incentive for an efficient entrepreneur to opt for subcontracting in preference to direct exporting. This incentive forms for a variety of reasons. Products from the OT do not qualify for the zero or reduced duties granted to Israel by the US under its Free Trade Agreement of 1985. Products from the OT may enter the US on a GSP-mandated origin designator ("Made in the Israeli-Occupied West Bank," "Made in Israel" or "Product of Israel"). They are not accorded FTA preferences unless exported by an Israeli firm claiming 35 percent or more Israeli content or a mix of Israeli and US content. Israeli customs allow the value of work subcontracted to Palestinian firms or Israeli settlements to count toward the 35 percent requirement. By 1991, the US tariff differential across Israeli versus Palestinian textile and leather products had crossed 900 percent in favor of the former. Leaving aside the question of Israeli export subsidies, this factor alone enables Israeli firms to undersell Palestinian firms even when the latter are prime manufacturers of the product.

2.77 Since 1987, Palestinian products have been acceptable in the EC but have tended to "fall through the cracks" as far as duty-free entry goes. Under the EUR1 form, textile and leather goods must have undergone at least two stages of transformation in the OT for them to qualify for duty-free entry (regardless of the local content percentage) unless the major raw materials are of EC origin. Israeli firms are able to qualify by virtue of the inclusion of subcontracted operations in the OT.

2.78 While under EC regulations, duty drawbacks automatically disqualify the exporter from preferential tariff treatment, this does not apply to the VAT and purchase tax. Palestinian and Israeli

producers are equally eligible under Israeli law for refunds of the VAT and purchase tax, but the asymmetric administrative procedures discussed earlier work against the former receiving refunds promptly. While Israeli firms are eligible for postponement of VAT payment in the first place (by posting bank guarantees that are largely unavailable to Palestinian firms without 100 percent collateral), Palestinian firms are compelled to lock up capital (in either the VAT or the collateral for the bond required to waive VAT). Delayed refunds of the VAT, taken together with other constraints such as the fear of devaluation of the Israeli currency (Palestinian firms are not eligible for capital conservation allowances) and a shortage of working capital, leave firms hard-pressed to survive.

2.79 In summary, the regulatory system either imposes barriers to entry or trade directly or does so indirectly, by causing capital shortfalls that cannot be replenished from the usual credit sources. This latter effect is by far the more serious one, as attested to by all the firms in the survey. There is little recourse against this type of barrier, it being well-nigh impossible to document and prove. Mission survey findings confirm the conjoint effect of capital shortages and the advance payment of tax as major disincentives to free trade and investment.



## ANNEX III THE FINANCIAL SECTOR

### Introduction

3.1 This annex assesses the status of the financial sector in the West Bank and Gaza. It is based on information gathered during a visit to the Occupied Territories (OT) and Israel in January-February 1993 and on documents provided to the World Bank by the Government of Israel, the Palestinian delegation to the Peace Talks and numerous governmental and nongovernmental organizations (NGOs) interested in the financial sector of the West Bank and Gaza.<sup>1</sup> Most of the economic and financial data available are from official Israeli government sources; since the beginning of the Intifada in late 1987, the reliability of these data have become far less, according to the responsible agencies.<sup>2</sup> After describing the constraints and obstacles to the growth of the financial sector in the OT, this annex recommends policy and institutional changes to improve the legal and regulatory framework of the banking sector, expand banking activities, strengthen the management of existing financial institutions, introduce measures to develop the securities market and provide training and technical assistance to facilitate the growth of the financial sector.

3.2 The most distinctive characteristic of the financial sector in the OT is the low level of measurable, formal, financial intermediation. This has been the case since the Israeli military authorities ordered the closure of the Arab and non-Arab banks operating in the OT at the time of the Arab-Israeli War in June 1967. This gap has been filled by efficient, informal financial services provided by money changers and nonfinancial agents for short-term private and commercial needs.

3.3 There has been substantial capital investment by the private sector, despite the restrictions on Palestinian economic activity imposed by the military occupation and the absence of a supportive financial sector. Gross fixed capital formation (GFCF) averaged 27 percent of GDP between 1968-1991. Only 15 percent of this sum represented the investment of government authorities, almost solely the Israeli Civil Administration. Fully 85 percent of investment was by the private sector, about 80 percent of which was in construction. There was little net investment in other productive sectors; about 85 percent of this amount (20 percent of total investment) merely covered the depreciation of productive

---

<sup>1</sup> Numerous excellent papers have been written on the financial sector in the Occupied Territories, or deal with the sector as part of an analysis of the economy. These papers were consulted in detail in the preparation of this report and are referred to in the notes to the text of this paper. Because these papers are available, it was decided not to reiterate the information in those papers here but to focus instead on limited background information deemed necessary to set the stage for the policy and institutional changes recommended. The reader is invited to turn to those papers for background information on the financial sector in the West Bank and Gaza. The best sources include: (1) UNCTAD, *The Palestinian Financial Sector Under Israeli Occupation*, UNCTAD/ST/SEU/3/Rev.1, United Nations, New York, 1989, p. 35 (hereinafter referred to as the UNCTAD Study); (2) the bulletins published by the Research Department of the Bank of Israel in the 1980s: Dan Zakai, *Economic Development in Judea-Samaria and the Gaza District (1981-1982, 1983-1984 and 1985-1986)*; (3) George T. Abed (editor), *The Palestinian Economy: Studies in Development under Prolonged Occupation*, Routledge, New York, 1988; and (4) *Development Opportunities in the Occupied Territories: Finance and Credit* by Policy Research Incorporated, Clarksville, Maryland, October 1992.

<sup>2</sup> See the comments included by the Bank of Israel in the *Statistical Abstract of Israel, 1991*, (#42), pp. 100-106.

assets, according to Israeli government estimates. This finding is confirmed by a mission survey<sup>3</sup> which found that total assets in the private sector in 1990 were only 2 percent (in real terms) above the level of 1975.<sup>4</sup>

3.4 Despite significant private sector entrepreneurial initiative, there is little effective demand at present for long-term investment capital at market prices due to political and economic uncertainties; the unwillingness of borrowers to pledge land as collateral; and the reluctance of banks to lend due to the internal security situation. The presence of donor-financed, subsidized, medium-term credit may even divert some small demand from the formal banking sector. Despite economic difficulties, there is high liquidity and ready cash availability; the recent oversubscription of new joint-stock companies demonstrates both the high degree of liquidity and the current scarcity of opportunities for investments denominated in Jordanian dinars.

### I. Financial Sector Development Since 1967

#### The Banking System

3.5 At the time of the Arab-Israeli War in June 1967, there were 8 Jordanian and foreign-owned banks with 26 branches in the West Bank, and 3 Egyptian and foreign-owned banks, with 4 branches in Gaza. Those in the West Bank (administered by Jordan) operated under the Jordanian Banking Law of 1965, while those in Gaza (administered by Egypt) operated under the Banking Ordinance of 1941, established by the British mandatory authority.<sup>5</sup> The Israeli military closed all Arab and foreign-owned banks immediately after their conquest of the West Bank and Gaza, froze their accounts and transferred the cash balances to the Central Bank of Israel as deposit accounts in the banks' names.<sup>6</sup> The Israeli currency was declared the legal tender in the OT and Israeli foreign exchange control regulations, far more restrictive than Jordanian regulations or practice, were applied. However, the Jordanian dinar continued to circulate as a legal currency in the West Bank (and unofficially in Gaza), and the bridges across the River Jordan remained open to a sharply reduced flow of commerce and visitors. The Egyptian pound ceased to be legal tender in Gaza, although it continued to circulate for a few years. Former employees remained on the payrolls of the closed banks, and some continued to promote business on behalf of their headquarters. The Central Bank of Jordan assumed responsibility for the assets and liabilities of Jordanian banks, and these were liquidated in an orderly manner. The Egyptian Government took no such action concerning the banks operating in Gaza, and the border with

<sup>3</sup> See Appendix B for methodology

<sup>4</sup> World Bank, "Report on the Private Sector: Industry Field Survey, Regulatory and Taxation System, [Tourism] Tourism - Analysis and Recommendations", unpublished confidential working paper by Dr. Dileep Hurry, pp.7-9. This observation was confirmed in the mid-1980s by Dan Zakai, who observed that 80-85 percent of equipment investment went to cover the current depreciation of the capital stock. See Bank of Israel, Research Department, Economic Development in Judea-Samaria and the Gaza District, 1985-86, p.29.

<sup>5</sup> Sources: UNCTAD study and Central Bank of Jordan, 1968 Annual Report.

<sup>6</sup> UNCTAD study, pp.35-36.

Egypt was closed to all legal commerce. Effectively, the OT were left without a formal banking system, although West Bank and Gaza residents retained access to their bank accounts in Jordan and abroad.

3.6 Mobilization of Savings and Investment. At the time of the occupation in 1967, the economies of the West Bank and Gaza functioned as parts of Jordan and Egypt, respectively, without organic links between the two territories. With its cultural and commercial centers of Jerusalem, Nablus and Hebron, the West Bank was considered to be the most dynamic region of Jordan. The West Bank constituted about 25 percent of the GDP of Jordan at that point, with about 30 percent of the population. Although separate figures are not available for Gaza, it apparently enjoyed a "golden age" between 1958-1967 when the introduction of socialism in Egypt turned the beaches of the Gaza Strip into a conveniently located entrepot for smugglers.<sup>7</sup> Prior to 1967, although not sophisticated by today's standards, the banking system provided substantial financial intermediation for the economy. In 1966, deposits (\$189 million) in the Jordanian banking sector amounted to nearly 50 percent of GDP; bank credit amounted to 25 percent of GDP; and GFCF constituted 80 percent of domestic bank credit. By comparison, total bank deposits in the West Bank were \$39 million in 1966, and total bank credit was \$28 million, or about 30 percent of the region's GDP of \$99 million.<sup>8</sup>

3.7 Israeli Banks. Under occupation, the indigenous banking system in the OT disappeared and with it any direct financial links to Arab countries, including Jordan and Egypt. Thereafter, the only banks licensed to operate were Israeli banks, which expanded through the 1970s and 1980s until they numbered 31 branches in 1984. While some of these banks served only the needs of Israeli settlers, 22 branches were located in Arab towns. Until the start of the Intifada, Israeli banks followed more aggressive lending practices than had been the case with Arab banks. Israeli banks accepted industrial equipment, vehicles, promissory notes and even post-dated checks as collateral, rather than insisting on real estate, because of Arab sensitivity to mortgaging land or houses to an Israeli bank. Through Israeli banks, Arab investors had access to OECD country bilateral export credit programs and the Bank of Israel's (BOI) loan guarantee program for OT residents, until both ceased to operate in 1988. In the 1980s, intense competition caused substantial investment in computer technology, which raised the level of customer service beyond the levels in some OECD countries.<sup>9</sup>

3.8 Despite their virtual monopoly position after 1967 and useful, high quality services, Israeli banks have provided very limited financial services to Arab residents in the OT. According to official statistics, credit from Israeli banks in the OT averaged only 1 percent of GDP between 1977-1987 and

---

<sup>7</sup> Interview, Banker, Gaza, February 1993.

<sup>8</sup> Regional GDP for 1966 has been estimated from available GDP data for 1968 published by the Israel Central Bureau of Statistics, National Accounts for Judea, Samaria and the Gaza District, 1968-1986, p. 55. These ratios are far lower than the level of financial intermediation in Jordan or Israel today, though not so different from the level of bank intermediation in contemporary Syria which has a much less dynamic private sector (see Table 3.1).

<sup>9</sup> Interviews with bank managers, Jerusalem, January 1993.



peaked at just \$48 million equivalent in 1987.<sup>10</sup> Following the Intifada, all but 6 of the some 30 Israeli bank branches in the OT were closed, and the level of business at one of the principal bank branches declining with Arab customers had, by 1992, declined to only 20 percent of the already low, pre-Intifada level.<sup>11</sup>

3.9 The primary reason for the low market penetration of the Israeli banks was political: given a choice, few Palestinians willingly utilized Israeli financial institutions. According to a close Israeli observer of the OT economy, the limited use of the banking system stemmed from either the Arab public's lack of confidence in the Israeli banks and their preference for Jordanian banks, although difficult to access, or to the extensive informal financial sector of moneychangers, merchants and middleman.<sup>12</sup> This lack of confidence was due to a pervasive fear that financial information on Arab customers in Israeli banks would become available to the Israeli tax authorities and to an unwillingness to mortgage Arab-owned land to any Israeli institution, even a non-governmental one in the private sector. A third reason was the prevailing pattern of payments and savings in the OT: cash has been the common means of payment; the hoarding of gold and strong currencies, the normal means of saving. High inflation in Israel (averaging 144 percent annually between 1983-1987), the continuous devaluation of the shekel (in contrast to the stability of the dinar before 1988) and an Israeli banking crisis in the early 1980s, led to a preference for the dinar (and other foreign currencies) as a store of value for investment purposes and to the use of Jordanian banks. Since the Israeli banks were not allowed to handle dinars, transactions between OT residents and foreign transfers (generally in dinars) passed through Jordanian banks or moneychangers. The use of the Israeli banks was limited primarily to spot market transactions in shekels (NIS) with the Israeli economy or payments to the Israeli administrative authorities.

3.10 Reopening of Arab Banks. Beginning immediately after the 1967 war, there were several unsuccessful rounds of negotiations aimed at reopening the banks that had been operating in the OT at the time of the June war. These negotiations were unable to resolve fundamental political issues, including the reopening of former branches in East Jerusalem, which were annexed by Israel after the war; parallel supervision of the central banks of two countries still at war with each other; or technical issues regarding capital requirements, control over external deposits and legal reserves. Finally, in 1981, after several years of intense lobbying, the Bank of Palestine (BOP) was allowed to reopen in Gaza, and now has three branches in the Gaza area. In 1986, the Cairo-Amman Bank (CAB) reopened in Nablus on the West Bank, and recently opened its eighth and ninth branches in the West Bank. Although each bank may deal in shekels, neither is allowed to expand beyond its respective borders e.g. West Bank and Gaza. Given the current poor security situation, both banks follow very conservative lending policies and provide limited banking services to the economy. At the end of 1992, they provided credit of only

<sup>10</sup> Figures have been taken from: Bank of Israel, Supervisor of Banks, Annual Statistics of Israel's Banking System (various annual editions with the latest being 1983 - 1987) and Israel, Central Bureau of Statistics, National Accounts of Judea, Samaria and Gaza Area, 1968-1986 and the same document covering the years 1983-1990. For an analysis of the subject, see the bulletins published by the Research Department of the Bank of Israel in the 1980s: Dan Zakai, Economic Development in Judea-Samaria and the Gaza District (1981-1982, 1983-1984 and 1985-1986).

<sup>11</sup> Interview, bank manager, West Bank, February 1993.

<sup>12</sup> This paragraph is based on the analysis of Dan Zakai, op. cit., 1981-82, pp.65-68, as well as interviews with numerous Palestinian businessmen and bankers. See also Zakai's excellent volumes covering 1983-84 and 1985-86.

\$17 million, less than 1 percent of GDP (Table 3.1). Table 3.2 highlights the low level of financial intermediation by OT banks compared to banks in Israel, Jordan and Syria.

Table 3.1: Summary Balance Sheet of the Commercial Banks: 1991-1992  
(US\$ Million)

	1991	1992
<u>Assets</u>		
Cash in Banks	\$48.0	\$63.1
Loans	15.4	17.3
Investments	54.5	51.4
Other Assets	18.2	41.2
Total Assets	136.1	173.0
<u>Liabilities &amp; Capital</u>		
Deposits		
-less than 1 year	90.5	128.1
-savings & time deps.	17.1	14.8
Total Deposits	107.6	142.9
Other Liabilities	3.0	25.9
Total Liabilities	110.6	168.8
Capital & Reserves <sup>a/</sup>	3.6	4.2
Total Liab. & Capital	\$117.2	\$173.0
Guarantees	5.6	8.0

<sup>a/</sup> For one bank. The other bank has capital deposit equivalents in the form of negotiable Government of Jordan Treasury bills (US\$96 million equivalent) and an international guarantee @ 7% of deposits (US\$8.4 million), for a total of US\$104.4 million, on a total balance sheet of US\$145 million.

Table 3.2: Comparative Financial Sector Analysis - 1990  
(US\$ million)

Basic Data	Jordan	Occupied Territories	Israel	Syria
GDP	3,937	2,221	50,424	24,823
GDP per Capita	1,142	1,385	10,472	2,082
Population (millions)	3.45	1.60	4.82	11.92
Exchange Rate (to US dollar)	0.66	2.01	2.01	11.22
Investment & Credit				
Gross Fixed Capital Formation (GFCF)	1,020	598	8,664	3,641
Domestic Credit	4,729	14	54,895	7,667
Total Bank Assets	6,146	107	72,910	10,218
Claims on Private Sector	2,901	14	29,764	1,783
Claims on Government	1,828	0	24,323	5,884
Demand and Savings Deposits	4,224	78	64,031	7,599
Capital	247	39	3,227	280
Ratio Analysis				
Deposits as % of GDP	107.0	4.0	127.0	31.0
Domestic Credit as % of GDP	120.0	0.7	108.9	31.0
Claims on Private Sector as % of GDP	73.3	0.7	59.0	7.2
GFCF as % of GDP	25.9	26.9	17.2	14.7
GFCF as % of Domestic Bank Credit	21.6	4271.0	17.0	47.5
Bank Deposits per Capita	1,224	49	13,284	638
Capital as % of Risk Assets	5.2	279	5.9	3.7
Capital as % of Total Assets	4.0	36.4	4.4	2.7
Capital as % of Deposits	5.8	50.0	5.0	3.7

Sources: IMF, International Financial Statistics, Yearbook 1992 for Israel, Jordan, Syria and Israel, Central Bureau of Statistics, National Accounts of Judea, Samaria and Gaza Area, 1968-1986 and 1986-1991, for the Occupied Territories.



3.11 Competition in Bank Services. With only one Arab bank each in the West Bank and Gaza, the minimal Israeli bank presence and a high risk business environment which is not conducive to normal banking transactions, there is little competition in banking services at present and interest spreads are high, as shown in the following Table 3.3.

Table 3.3: Current Bank Interest Rates (in percent)<sup>13</sup>

	Arab Banks			Israeli Banks	
	Dinars	NIS	Dollar	NIS	Dollar
Deposit	0-2	10	2.5	--	3.0
Lending	9-12	20-25	16.0	--	5.0
Interest Spread	9-12.5	10-15	13.5	8.0	2.0

3.12 The Arab banks also charge relatively high fees: for example, the Bank of Palestine is said to charge 2 percent per month for a bank guarantee in Gaza.<sup>14</sup> In addition, the CAB and BOP are circumscribed, by the terms of the agreements licensing their operations, in the channels through which they may offer international services to their customers. They may not send transfers directly to foreign bank branches or open letters of credit, but must deal through an Israeli bank. This places the Arab banks at a substantial competitive disadvantage, both in terms of a less flexible fee structure, which must be split with the Israeli bank, but also in terms of the time taken to complete a foreign transfer. According to businessmen, transfers through an Arab bank and their Israeli correspondent can take up to six days, whereas that transfer done directly through an Israeli bank take only one day.<sup>15</sup> Transfers via Amman may also be subject to several days' delay. However, it can mean that transaction costs to their customers are lower when processed through Israeli banks.

3.13 The Israeli banking sector is far more competitive than the Arab banks in the OT, with narrower margins, more flexible policies on collateral and better service. For example, Israeli banks have an 8 percent spread on typical NIS-denominated business loans and charges LIBOR plus 1.5-2 percent (currently about 7 percent) for a five-year dollar loan.<sup>16</sup> Israeli banks typically require only 25 percent cash collateral for a six-month letter of credit, whereas Arab banks require 80-100 percent cash collateral at higher interest spreads. Adding to their competitive edge - and the lower cost of doing business for their clients - is the high level of automation at the Israeli banks. Whereas Arab banking practices are traditional, with numerous signatures required to complete a transaction, Israeli banks use a "teller" system. Cashing a check reportedly takes 30 minutes at an Arab bank branch and only 2

<sup>13</sup> Interest rates as of late January 1993, according to bank managers in the West Bank and Gaza.

<sup>14</sup> Interview, industrial investor, Gaza, January 27, 1993.

<sup>15</sup> Interview, bank manager, West Bank, January 1993.

<sup>16</sup> Interview, Israeli bank manager and Arab businessman, West Bank, January 1993.

minutes at an Israeli one.<sup>17</sup> All accounts at Israeli banks are now fully "on-line," permitting immediate posting to a client's account anywhere in the world within the bank's branch network. A number of Arab businessmen interviewed prefer Israeli banks for sound business reasons, despite the political onus of dealing with an Israeli bank.

3.14 Establishment of New Banks. In the absence of a well-developed banking sector, there have been a number of local investor groups from the West Bank and Gaza, some with external financial and managerial support, which, since the early 1980s, have applied without success to the Israeli authorities for licenses to open new banks. According to representatives of these groups, applications have been made for two commercial banks, an Islamic bank, an agricultural cooperative bank and two development banks. According to the sponsors, the Islamic Bank has been denied a license. In the other five cases, the CA has not explicitly denied the applications. The investors appear to have different expectations. In some cases, they expect to operate under Israeli banking laws; in other cases, under Jordanian law; but all expect to operate in dinars. In that case, the Central Bank of Jordan must approve any bank that intends to operate in dinars, permission that has not been granted up to now. There is preference for the reopening of banks that operated in the OT before 1967 to the establishment of new banks.<sup>18</sup> The issue of minimum capital is one area of ambiguity: Jordanian banking law requires minimum capital of \$7.5 million equivalent; for the OT, the BOI had previously set a minimum capital level of \$15 million. Though it has not provided written guidelines or comments on the criteria that must be met for approval, the authorities maintain that this gives them some flexibility in implementing the capital requirements. It has apparently discussed with investors the key concerns of the BOI, including the level of capitalization required, recently reduced to US\$10 million, for a locally incorporated bank. Some investors seem to think that the minimum capital requirement is negotiable; others do not. The lack of explicit written guidelines gives investors the impression that the authorities react to their applications in an arbitrary and discretionary manner, while according to the authorities, no investor group has yet mobilized the capital to be granted a license.

3.15 Legal and Regulatory Framework. Table 3.4 presents the laws and regulatory authorities applicable to the financial sector. The following discussion deals primarily with the banking sector. Presently four banks operate in the OT: two Arab banks, the Bank of Palestine in Gaza and the Cairo-Amman Bank in the West Bank; and two Israeli banks, the Bank Leumi Le-Israel and Haopalin Bank in the West Bank. The banks operate under a legal framework composed of separate banking laws for Gaza and Jordan (the West Bank) that existed in June 1967 and Israeli banking laws.<sup>19</sup> Rather than unify these three banking laws or standardize Israeli banking laws, the military authorities argue that they were required, as an occupying power, to perpetuate the legal status quo. In practice, they have neither perpetuated that status quo nor substituted a common legal framework covering all banks operating in the

<sup>17</sup> Interview, bank manager, West Bank, January 1993.

<sup>18</sup> Interview, bank official, Amman, February 1993.

<sup>19</sup> The banking law for Gaza in 1967 was the Banking Ordinance of 1941 from the British mandate. It was updated in 1980. The Banking Law of Jordan (#94) of 1966 applied to Jordanian and non-Jordanian banks operating in the West Bank. Jordan replaced that law with a new Banking Law (#24) in 1971, which was amended in 1992. Jordan also revised the law governing the operation of money changers in 1992 (Law #26). The operations of Israeli and international banks in Israel and the OT are covered by the Banking Ordinance of 1941 from the British mandate, as amended in April 1988, the Bank of Israel Law (1954), and the Banking (Licensing) Law (1971), as amended in April 1988.

OT.<sup>20</sup> Nor have they adopted the amendments to Jordanian banking legislation that were enacted in 1971 and 1992. The military authorities have continued the pre-occupation practice of separate legal regimes for Gaza and the West Bank, based on the legislation in force at the time, as modified by some 265 military orders issued since 1967. This has perpetuated the separation of these two regions and has reinforced their differences by adding separate legal regimes for Arab and Israeli banks.

---

<sup>20</sup> For a summary of Israeli Military Orders applicable to the financial sector see, Israeli Obstacles to Economic Development in the Occupied Palestinian Territories, published by the Jerusalem Media and Communication Centre, Jerusalem, November 1992. An index to these military orders, Israeli Military Orders in the Occupied Palestinian West Bank 1967-1992, was published by Jerusalem Media and Communication Centre in February 1993. For an analysis of these military orders see Raja Shehadeh, Occupier's Law: Israel and the West Bank, Institute for Palestine Studies, Washington, D.C., 1988.



Table 3.4: Matrix of Laws and Regulatory Authorities Applicable to the Financial Sector

	<u>West Bank</u>	<u>Gaza</u>	<u>Israeli Entities</u>
Banking a/	<ul style="list-style-type: none"> <li>- Banking Law of Jordan (#94 of 1966), as amended by military orders</li> <li>- Civil Admin (BOI)</li> </ul>	<ul style="list-style-type: none"> <li>- Palestine Mandate Banking Ordinance (1941), as amended by military orders (updated 1980)</li> <li>- Civil Admin (BOI)</li> </ul>	<ul style="list-style-type: none"> <li>- Banking Law (1971, updated 1988)</li> <li>- Bank of Israel Law (1954)</li> <li>- Bank of Israel</li> </ul>
Money Changers b/	<ul style="list-style-type: none"> <li>- Not regulated at present</li> </ul>	<ul style="list-style-type: none"> <li>- Not regulated at present</li> </ul>	<ul style="list-style-type: none"> <li>- Do not operate in Israel</li> <li>- Currency Control Law of 1978</li> <li>- Bank of Israel</li> </ul>
Corporate Securities	<ul style="list-style-type: none"> <li>- Issuance of shares as per Jordan Company Law</li> <li>- Civil Administration</li> </ul>	<ul style="list-style-type: none"> <li>- Issuance of shares as per Palestine Mandate Companies Law</li> <li>- Civil Administration</li> </ul>	<ul style="list-style-type: none"> <li>- Securities Law of 1968</li> <li>- Securities Authority</li> </ul>
Leasing	<ul style="list-style-type: none"> <li>- No special regulation or authority</li> </ul>	<ul style="list-style-type: none"> <li>- No special regulation or authority</li> </ul>	<ul style="list-style-type: none"> <li>- No special regulation or authority</li> </ul>
Company Law	<ul style="list-style-type: none"> <li>- Jordan Company Law of 1964 as amended by military orders</li> <li>- Civil Administration</li> </ul>	<ul style="list-style-type: none"> <li>- Palestine Mandate Companies Law of 1929 as amended by military orders</li> <li>- Civil Administration</li> </ul>	<ul style="list-style-type: none"> <li>- Israeli Companies Ordinance (New Version) of 1983</li> <li>- Companies Registrar</li> </ul>
Insurance	<ul style="list-style-type: none"> <li>- Jordan Insurance Law as amended by military orders and now replaced by Israeli CIBL</li> <li>- Controller of Insurance (Israel)</li> </ul>	<ul style="list-style-type: none"> <li>- Jordan Insurance Law as amended by military orders and now replaced by Israeli CIBL</li> <li>- Controller of Insurance (Israel)</li> </ul>	<ul style="list-style-type: none"> <li>- Control of Insurance Business Law (CIBL) (draft) (January 1993)</li> <li>- Controller of Insurance (Israel)</li> </ul>

a/ New Jordanian Banking Law in 1992.

b/ New Jordanian Law on Exchange Operations (#26 of 1992).

3.16 The fragmentation of the legal framework has been reinforced by the establishment of separate legal agreements and regulatory practices that were established at the time the Bank of Palestine and the Cairo-Amman Bank were reopened.<sup>21</sup> Rather than applying a common set of requirements for

<sup>21</sup> The discussion in these few paragraphs of the fragmented legal framework and discretionary regulatory practice with regard to the banking sector also applied to the insurance sector until a new Control on Insurance Business Law was drafted in January 1993, which sets a clear, if different, legal basis for all Israeli and OT insurance companies.

minimum bank capital, capital adequacy,<sup>22</sup> reserve requirements and lending ratios, the military authorities have used separate yardsticks to monitor bank performance and to measure the soundness of applications to expand bank branches, leaving the determination of appropriate practice in each case to the discretion of the BOI. While this unequal treatment may be understandable given the highly unusual situation - reopening banks under a state of military occupation - it has created an unequal operating environment for the banking sector, in terms of a level playing field on which all banks compete equally, or a single clear set of criteria by which to evaluate bank performance, or allowing either the expansion of existing banks and bank services or the establishment of new ones. Table 3.5 summarizes the dissimilarities in the current treatment of some key standards and prudential ratios that apply to banks operating in the OT.

Table 3.5 Current Bank Prudential Ratios  
(US \$ Million)

Bank Account/Type	Minimum <sup>d</sup> Paid-In Capital	Capital Adequacy Ratio	Liquidity Ratio	Reserve Requirement
Bank of Palestine	3.8	<u>c/</u> <u>not applied</u>	none applicable	100% on FX deposits/7%-10% on LC deposits
Bank Leumi	50 <u>a/</u>		none applicable	0%-75% on FX 4%-100% on LC
Cairo-Amman Bank -in Jordan -in West Bank	7.5 104 <u>b/</u>	1.4x	n.a. n.a.	35% FX/15% LC 17% on FX and LC

a/ Notional because no banks have been established in the past 20 years.

b/ Securities and guarantees in lieu of paid-in capital and reserves.

c/ Would be about 8% if it were to be applied. Current ratio exceeds this limit.

d/ Would be \$10 million for a new applicant in the OT.

Source: Interviews with commercial bank managers and officials of the Bank of Israel

3.17 As a case in point, the BOP, which has its headquarters in Gaza, was allowed to reopen in 1981 with capital (in the form of personal pledges and bank guarantees) of 5.5 million Egyptian pounds (US\$3.8 million equivalent), sufficient to cover some doubtful assets. The BOP has remained a conservative, liquid bank, and no formal liquidity or capital adequacy ratio has been applied in practice. When the CAB reopened in 1986, (arguably a far larger bank, with a much larger potential mark up, which is headquartered in Jordan beyond the reach of the BOI), it was required to provide an extraordinary level of security in lieu of capital. According to the terms of the agreement, the CAB must hold as deposit with its local main office negotiable Jordanian government bonds or provide an international bank guarantee equivalent to 7 percent of total deposits; and maintain, at all times, a cushion

<sup>22</sup> For example, capital to deposits, loans and total assets.

of assets 10 percent greater than total liabilities in lieu of capital. At the end of 1992, the combined value of deposited government securities and the international bank guarantee was US\$104 million equivalent, on deposits and risk assets of US\$143 million and US\$15 million equivalent, respectively.<sup>23</sup> While such stringent capital equivalents may have been justified at the time of reopening, given the unprecedented nature of the situation, all parties now agree that the current level is excessive, given the slack demand for bank credit. The principle of a deposit in lieu of capital is normal practice for the branch of a foreign bank in another country, but it should be a ratio of qualifying capital to risk-weighted assets. For a sound, well-managed bank that has provided for all identified and potential losses, such a ratio should be about 8 percent of risk-weighted assets, including those that are "off the balance sheet." Such a level of protection, in line with current international practice, would be far below the level usually required.

### Money Changers

3.18 The absence of readily accessible national banking institutions, the existence of two legal currencies (dinar and shekel) in the West Bank (the shekel is the only legal currency in Gaza), stringent exchange controls and rapid inflation gave impetus to the rapid expansion of money changers after 1967 as a substitute financial sector. The number of money changers in the West Bank grew from 42 in 1967 to 196 by 1986.<sup>24</sup> The services offered by each money changer depend on the size of his operation, capital base and branch or correspondent network. The larger, better-established money changers operate as small international banks, with offices in the Gulf and banking relationships in Europe and North America. Their primary services include foreign currency exchange, inward and outward money transfers and remittances and check cashing on external accounts. Prior to 1989 transfers between Amman and the OT amounted to as much as \$750 million annually.<sup>25</sup> In general, the services of the money changers are more flexible, faster and less expensive than comparable bank services. For example, their margins on foreign currency exchange and money transfers can be less than 0.05 percent, while commercial banks may charge as much as 3 percent.<sup>26</sup> Those with international networks offer money transfer by telephone or fax, with immediate credit in major financial centers, for amounts up to several million dollars, which is comparable to the service of the best Israeli banks and better than the current standard of service at Arab banks.<sup>27</sup> In addition to these financial benefits, they offer anonymity and the assurance that neither specific transactions nor the size or location of a client's wealth will become known to the Israeli tax, customs or civil administration authorities.

<sup>23</sup> Interview, bank managers, West Bank and Amman, January-February, 1993.

<sup>24</sup> This paragraph is based on the information on the money changers in the UNCTAD study, pp. 61-65 and the excellent analysis of their role and function carried out in the mid-1980s by Laurence Harris, "Money and Finance with Undeveloped Banking in the Occupied Territories," in George T. Abed (editor), The Palestinian Economy: Studies in Development under Prolonged Occupation, Routledge, New York, 1988, pp. 191-222.

<sup>25</sup> Interview, money changers, Amman, February 1993. Lawrence Harris estimates the net inflow of transfers into the OT at \$410 million in 1985. Harris, op.cit., p.195.

<sup>26</sup> Money changers and commercial bankers interviewed in the West Bank, Gaza and Jerusalem in January-February 1993 cited even lower rates for the services of money changes, though they vary with supply and demand and with differentials between officials and free market exchange rates. See also the studies by UNCTAD and Laurence Harris already cited.

<sup>27</sup> The estimates of relative service quality were made by both bankers and bank customers in the OT and Amman during interviews in February 1993.



3.19 On a selective basis, the larger money changers also accept deposits, extend short-term account overdraft facilities from one month to a year, guarantee clients with a third party and invest funds on a fiduciary basis: the nature, size and frequency of these services depends on the relationship with a particular client. However, according to money changers interviewed in the OT, credit extension is neither a principal activity nor a particular interest and is a service provided to trusted clients only when necessary.<sup>28</sup> That this is so is due, first, to the fact that given the capital requirements and risks involved, accepting deposits and lending money is probably less profitable than the principal business activities of money changers (high volume transactions, such as foreign currency trading, which have thin margins but which are not capital-intensive); second, the very nature of their operations – short term, transaction-oriented and based on personal knowledge of clients – is not conducive to financial intermediation, except on an infrequent, selective basis; third, since most money changers are unlicensed, there is no legal basis for them to establish a relationship to provide substantial capital for long-term investment; fourth, because they are dealing primarily in a "foreign" currency (the dinar and the dollar illegally), net settlements must be physically transported across the bridges to Amman, an awkward procedure; and fifth, since most of their business is undocumented, and some of it illegal, there is little opportunity for money changers or their clients to pursue legal means to settle business disputes.

3.20 As a result of these factors, other analysts have found that the money changers have played no role in financing industry, agriculture or the construction sectors, beyond occasional finance for a client's working capital requirements and, then, not on a continuing basis. However, due to the circumstances of the occupation, the money changers have become a relatively efficient informal, emergency financial sector. This sector has successfully handled several hundred million dollars of currency exchange, money transfers and remittances annually but has not provided an effective alternative for savings mobilization or the extension of credit over the medium to long-term, or for substantial working capital requirements over the short-term.<sup>29</sup> For that, an efficient banking system and capital market are required. However, the money changers offer efficient financial services at reasonable costs and their continued operation should be encouraged. Regulating them would be exceptionally difficult without a skilled supervisory body and could send a strong negative signal to the market about the direction of future financial policies.

#### Credit Programs

3.21 The lack of effective mechanisms to mobilize savings and provide credit in the OT has led to many initiatives since 1967 to extend medium- and long-term capital outside the banking system.<sup>30</sup> A major program to provide credit from external sources was the Palestinian/Jordan Joint Coordinating

<sup>28</sup> Interview with money changers in West Bank, January 1993. The UNCTAD and Harris studies suggest that the interest rates charged range from 0 to 40 percent, depending on the client and the nature of the transaction, but they confirm that it is not a principal line of business activity.

<sup>29</sup> PIDEA, plc (Planning, Economic and Development Consultants), Review of Small Scale Enterprise Programmes: West Bank and Gaza, London, May 1992, pp. 4-8 and Harris, *op. cit.*

<sup>30</sup> The information in this section on the credit institutions and their programs is drawn primarily from a fine analysis of these institutions by PIDEA, *op. cit.*, and the UNDP, Assistance to the Occupied Palestinian Territories, 1992 Compendium of Ongoing and Planned Projects, Jerusalem, April 1992. In addition, information was collected on many of the programs during a series of interviews in February 1993. Table 3.6 was prepared based on data collected by Mr. Samir Huleileh and Mr. Ashraf Zein, counterparts to the World Bank mission.

Committee, set up to distribute money pledged to the OT and other non-oil producing states by the Arab states at the Baghdad Conference in 1978. An estimated \$460 million was distributed in the OT in the early to mid-1980s, mostly as grants, across a number of sectors. The money was viewed by recipients as income redistribution and little of that.<sup>31</sup>

3.22 Since the early 1980s, more than 20 credit programs and institutions have been established to serve as conduits for external, private and official, bilateral and multilateral funds to support the Palestinian economy and people (see Table 3.6). All were established to achieve a variety of worthwhile developmental, charitable and social welfare objectives, such as income generation among women and poverty alleviation. While there has been considerable overlap in areas such as agriculture and small-scale enterprise, some programs have begun to develop a specialized focus as part of a recent trend toward greater coordination and tighter financial management. Almost all of these programs are administered by Palestinian non-profit organizations or foreign NGOs and may be managed by development specialists, not financial professionals. Most programs were established in the West Bank but have now begun to seek better balance by giving more attention to operations in Gaza. All of these programs are small and provide very small loans, averaging \$ 10,000 each: the aggregate portfolio of outstanding loans in all 23 credit programs was \$16 million at the end of 1992, comparable to credit outstanding from the commercial banks. Considerable near-term growth can be expected since the EC is providing additional grants of ECU 19 million (US\$ 22.8 million equivalent) during the 1993-95 period.

3.23 There are differences in lending practices among so diverse and numerous a group. In general, however, the credit institutions have provided very cheap capital (an average interest rate of 5 percent, including fees, in US dollars), given their high risk in lending to small and micro-scale (SME) enterprises, which is at sharp variance to normal, risk-adjusted bank lending policies to SMEs in both developing and developed countries. These policies are not an appropriate basis for sustainable long-term lending.<sup>32</sup> Over the past few years, they have provided funds at below market rates of interest – as much as 50 percent less – and have generally given easier terms to the riskier loans, using more conservative loans to subsidize higher risk borrowers. Although they tend to serve somewhat different markets by virtue of the small size of their loans, their "soft" lending practices have made it difficult for credit programs to institute tougher measures. More importantly, they have helped create an environment in which the credit programs are often viewed more as charity or a politically motivated grant than as a business transaction. As a result of the casual enforcement of collateral and loan collection, and given the depressed economy and difficult political and security situation in the OT due to the Gulf war and the Intifada, repayment rates are low – as low as 28 percent and only reach sustainable levels over 90 percent at a few of the smaller, newer programs. There are few cases where interest payments cover administrative costs, let alone loan losses, and none of these programs would seem able to continue without additional grants to sustain them.

---

<sup>31</sup> PIDEA, p.9 and UNCTAD, pp. 117-119.

<sup>32</sup> This summary of operations is drawn from PIDEA, pp.9-12 and Annexes 2-4, as well as from individual program documents and interviews. Information on differences in management practices and credit policies and experiences can be found in that document.



Table 3.6: Credit Programs in the Occupied Territories  
(Values in US\$ x 000 @ 12.92)

Name of Program/Agency	Year Estab.	Capital a/	No. of Loans	Value of Loans Outstanding			
				Agric.	Industry	Services	Total
Ag.Devel. & Credit Co/ADCC	1987	3500	650	2370	710	53	3133
Econ. Devel. Group/EDG	1987	3000	364	800	2120	60	2980
Tech. Devel. Corp./TDC	1991	932	102	270	180	115	565
Business Develop. Center/UNDP	1990	1000	5	0	579	0	579
Coop. for Development/CD		906	120	273	432	275	980
United Agric. Fund/UAF		1000					
Catholic Relief Services			69		--		420
Save the Children	1986	1250	330		--		1250
UNRWA-Income Gen. Project	1992	2300	98		--		1800
Higher Housing Council	1992	37000	0		--	0	0
Coop. Devel. Program/CDP		1250		1250	--	--	1250
Palestinian Ag. Relief/PARC				66	--	--	206
M.E. Council of Churches		500		--	--	500	500
ANERA							0
-Ramallah Marketing Coop	1989	250	97	239	--	--	239
-Beit Lahia Agric. Coop	1989	250	105	229	--	--	229
-Khan Yunis Agric. Coop	1992	250	33	143	--	--	143
-Qalqilya Agric. Coop	1992	250	17	75	--	--	75
-Hebron Ag. & Marketing. Co	1992	150	32	81	--	--	81
-Nablus Marketing Coop	1993	150	0	0	--	--	0
-Tulkarem Marketing. Coop	1993	250	0	0	--	--	0
-Jenin Marketing. Coop	1993						--
Welfare Association			68	427	482	864	1773
TOTAL		54,188	2,090	6,223	4,503	864	16,203



3.24 Such a situation is not sustainable in the future, not only because a continuation of current policies and practices will undermine the financial integrity of the credit programs, but also because perpetuating such practices will have broad negative effects on the financial sector. Thus, those steps already taken to ensure closer coordination between the larger credit agencies have been important, but there is also an urgent need for further measures to strengthen financial management at the credit programs and adopt more disciplined credit practices.

#### Insurance Companies

3.25 Until February 1993, there was only one local insurance company in the West Bank and Gaza, the Arab Insurance Company (AIC), headquartered in Nablus. This company was established according to the Jordanian Insurance Law in effect before 1967, but its activities are now monitored by the Israeli Controller of Insurance; it is required to conform to regulatory standards somewhere between the prudential limits set by Jordanian law and the tougher legal limits in Israel. AIC is only a modest supplier of capital to the OT economy since its investment activities are heavily circumscribed by the regulatory authority.<sup>33</sup> There are relatively few official limits on its investment activities: although real estate investments may only amount to a maximum of 10 percent of assets, there are no limits on equity investments. AIC is a founder shareholder in many of the newly formed, joint-stock industrial companies but its share-holdings do not exceed 2% of total assets. It also makes limited, short-term personal loans of no more than \$ 0.3 million, primarily to policyholders. However, since its premiums and claims are linked to changes in the consumer price index or the exchange rate of the US dollar, about 98 percent of its assets are in matching funds: CPI or dollar-linked bonds guaranteed by the Bank of Israel.

3.26 The establishment of the new National Insurance Company demonstrates the uncertainty of the mixed Jordanian-Israeli regulatory environment, for example the level of minimum capital required by the Israeli authorities to establish a new company. In this case, the licensing requirements have been unchanged since the Jordanian Insurance Law was enacted prior to 1967. After receiving an application to establish the company, the minimum capital required by the Israeli regulatory authorities was raised in several stages from \$0.5 million (required by the Jordanian Law existing in 1967) to \$3 million, partially paid, to more than \$5 million, fully paid. The sponsors complied with the full capital requirement and engaged experienced professional management and a license was finally granted in February 1993, 20 months after the initial application.<sup>34</sup> Since the initial equity offering was oversubscribed, the changes in required minimum capital were met by the sponsors without difficulty. While changing the licensing requirements may seem justified by the regulatory authorities on grounds of prudence to ensure the managerial competence and capital adequacy of new institutions, without an explicit and announced set of uniform guidelines or criteria for measurement, this flexibility on the part of the regulatory authorities can seem capricious and arbitrary to investor groups. These concerns may have been partially allayed by the drafting of a new Insurance Law in January 1993, which sets revised capital requirements and security deposits to protect policyholders but maintains differential treatment for all insurance companies, based on their date of establishment, and for Arab and Israeli insurance companies.<sup>35</sup>

<sup>33</sup> Interview, insurance company manager, West Bank, January 1993.

<sup>34</sup> Interview, insurance company investors, West Bank, January-February 1993.

<sup>35</sup> Control of Insurance Business Law (draft), dated January 29, 1993, as translated and explained by Ms. Michal Dagan, Tel Aviv.

## II. Investment and Demand for Credit

3.27 Given the heavy reliance on the informal financial sector and the absence of financial reporting, there are very few facts about the demand for credit. Estimates are impressionistic and wide-ranging. Outstanding loans from the commercial banks (\$17 million at the end of 1992) and from the credit agencies (\$16 million at the end of 1992) totalled only \$33 million at the end of 1992. At just 1.4 percent of GDP, this must be one of the lowest levels of formal financial intermediation recorded internationally. Other evidence suggests that lending from these two sources does not comprise an accurate gauge of the level of effective demand for credit from the productive sectors of the economy at present: there has been substantial investment in fixed assets, and the shortage of investment capital has been consistently reported as a serious constraint to the growth of the private sector. This section reviews the level of investment in various sectors of the economy and seeks to derive an estimate of effective demand for capital.

3.28 Gross Fixed Capital Formation (GFCF). Gross fixed capital formation has been surprisingly robust in the OT, as compared to the economies of the neighboring countries averaging 27.3 percent of GDP in real terms between 1968 and 1991. Despite the drop in remittances and as much as a 25 percent decline in disposable income as a result of the forced dissaving occasioned by the Intifada and the Gulf war, GFCF has still averaged 26 percent of GDP in real terms since 1987. According to very rough estimates made by the Israeli Central Bureau of Statistics, during the five-year period since 1987, annual investment averaged \$535 million equivalent in current terms. The private sector accounted for 85 percent of aggregate investment over the 1968-91 period; the balance was accounted for by the CA and limited investments by Arab municipalities.

3.29 Construction. According to official statistics, construction accounted for 81 percent of aggregate private sector investment over the 1968-91 period, averaging \$305 million between 1975-1991 in current dollars. Given the large number of expatriate Palestinians, the uncertain political and economic situation and the lack of publicly financed housing, private investment in real property and house construction has been a natural investment priority. Although it is common practice in other Arab countries, because of the military occupation, Palestinians do not mortgage land for fear that the Israeli authorities might acquire legal title; therefore, Palestinians rarely borrow for construction purposes. To begin to fill this gap, in 1989, the Arab Insurance Company began building middle class apartments in the West Bank with 5 year, 50 percent financing. In 1992, the EC agreed to provide ECU 29 million (US\$ 35 million equivalent) to build and sell low-cost houses and apartments, with 15- to 20-year repayment and only a 1 percent service charge. There is no operating experience to draw on in estimating private sector demand for housing credit. Given peace, many refugee camps would be upgraded into better quality permanent residential communities, and much of this would probably be privately financed, based on past practice and preference. The infrastructure sector report estimates the investment in private housing for returnees alone could amount to \$450 million annually between 1994-2000, exclusive of land cost and investments in upgrading existing housing or in building housing to meet indigenous population growth.

3.30 Industry and Services. The remaining 19 percent of private sector investment, covering machinery, transport and other types of equipment for all the sectors of the economy, averaged just \$75 million in current terms over the 1975-91 period. According to information gathered by the World Bank survey, there was no net investment in industry during the 1975-90 period: capital investment rose 65



percent in real terms between 1975 and 1985 but declined over the next 5 years back to the 1975 level.<sup>36</sup> This pattern of investment closely followed a similar trend in sales revenues and profitability during the same period. In contrast, real investment among a small group of 9 major subcontractors grew 15-fold between 1975 and 1990, in line with their rapid growth in sales, though not profitability, during this period.<sup>37</sup>

3.31 One of the principal findings of the recent World Bank survey is that access to capital is the most frequently cited reason for the success (or failure) of private sector firms. The sample of nine subcontracting firms is a case in point: they stated that the most significant reason for their success was the availability of adequate capital, either from their own resources or from the Israeli firms for which they did work; they did not tap the banking sectors for credit. The survey also found that private sector investment in the productive sectors was almost entirely financed by owners' equity, rather than the banking system, resulting in part from the absence of formal borrowing options, as well as a preference for family ownership and control. More than 85 percent of outstanding commercial bank loans are for the trade sector and employees. The low utilization of the banking sector is confirmed by the fact that commercial banks loans, as a percentage of total bank assets, declined to just 10 percent of total bank assets in 1992.

3.32 Although real investment has risen 6 percent between 1990 and 1992, according to the World Bank survey, the lending experience of the credit agencies in 1992 suggests that effective demand from all sections of the OT economy remains low under current economic circumstances, even for their heavily subsidized credit.<sup>38</sup> According to data provided to the mission, 13 of these agencies received nearly 10,000 applications for credit in 1992, worth more than \$140 million. Only 4 percent of these applications were approved, with an average value of \$9,000, for a total of just \$5.7 million, suggesting that the number of multiple applications is high and the number of viable investment proposals very low. Based on this experience, several of the credit agencies have concluded that the market for credit below \$50,000 is saturated, but that there is still unsatisfied demand for credit in projects ranging from \$50,000 to \$250,000. Under present political and economic circumstances, however, there may be little effective demand for credit even at levels above \$100,000.<sup>39</sup>

3.33 Agriculture. Estimates of credit demand in the agricultural sector range from below \$100 million to nearly \$200 million annually. At the low end, the Agriculture Development and Credit Company (ADCC), the largest credit agency for the sector, estimates the cost of inputs annually at \$100

---

<sup>36</sup> World Bank, "Report on the Private Sector: Industry Field Survey, Regulatory and Taxation System, Tourism - Analysis and Recommendations", unpublished confidential working paper by Dr. Dileep Hurry, pp. 7-9. This observation was confirmed in the mid-1980s by Dan Zakai, who observed that 80-85 percent of equipment investment went to cover the current depreciation of the capital stock. See Bank of Israel, Research Department, Economic Development in Judea-Samaria and the Gaza District, 1985-86, p.29.

<sup>37</sup> World Bank study, pp.13-15.

<sup>38</sup> Surveys carried out in late 1992 and early 1993 by The UNDP-financed Business Development Center and UNRWA. Interviews in Jerusalem and Gaza, January-February 1993.

<sup>39</sup> The experience of UNRWA is instructive. The Income Generation Project received 843 applications worth \$22.5 million in 1992. One application was for \$3 million for a flour mill. There were 4 others above \$100,000 each. The remaining 840 were for lesser amounts, averaging only \$27,000. Interview, UNRWA officials, West Bank and Gaza, January-February 1993.



million, mostly financed with borrowed funds.<sup>40</sup> At the high end, a recent study by Austrian and Palestinian experts analyzed credit sources and development and investment needs in detail.<sup>41</sup> Based on average credit requirements per dunum of irrigated and rain-fed land of \$300 and \$50-60 per growing season, respectively and cropping patterns of 1.5 and 1 crops annually per dunum, on irrigated and rain-fed land, respectively, the amount of land cultivated presently would require about \$190 million of credit each year. This level of sectoral credit would amount to about 30 percent of total agricultural output (\$650 million) in 1990. By contrast, in Jordan, which has a dedicated agricultural bank, outstanding bank credit to the agricultural sector in 1987-1990 (about \$120 million annually) amounted to about 50 percent of total sector output.

3.34 At present, small as their support may be, the credit agencies are the major formal source of credit to the agricultural sector. Between 1987 and 1990, they provided a total of only \$5 million of subsidized credit at an interest rate of 4-5 percent per annum.<sup>42</sup> The Bank of Palestine has provided some seasonal credit to the Citrus Growers Association in Gaza at 16 percent in NIS, about 4 percent below its normal lending rate.<sup>43</sup> Rural credit and savings cooperatives are a final source of formal credit to the sector. There are 142 such cooperatives in the West Bank but only 6 in Gaza. Until 1988, West Bank coops funneled credits from the Jordanian Cooperative Bank to their members; no such facilities existed for Gaza. The mission was unable to get figures on the level of credit provided by these co-ops but it is thought to be very small. Recently, USAID has provided about \$2 million through ANERA to establish small revolving loan funds at seven regional marketing cooperatives.

3.35 According to available reports and the estimates of sectoral specialists, the bulk of sectoral credit is provided by produce wholesalers, suppliers of agricultural inputs and landowners, at interest rates ranging from 3-4 percent per month.<sup>44</sup> Specific amounts and the terms and condition of lending could not be confirmed in interviews with financial intermediaries. However, two major produce wholesalers stated that standard practice was to "advance" about 75-100 percent of required inputs to farmers at a mark-up over cost ranging from 2-10 percent, but without an interest charge, and then to take a 7 percent commission from the sale of produce after harvest.<sup>45</sup>

3.36 Based on the available evidence, there appear to be adequate credit facilities to support the present working capital requirements of the sector, albeit at a high cost compared to other sectors (annualized interest rate of about 35 percent in JD terms compared to about 12 percent for the industrial

---

<sup>40</sup> Interview, credit agency officials, West Bank, January 1993.

<sup>41</sup> Developmental Perspectives for Agriculture in the Occupied Palestinian Territories, Jerusalem and Vienna, 1992, pp. 33-37 and 80-81. These estimates were given to the mission by Mr. Omar Daoudi of the UNDP, one of the agricultural experts on the study team, in an interview in Jerusalem, January 28, 1993.

<sup>42</sup> UNDP, Assistance to the Occupied Palestinian Territories, 1992 Compendium of Ongoing and Planned Projects, Jerusalem, April 1992.

<sup>43</sup> Austrian study, p. 237.

<sup>44</sup> The Austrian study reports that money changers make very limited amounts of credit available at these rates (pages 237). Mr. Daoudi of UNDP estimates that these middlemen charge interest rates of about 30% on an annualized basis. Interview, Jerusalem, January 28, 1993.

<sup>45</sup> Interviews with produce wholesalers and fertilizer distributors, West Bank, February 1993.

sector). Medium- and long-term capital investment in agriculture seems to be financed primarily by private equity since the credit programs only provide about \$1 million annually; there may be a very low level of capital investment in the sector, however, given the issues of security of land ownership and access to sufficient water. With peace, it seems likely that there would be far greater capital investment for which there may be neither adequate funds at competitive interest rates nor insurance mechanisms (hedging contracts and crop loss insurance) to protect farmers against extraordinary loss.<sup>46</sup>

3.37 Trade Credits. Imports into the OT through Israel have averaged about \$1 billion in each of the past 10 years. Prior to 1987, Israeli importers provided trade credits to Arab merchants ranging from one to three months. Assuming that those credits averaged 6 weeks, trade credits would have amounted to about \$125 million annually. Since the Intifada, almost all sales have been for cash. Only a few well-established Arab businessmen have been able to receive short-term credit from foreign sellers of equipment and raw materials to supplement or replace these trade credits.<sup>47</sup>

3.38 Estimated Level of Investment. In summary, based on the evidence given above the estimated level of annual private investment by sector under present economic conditions, could be as follows:

Table 3.7: Estimated Annual Private Investment  
(US\$ million)

	Current Range	Midpoint	Future
Residential Construction	60-300	180	450
Industry and Services	60- 90	75	125
Agriculture	100-190	145	225
Trade	100-190	125	200
TOTAL	\$320-730	\$525	\$1,000

3.39 A reasonable mid-point of the range for the current level of investment might be \$525 million annually. These figures should be treated, however, with great caution: even the Israeli Central Statistics Office places numerous caveats on the accuracy of its own data, and the level of remittances has dropped by at least 25 percent in the past 3 years. The results of the Bank's own survey suggest that businesses have been decapitalized to maintain a lower level of capacity utilization, leading to the possibility that the current level of investment may lie toward the low end of the range.

3.40 In the absence of a detailed analysis of sectoral investment potential, there is no firm basis on which to project the future level of private sector investment. The numbers used above are conservative. They are based on actual levels of investment in agriculture and industry during the past five years, where it has been assumed there was virtually no investment in fixed assets, plus about a 50 percent increase to account for future long-term investment. Projected investment in residential

<sup>46</sup> Austrian study, pp. 121 and 169.

<sup>47</sup> Interview, industrialist, West Bank, February 1993.

construction is based on the estimate of the infrastructure paper for returnees' housing plus the cost of land acquisition. Investment in retail and wholesale trade also assumes a 50 percent increase from the level described above. With a political settlement and open borders, these numbers could be low; without peace, they are likely to be optimistic.

3.41 Estimated Effective Demand for Credit. Given the constraints on economic activity in the West Bank and Gaza caused by the occupation, the Intifada, the Gulf war and the lack of secure property rights, the current low level of demand for credit is probably not an accurate proxy for the likely level of investment or the effective demand for credit in the event of a political settlement. With peace, political autonomy and free trade between Israel and its Arab neighbors, one would expect the demand for financial services to flourish, both in terms of the level of demand for credit and in the sophistication and range of financial services required. Jordan probably represents the best available proxy for the level of financial sector activity that might be expected in the West Bank and Gaza in the event of a settlement. Table 3.8 compares financial intermediation in Jordan and the OT and extrapolates from the level in the OT, using Jordanian financial and economic ratios, to estimate the size of the formal financial sector in the OT under "normal" circumstances. On that basis, the level of bank deposits and bank credit would be expected to grow by about \$ 2.3 and \$2.6 billion, respectively.



Table 3.8: Comparative Financial Sector Analysis - Jordan & Occupied Territories  
(US\$ million)

	Jordan (1966) a/	Occupied Territories			
		(1987) (Actual)	(1990) (Actual)	(1990) (Normalized)	(1990) (Variance)
GDP	390	1,754	1,959	1,959	n.a.
GDP per Capita	\$198	\$1,223	\$1,224	\$1,224	n.a.
Population	1.97	1.43	1.60	1.60	n.a.
<u>Investment &amp; Credit</u>					
Gross Fixed Capital Formation (GFCF)	78	559	346	507	+161
Domestic Credit	98	64*	14	2,351	+2,337
Total Bank Assets	284	120*	107	3,067	+2,960
- Claims on Private Sector	133	64*	14	1,436	+1,422
- Claims on Government	-35	n.a.	0	905	+905
Demand and Savings Deposits	189	95*	78	2,096	+2,018
Capital	39	2**	39	122	+83
<u>Ratio Analysis</u>					
Deposits as % of GDP	48.5%	5.4%*	4%	107%	+2,575%
Domestic Credit as % of GDP	25.1%	3.6%*	0.7%	120%	+17,132%
Claims on Private Sector as % of GDP	34.1%	3.6%*	0.7%	73.3%	+10,470
GFCF as % of GDP	20.0%	3.19%	17.7%	25.9	+46.3
GFCF as % of Domestic Bank Credit	79.6%	773%	2471%	21.6%	-99%
Bank Deposits per Capita	\$96	\$66	\$49	\$1,037	+\$988
Capital as % of Risk Assets	39.8%	69.4%**	279%	5.2%	-98%
Capital as % of Total Assets	13.7%	23.5%**	36.4%	4.0%	-89%
Capital as % of Deposits	20.6%	32.1%**	50.0%	5.8%	-88%

Sources: Central Bank of Jordan, Annual Report, 1968, for Jordan and Israel and Central Bureau of Statistics, National Accounts of Judea, Samaria, and Gaza Area, 1968-1986 for the Occupied Territories.

Notes:

includes Bank of Palestine and Israeli bank branches in the OT.  
includes Bank of Palestine only.

3.42 In order to estimate the possible sectoral demand for credit in the OT, one can apply the ratios of the sectoral distribution of bank lending in Jordan in 1990. This leads to the following distribution:

Table 3.9: "Normalized" Sectoral Distribution of Private Sector Credit Demand

<u>Sector</u>	<u>Credit % of Total</u>	<u>Amount (US\$ Million)</u>
Agriculture	6	\$ 160
Industry	16	425
Services/Trade	31	830
Construction	47	1,250
Total	100%	\$2,665

3.43 These estimates should be treated with caution since Jordan was in a recession in 1990 and most industrial credit goes to the mining sector. However, there is likely to be substantial investment in infrastructure to make up for 25 years of under-investment in the OT. Government borrowing for investment in physical and social infrastructure can also be expected to be a major new source of demand for credit. In Jordan in 1990, government borrowing constituted 39 percent of total domestic credit. Achieving these levels of investment and savings mobilization will not be possible without an increase in the number of banks operating in the West Bank and Gaza.

3.44 Early confirmation that investment, and with it the demand for credit, is likely to accelerate in the event of a settlement is provided by the sharp jump in the level of investment in Gaza and the West Bank since the peace talks opened in Madrid. For example, in Gaza in 1992 the Civil Administration approved 23 new investments, from among 60 applications, with a total project cost of \$7.5 million. In the West Bank too, there are three large projects under preparation that focus on the Israeli, Palestinian and Jordanian markets, with a total estimated cost of \$65 million.<sup>48</sup>

### III. Recommended Policy and Institutional Changes

3.45 The policy and institutional recommendations in this section fall into two general categories: first, those which are intended to improve the supply of financial services by reestablishing a banking sector that operates on a competitive and level playing field; and, second, those which are intended to improve the demand for financial services. A distinction is made in the recommendations between confidence-building measures, which could be implemented in the short term, and measures that will take time and a supportive business environment to enact. A general thesis is that increased availability of capital will not itself promote economic growth, but that once conditions are ripe for greater investment, the absence of efficient financial intermediation will immediately become an obstacle to growth.

<sup>48</sup> Statistics collected by the Civil Administration from investors filing for new project investment incentives available under Military Order #1342 of July 7, 1991, as amended by an unnumbered military order of November 21, 1991. Information received from the Civil Administration, Ministry of Defence, Tel Aviv, dated April 13, 1993.

## Measures to Enhance Bank Operations

3.46 Certain basic assumptions underline the policy and institutional recommendations in the following paragraphs. While this paper makes no assumptions about the nature of a political settlement or the relationship of the OT to Israel, Jordan or Egypt in the long term, it treats the West Bank and Gaza as an integrated unit. It assumes that Israel, the OT and Jordan, in the medium term, would move toward similar liberal financial policies. In the process, the patchwork of existing Palestine Mandate, Jordanian and Israeli laws, regulations and military orders that apply to the OT would be eliminated, in favor of a single set of laws and regulations that apply both to the West Bank and Gaza and that are generally consistent with current international practice. Finally, it assumes that there would be a transitional period that would allow for orderly institutional development and training in areas of need and that would explore the options that flow from alternative political arrangements. The following paragraphs recommend a series of changes to improve the operation of the financial sector in the OT, focussing primarily on the encouragement of a more active banking system.

3.47 Legal and Regulatory Framework. The future legal and regulatory framework of the banking sector needs to address four key issues in order to establish a competitive level playing field banks operating in the OT.

- Unified prudential regulations and practices for the banking sector, based on appropriate international practice
- The stability, solvency and liquidity of the banking system
- The supervision of banks (and other financial intermediaries) operating in the OT
- The expansion of existing banks and the establishment of new ones.

3.48 The selection of an appropriate strategy and program to correct the deficiencies in the present legal and regulatory framework and provide an adequate alternative that properly balances the regulation and development of banking activities depends on both the future political situation and technical issues. There are basically three approaches to dealing with the reform of the legal and regulatory framework: a) the continuation of the status quo, while correcting the most obvious legal and regulatory disparities; b) reopening of the banks that operated in the OT prior to 1967; and c) the establishment of an independent regulatory system based on a new banking law. The following paragraphs review the advantages and disadvantages of each option.

3.49 The present set of laws and regulatory practices dealing with the banking sector does not adequately address the key issues enumerated above. Although the Bank of Israel (BOI) provides close supervision of the banks operating in the OT, the current framework is deficient in the three other key areas: it does not provide a unified set of prudential regulations and guidelines; the Bank of Israel does not act as a lender of last resort for the banking sector; and it does not provide a uniform set of criteria covering bank expansion or the establishment of new banks. All parties involved with bank operation



and supervision in the OT and Jordan agree that the current framework is totally unsatisfactory and should be replaced.<sup>49</sup>

3.50 The new legal and regulatory framework now under discussion would permit the reopening of banks, primarily Jordanian ones, that used to operate in the OT. This agreement would replace the separate and outmoded legal agreements that licensed the operations of the two existing Arab banks. The 1986 agreement, which allowed the reopening of the CAB under tight Israeli central bank control, would be replaced by an agreement based on the general division of responsibilities for the supervision of banks from one country operating in another country, as set forth in the Basle Concordat. Jordanian banks that wanted to operate in the West Bank would have to conform to the legal and regulatory requirements of this agreement. However, the agreement would only apply to the West Bank, at least at the outset. To provide a unified banking law for the OT, such an agreement should cover both Gaza and the West Bank. It is intended to apply this arrangement to the BOP as well as to Israeli banks, if they were to operate in the OT.

3.51 Under the proposed agreement, the Central Bank of Jordan (CBJ) would assume direct responsibility for the solvency and stability of Jordanian banks, as "lender of last resort" for Jordan's few banks in the West Bank, a responsibility for OT bank operations the BOI has never accepted. However, CBJ would apparently not act in this capacity for the BOP, and it would not consider the expansion of Jordanian-based banks to Gaza until there were an adequate political settlement. The CBJ would carry out on-site supervision of the reopened banks, something the BOI only initiated in 1992. The agreement would replace the discretionary ceilings on deposits and lending, and the use of government securities and international bank guarantees to govern the operations of the CAB and protect depositors, with current Jordanian banking regulations on reserve requirements, capital adequacy and liquidity for operations in dinars. Such an arrangement would be far closer to international banking practice than is currently the case in the OT. Because of the indeterminate political status of the OT, in the interim, the stricter of Jordanian or Israeli banking laws would apply. Thus, banks would adhere to current Israeli foreign exchange regulations, which are expected to be liberalized over the next few years. The BOI would carry out parallel bank supervision, at least until the end of any "transitional" period.<sup>50</sup>

3.52 In addition to establishing a standard and more accommodating legal and regulatory framework, the agreement is expected to authorize the reopening of all banks that were operating in the West Bank in 1967. As many as four Jordanian banks could be expected to open immediately, thus introducing far more commercial bank competition and, with it, the likelihood of lower interest rates and fees than is currently the case. Once open, lending spreads could be expected to narrow from the current level of about 10 percent in dinars and as much as 13 percent in dollars to the current level of 5-6 percent on the Jordanian market in dinars and about 2 percent in dollars, thereby significantly lowering the cost of financing business. The cash collateral required to open a letter of credit could also be expected to decline toward the 10 to 20 percent level prevailing in Jordan. Should such an agreement not be

---

<sup>49</sup> The substantial legal and fiscal obstacles to forming a new Arab bank in the OT have been carefully analyzed in a recent study by Israeli lawyers and accountants commissioned by potential Palestinian investors in a new development bank. See, "The Formation of a New Arab Bank: Outcome of a Study" by Etgar, Gera & Co. (law office) and Oded Seginer (CPA), April 1993.

<sup>50</sup> The analysis in this section is based on detailed interviews in January and February 1993 with Jordanian and Israeli central bank officials and with senior management of banks already operating in the OT; and those contemplating reopening their operations.

approved at present, for whatever reason, a substitute legal and regulatory framework along similar lines would need to be established between Israeli and Palestinian authorities as a matter of the highest priority.

3.53 As welcome an improvement as this agreement would be, a number of important issues would remain unresolved, including the use of a common currency as legal tender in both parts of the OT; the integration of the banking sector in Gaza and the West Bank; the expansion and automation of existing banks; the establishment of new banks, especially those with broad international networks; direct access to foreign accounts; and the regulation of the securities market and other financial activities and intermediaries.

3.54 A third alternative could be the establishment of a new, independent legal and regulatory framework for the banking sector. The substance and timetable for the establishment of a Palestinian banking system would depend on the outcome of the political settlement still to be negotiated; the nature of the ultimate economic and political relationships between the OT, Jordan and Israel; and the currencies in use. However, whether or not a political settlement is oriented toward autonomy or independence, and whatever currency or currencies circulate in Gaza and the West Bank, there are enough deficiencies in the two other options to recommend establishing an independent regulatory framework at this point, even though it would be complicated, time-consuming and require substantial local and external resources to properly design and implement.

3.55 The most important step toward reactivating the financial sector would be to encourage the operation of well-capitalized banks, with experienced management, that were allowed to compete freely, within a clearly articulated set of banking regulations. Reopening the Jordanian banks might resolve many problems, but it could leave untouched other issues important to the OT population: the stability and solvency of the banking system as a whole (not only of Jordanian banks); the efficiency of the banking system and its capacity to foster competition and innovation; access to sufficient credit to meet the reasonable credit needs of the population; and the economic development of both territories. The territorial coverage of the banks and the circulation of a common legal tender in the West Bank and Gaza as mentioned above, are also problems that may not be addressed.

3.56 Pursuing this option would be facilitated by a unified banking law covering the West Bank and Gaza that would deal with the sector in a comprehensive manner, either by adopting an existing law, at least for an interim period, or by drafting a new law for the OT. This law would need to establish the institutional responsibility for the prudential regulation of banks operating in the OT and determine the participation of other interested parties, such as the central banks of Israel and Jordan. Whether the regulatory agency should function only as a supervisory authority, at least for what could be as long as a five-year transitional period, or take on the responsibility to maintain the solvency of the banking system as the lender of last resort must also be determined. Issues such as whether or not to establish a local currency, or continue to use multiple currencies, and how to set up an independent national central bank could probably be left to a later time. (Please see Macro Report for discussion of currency options).

3.57 Fortunately, the establishment of a body responsible for the development and prudential regulation of the banking sector is not dependent upon the nature or the timetable of the transitional mechanisms that may be a part of any interim self-governing agreement. It seems likely that Israel and Jordan would expect to participate in those transitional arrangements and in the establishment and early operation of any entities set up to govern the West Bank and Gaza. Palestinian participation in the process of policy formulation and on the staff of a regulatory body set up to develop and supervise the financial sector would be advisable from the outset of the transitional period so that local officials could



become experienced in economic and financial sector development issues, and represent the views of the local population on the economic and financial issues mentioned above. Jointly with Jordanian and Israeli authorities, this regulatory body could supervise the activities of existing banks in the OT, Jordanian and international banks that might reopen and new Palestinian banks that might be established, as well as the credit institutions should they come under central bank supervision. It might be possible to transfer the staff and current regulatory functions of the BOI covering the OT to help start this independent regulatory entity, with Palestinian and Jordanian representatives.

3.58 Branch Expansion in the OT. In addition to a common currency linking Gaza and the West Bank, the OT need financial institutions that can operate in both territories, rather than the forced separation now in practice. Almost all of the business relating to transfers between the West Bank and Gaza have been handled by money changers and (to a far lesser extent) Israeli banks, the only financial intermediaries currently operating in both areas. The absence of common banks forces Palestinian and Jordanian businesses to utilize money changers or Israeli banks to handle transfers between the territories, a practice that limits the growth of the banking system in the West Bank and Gaza.

3.59 One means to encourage broader access to banking services would be to allow the expansion of existing banks into other portions of the OT, or to authorize the opening of new branches to meet bank management's business development objectives, if an agreement on reopening Jordanian banks is reached. Jordanian practice is to rely on the total balance sheet of a bank when approving branch expansions, rather than the subjective criteria used by the BOI with regard to the licensing of each branch expansion requested by Arab banks in the OT. Jordanian practice would be an improvement in transparency over current Israeli practice, though, in many countries, branch expansion is a management, and not a regulatory, decision. Instituting this more liberal approach to branch expansion, while insisting on a solid capital base for the bank, would take advantage of inter-bank competition to encourage a broader penetration of banking services in the OT market.<sup>51</sup>

3.60 The major obstacle to the expansion of banks in the OT would be the need to get Jordanian agreement to the expansion of any Jordan-based bank into Gaza, or to allow the BOP, which is not incorporated in Jordan, to expand into the West Bank, prior to the signing of a satisfactory peace agreement.<sup>52</sup> The CAB has requested permission to open a branch in Gaza since 1988. The BOI has endorsed this request and has said it would encourage the use of the dinar as legal tender in Gaza. However, it defers to the CBJ on these matters. This is both a practical and a customary response: banks in the OT need to be able to clear payments in dinars through Jordan since there is no external market for the currency and since the CBJ has the ultimate responsibility for the solvency of Jordanian banks in the OT. In order to facilitate cross-investment and trade between the territories, a trend that has become more noticeable since 1990 and one that is likely to increase with the expectation of a settlement, the CBJ should be asked, on economic grounds, to reconsider its present position and permit branch expansion to Gaza by the CAB; as well as the establishment of branches in Gaza by Jordanian banks if they reopen. For similar reasons, the CBJ should also be asked to allow the BOP to extend its operations to the West Bank, possibly by reincorporating with a special OT license under Jordanian bank legislation and CBJ regulations. However, if such decisions are to be made on political, rather than financial or economic criteria, a positive response may be unlikely before a political settlement.

<sup>51</sup> Interview, Bank of Israel official, February 1993.

<sup>52</sup> Interview, Central Bank of Jordan official, February 1993.



3.61 Establishment of New Banks in the OT. According to local business groups, there are currently five groups considering establishment of new commercial, cooperative and development banks in the OT. None of the local sponsors has previous banking experience and none has yet raised the minimum level of capital (recently lowered to US\$10 million) for a locally incorporated bank set by the Israeli authorities. Apparently only 1 has so far resulted in a formal application and the sponsors are seeking to mobilize the level of capital required. Reopening the Jordanian banks that operated in the OT previously, with their established services and correspondent networks, is seen by the CA as a low-risk means to satisfy most of the retail demand for Arab-owned banking institutions, provided the Jordanian banks can offer competitive banking services throughout the OT. It may also encourage the present sponsors to wait and reassess the demand for additional banks and services, or to investigate the establishment of other financial services, such as leasing or finance companies or an investment bank, entities that are not presently licensed by the Bank of Israel and that might, therefore, be easier to establish than a commercial or development bank. However, with the exception of the Arab Bank and the British Bank of the Middle East (a Hong Kong Shanghai Bank subsidiary), the banks that now seem likely to reopen are neither very international nor very advanced in the technological level of their operations. These banks may not be able to provide OT business customers with access to the broad international banking contacts needed to service the wide Palestinian diaspora and establish international trading relations after several decades of isolation.

3.62 The primary consideration of the CA should be to encourage the establishment of banks with sound capital and experienced management that can offer efficient banking services. Even the prospect of the reopening of a number of Jordanian banks in the OT, should not discourage establishment of banks sponsored by local businessmen, so long as the sponsors succeed in mobilizing the minimum required paid-in capital and provide adequate proof of managerial expertise. However, according to Basel principles the CA would seek Jordanian consent before granting a license if the banks were planning to operate in dinars. Jordan's position is crucial since any bank operating in dinars would require CBJ permission to clear dinar payments through Amman.

3.63 The increased competition that would result from the opening of more Arab banks in the OT should lower the cost of bank intermediation. However, without substantial investment in contemporary computer technology and a reshaping of banking practices, the standard of service might not improve. The Arab Bank may be the only Jordanian bank that can match the current standard of service of the large Israeli commercial banks. The CAB recognizes that it will have to computerize its West Bank branches, at a cost of several million dollars, before introducing the same technology in Jordan, if it intends to remain competitive once other banks reopen. There will also need to be improvements in inter-bank clearing and changes in regulatory practices permitting Arab banks to establish direct, foreign correspondent relations in order to process external transactions without an Israeli bank intermediary - if all banks are to be able to compete on a level playing field.

3.64 Clearing Inter-Bank Payments. Once there is more than a single bank operating in Gaza and the West Bank, there will need to be a mechanism for clearing payments between them.<sup>53</sup> Reopening Jordanian banks under CBJ supervision would facilitate clearing dinar-denominated payments. However, if OT banks continue to operate in shekels, as well to accommodate current trade patterns, a joint clearing facility will be needed with BOI and CBJ cooperation to handle the multiple currencies in

---

<sup>53</sup> This paragraph is drawn from interviews with officials of the Bank of Israel and commercial banks operating in the OT, January-February 1993.

use. This will also require upgrading the computer capabilities and record keeping of Arab banks in the OT and Jordan. Israeli banks now have one day settlement of all payments; cross-border clearing currently takes up to five to six days because of the security precautions. OT and Jordanian banks will wish to move toward the Israeli standard for competitive reasons, if there are open borders, and this will necessitate rapid exchange of computerized data between Jordan, Israel and the OT and the decentralization of managerial authority from Amman to OT branches to approve payments. Moreover, the regulatory authorities will need to create a clearing committee to establish rules, standards and procedures. While customers will lose the float associated with extended clearing, one day clearing will lessen the credit risk for banks. Current international practice in the case of Luxembourg, Panama and Liechtenstein might serve as examples of measures which should be adopted in this case. Further analysis and recommendations concerning the establishment of an appropriate clearing system should be carried out once the shape of the political settlement is clear.

3.65 External Accounts. One final improvement needed in the current banking practice in the OT is to allow Arab banks the same freedom now granted Israeli banks to establish direct external accounts for customers with foreign correspondents and to open letters of credit directly. At present, the CAB and the BOP must go through Israeli banks for these services, placing them at a service and competitive pricing disadvantage. The BOI cites the application of more stringent accounting standards in Israel and the existence of more liberal Jordanian exchange controls on capital exports as reasons why it cannot now extend this practice to the Arab banks in the OT. In practice, individuals seeking to avoid Israeli exchange controls have access to the unregulated money changers that operate throughout the OT, thereby driving such business away from the commercial banks. (Many businesses would not, however, risk legal sanctions to make illegal transfers.) Israeli foreign exchange control regulations are in the process of being liberalized. Depending on the timetable for liberalization, Arab banks might be allowed to offer business customers, as a start, foreign accounts and letters of credit on a "direct" basis that is equal and competitive to the service of Israeli banks. Granting these freedoms would help to place Arab banks on a more equal footing and enable them to offer a broader range of banking services that would be more competitive with Israeli banks and with Jordanian banks that may reopen. This step should be taken immediately by the Civil Administration as a confidence-building measure, even though its short-term impact on economic activity might not be great.

#### Measures to Enhance Access to Capital and Credit

3.66 The measures recommended in the preceding paragraphs should lead to a more competitive and accessible financial sector, itself a favorable precondition for investment. However, while opening or reopening more banks would shift deposits into the banking system and should lower the cost of borrowing, it would not create demand for credit or reduce the present high liquidity in the formal and informal segments of the Palestinian economy. The single most important factor in promoting the demand for long-term capital would be a peace agreement. As experience has shown since the Madrid talks began, capital investment in Gaza and the West Bank has reacted quickly to the expectation of better economic opportunities signalled by the beginning of peace talks and the turnabout in Israeli occupation policy, which leans toward encouraging, rather than preventing, Palestinian investment and economic development.<sup>54</sup>

<sup>54</sup> According to the establishment survey carried out by the World Bank mission in January-February 1993, capital investment among the group of companies surveyed increased 6 percent between 1990 and 1992 after declining by 40 percent since 1985. This trend is confirmed by statistics collected by the CA that show that licenses requested by West



3.67 The following paragraphs recommend specific measures to encourage investment and facilitate intermediation by the financial sector. They include ways to enhance the utilization of available collateral, restore access to existing sources of bilateral export credits, introduce new methods of financing, tighten financial discipline, improve financial management, increase access to long-term capital, and provide support services to business.

3.68 Collateral Enhancement - Chattel Mortgages. The utilization of credit will not expand until a mechanism is found to enhance the value of existing, but unused, collateral. One measure would be to introduce the use of chattel mortgages on movable property, such as equipment and working capital. This practice could be introduced by adopting the chattel mortgage contracts used by Israeli banks or similar contracts used by British and other banks. Chattel mortgage is allowed under Palestine mandate law, but the Bank of Palestine does not use it as there is no practical mechanism to perfect a mortgage under the current political and security situation.<sup>55</sup> Moving toward greater similarity in collateral practices between Arab and Israeli banks would place Arab banks in a more competitive future position.

3.69 Collateral Enhancement - Establishment of a Trustee/Custodian. Another significant step would be a mechanism to tap the single greatest store of personal wealth in the OT, real property. Throughout the Middle East, land and housing are the most commonly used forms of collateral to secure credit. Even though Arab-owned banks now operate, Palestinians have been unwilling to pledge land and buildings as collateral, out of fear that the Israeli authorities will use the Israeli courts to foreclose on Arab property. This attitude seems unlikely to change, even with the reopening of Jordanian banks, so long as the OT does not have political stability.

3.70 A trustee/custodian beyond the reach of the Israeli military authorities and courts could unlock these land values and permit an explosion of collateral available to secure future bank lending during the transitional period. Candidates could include the Palestinian municipalities in Gaza and the West Bank or legally established non-profit organizations capitalized by external bilateral and/or multilateral development agencies. Borrowers would mortgage their property to the trustee/custodian, receiving funds from a participating bank in return and paying a market interest rate to a bank and a custodianship fee to the fund. Maximum loan size, loan administration and other issues of program operation would need to be addressed. Loans of up to \$0.5 million would cover almost all of the projects established in the past two years. The lending institutions should absorb all of the credit risk and handle loan administration. Once a loan has been fully discharged, the mortgage on the property would be released. This could be an excellent, short-term, confidence-building measure, since it aims specifically at resolving the problem of the absence of secure property rights under the occupation, a problem, which, it is hoped would disappear by the end of the transitional period.

3.71 Access to Export Credit Insurance Programs. During the 10 years prior to the Intifada, Palestinian businesses were able to purchase foreign equipment with the benefit of finance offered by European export credit programs and arranged through Israeli banks. Such credits are extended under bilateral programs between Israel and an exporting country and must be backed by the guarantee of an

---

Bank investors under the Investment Encouragement Law increased from 42 in 1990 to 112 in 1992. A similar pattern was experienced in Gaza. (CA communication to the World Bank, dated April 13, 1993, and briefings by Civil Administration personnel in the West Bank and Gaza, January-February 1993).

<sup>55</sup> Letter from a commercial bank, June 1993.



acceptable bank issued on behalf of the borrower. Prior to 1987, Israeli banks issued guarantees to Palestinian businesses with counter-guarantees from Arab and Israeli insurance companies. After 1987, Israeli banks suspended the application of these programs in the OT since they could no longer collect on the guarantees.

3.72 As the following table demonstrates, such funding, if available, would be cheap compared to commercial bank credits now available in Israel or the OT. This funding would represent an annual cost advantage to a business of about 12-13 percent pre-tax of the price of the equipment.

Table 3.10: Recent Comparative Bank and Export Credit Funding

Case A: Danish Export Credits	With Govt. Guarantee	Without Govt. Guarantee
Interest Rate	4% - 5%	11% - 2% fees
Maturity of Loan (years)	6 - 10 years	to 6 years
Collateral Requirement	none	100%
Case B: British Export Credits		
Interest Rate	7.28%	10% - 16%
Maturity of Loan (years)	5-8.5 years	to 3 years
Collateral Requirement	none	100%

3.73 These programs have been inaccessible to Palestinian businesses since 1987 due to the absence of acceptable government and bank guarantees. Access to these programs might be restored, however, in one of several ways. First, the CA could reestablish access to the Israeli program as an immediate, confidence-building measure, but it would probably have to be made available to customers of the Arab banks in the OT if it were to be used and have any impact. Second, and not a mutually exclusive alternative, third party governments, or government agencies, could guarantee a revolving export credit program of a certain amount, which would be administered by banks in the OT. In the past, the Saudi Fund for Development and the Kuwait Fund for Arab Economic Development have guaranteed ECGD exports for co-financed, public sector projects in third countries.<sup>56</sup> Third, an international agency, such as the Inter-Arab Investment Guarantee Agency in Kuwait might organize a multilateral guarantee fund for exports to the OT secured by participating export credit agencies. Fourth, Arab banks in the Gulf might be asked to issue guarantees on behalf of the export credit agencies.

3.74 Establishment of Leasing Companies. The first leasing company was formed in the West Bank in early 1993 by the newly established National Insurance Company and several of its founding shareholders to take advantage of a provision in the Israeli tax code concerning the recovery of the value

<sup>56</sup> Interview, ECGD officials, London, February 1993.

added tax (VAT) on new equipment purchases. The present legal structure in the OT favors leasing: unlike commercial banking, the establishment and operation of leasing companies is not regulated by Israeli law, and chattel mortgages on movable property are commonly used. In many countries, leasing is an effective means of finance for small and medium-scale enterprises because it can spread a sizeable portion of the capital cost of establishing and operating a business over a number of years. Moreover, there may be tax advantages to lease financing in countries with high corporate tax rates and favorable depreciation schedules. It is not clear that these advantages are present in the OT since many businesses reportedly do not pay much tax. However, the legal structure in the OT favors leasing: unlike commercial banking, there are no regulations covering the establishment and operation of leasing companies and chattel mortgages on movable property are allowed by Israeli law. Chattel mortgages are rarely used under current Jordanian law, and this could pose an impediment for Jordanian banks, if Jordanian law were reestablished in the West Bank. Since the Bank of Palestine operates under Israeli law in Gaza, it might consider establishing a leasing subsidiary or company as an attractive alternative. This course might also be an alternative for the sponsors of the proposed banks that have not yet been licensed. To be successful, lease financing is also likely to require the support of a more active insurance industry, which can provide broader industrial risk coverage than is presently the case, and an improved political and security environment.

3.75 The first leasing company has just been formed in the West Bank by the newly established National Insurance Company and several of its founding shareholders to take advantage of a provision in the Israeli tax code concerning the recovery of VAT on new equipment purchases. The experience of this company should be watched carefully. Depending on the success of this first venture and the lessons learned, international support for the establishment of other leasing companies might be appropriate.

3.76 Establishment of an Investment Bank. Under present political and economic circumstances, a traditional development bank would seem to be of doubtful viability in the OT. The idea has been studied in detail by several consultants in the past year, who have all reached similar conclusions: a bank offering long-term project loans would not be viable unless it undertakes a balanced portfolio of short- and long-term activities and operates with strict financial discipline.<sup>57</sup> International experience with specialized development banks has led to similar conclusions in many other countries. The problems of inadequate collateral and an environment that expects subsidized lending from development agencies must be addressed before any new institution could hope to become viable.

3.77 The principal arguments in favor of the establishment of a specialized bank include unsatisfied demand for investment capital and institution building. First, given the prospect of real peace, it seems likely that there will be substantial investment in projects of the size (assumed to be above \$0.5 million) that would require long-term debt and equity funding from a development or investment bank. During 1992, 5 of the 38 industrial projects approved under the Law for Capital Investments and the Foreign Investment Procedure in the West Bank and 14 of 45 industrial projects approved in Gaza had

---

<sup>57</sup> The most thorough analysis is the one prepared by the Welfare Association, "Development Finance and Leasing Company and Industrial Development Fund for the Occupied Territories in Palestine", Geneva, Switzerland, February 12, 1992. See also Frank Casey, "Report on Proposals for Long Term Development Banks in the West Bank and the Gaza Strip", prepared for the UNDP, March 13, 1992 and ANERA, "Preliminary Business Plan: Cooperative Finance Bank," 1992.



a total project cost above \$0.5 million.<sup>58</sup> The combined cost of these 19 projects amounted to \$26 million. In addition to these approved investments, there are presently under preparation several other large industrial projects, ranging in size from \$5-\$30 million, in textiles and cement. Other priority areas for investment are tourism and industrial estates, both likely to require significant amounts of capital. For example, development of the industrial estate facilities under construction or being planned for Gaza alone (1,682 dunums) will cost about \$ 150 million over the next few years. At this point, there are no credible estimates of likely investment demand from the private sector as a whole, but, given peace, it seems reasonable to project annual private sector investment of no less than \$125 million in industry and services. In addition, there is likely to be substantial investment in infrastructure to bring the West Bank and Gaza up to the standard of surrounding countries.<sup>59</sup> A good portion of this could be financed by local government debt, providing a major opportunity for a bank with strength in municipal finance. Raising a sum of at least \$100 million annually in municipal finance through the capital market might not be unthinkable. A further portion, particularly in telecommunications, electricity generation, water and public transportation, is expected to be financed by the private sector: these would be suitable private sector activities; and the total amount of investment required is likely to be beyond the capacity of the municipalities and international development agencies to finance.

3.78 It is assumed that a well-structured and strongly capitalized bank owned and controlled by the private sector would make a particularly important institution-building contribution in the highly unusual political-economic situation of the OT, given the scarcity of financial institutions at present. This would not change materially in the event that a number of Jordanian banks reopened because these are all commercial banks with very little diversification outside traditional commercial banking activities. The bank's contribution would be enhanced were it to focus its activities and staffing in priority investment areas, such as industrial estates (see below), infrastructure and municipal finance, garments/textiles, tourism and other sectors where the OT have both a priority need and comparative advantage. New financial services, such as the development of a corporate and municipal government securities market (see below) and the provision of support services to business (see below), are also priority investment areas.

3.79 Given the level of funding and types of financial services required, an investment bank might be the most appropriate type of bank to meet future demand. Not only would it complement a higher level of commercial banking services that would become available should the Jordanian banks reopen or other commercial bank licenses be approved, but an investment bank should be easier to establish within the existing legal framework than a commercial bank. Israeli banking law regulates financial institutions that take deposits and lend. An investment bank (that did not take deposits) apparently would only be regulated on specific investment-related activities, such as underwriting securities and issuing a prospectus. Establishing an investment bank would require strong international and technical links and substantial capital, even for the start-up period. The bank feasibility studies prepared by the Welfare Association and ANERA contain projections that could be adapted for estimating the break-even point for the operation of an investment bank. However, a full feasibility study should be carried out in the near future if requested by a viable group of Palestinian private sector sponsors. Although there are Palestinians throughout the world with investment banking skills who could staff such

---

<sup>58</sup> Information provided to the World Bank by the Government of Israel in a letter dated April 13, 1992.

<sup>59</sup> The World Bank mission concerning infrastructure estimates physical investment in infrastructure of \$2.2 billion.



a bank, an international banking partner, which could add its established stature, capital and skills, might be attracted to participate on the basis of an initial management contract.

3.80 Securities Market Development. There is no formal stock market and none of the financial intermediaries, laws or regulatory institutions in the OT that one would expect to be active. There are, however, at present 38 joint stock companies in the West Bank and 4 in Gaza; the oldest, the Jerusalem Cigarette Company, established in 1964, has 7000 shareholders. The issuance and transfer of shares are covered by the Jordan Companies Law (for companies registered in the West Bank) and the Palestine Companies Law of 1929 (for companies in Gaza), but neither Jordanian nor Israeli securities laws are applied to the trading of securities.<sup>60</sup> Shares are traded informally or through the offices of the company (although the latter may not be technically legal).<sup>61</sup> Since there is no formal market, there are no statistics on the number or value of shares traded, but data collected by the mission show that perhaps as little as 3 percent of shares outstanding trade in a year.<sup>62</sup> There are no provisions for custodial services; the limited financial information published only appears at the time of a company's annual meeting; and there are no newspaper reports on share activity. Despite these impediments companies are seeking measures to broaden ownership to tap the high level of liquidity and to take advantage of the tax-exempt nature of capital gains and dividends in the OT. As much as \$30 million equivalent has been raised in the past few years through the public subscription of equity in new joint-stock companies, including companies in paint, aluminum profiles, cardboard and insurance.<sup>63</sup> The last 5 new companies have been oversubscribed by as much as 500 percent, indicative of both high liquidity in the OT and the scarcity of dinar-denominated investments.

3.81 In theory, the Company Laws of Jordan and the Palestine Mandate provide a legal framework for the operation of a securities market in the OT. Neither of these laws is applied in practice. A market already operates in an informal way: prospectuses are issued, capital subscribed and shares bought and sold. The only oversight is provided by the boards of companies with publicly held securities, which must approve each transfer of ownership. The market is presently controlled by insiders. To serve the long-term goal of market growth, there should be a more objective and clearly defined legal framework that balances market development with some regulatory oversight to ensure fair trading and efficiency and protect the interests of shareholders. This may seem odd since the market is presently still small in volume, but publicly subscribed equity issues seem to have provided more business capital in 1992 than the banking sector and credit programs combined.

3.82 In addition to a legal and regulatory framework, the securities market seriously needs an efficient exit mechanism - a stock market or exchange - where investors can buy and sell. The present cumbersome and time-consuming process requires delivering securities to a company for board approval of ownership transfer and re-registration, and such services as custody, financial reporting and improved accounting and auditing standards and practices are lacking. There appear to be two major options at this

<sup>60</sup> Interview, lawyers, West Bank, February 1993.

<sup>61</sup> For example, a pharmacist in Nablus makes an "under-the-counter" market in shares. Interview, professor, West Bank, January 1993.

<sup>62</sup> Information provided by the company registrar through the Israeli military government in a letter to the World Bank, dated April 13, 1993.

<sup>63</sup> Interview, insurance company manager, West Bank, January 1993.

point: either to adopt and adapt an existing package of laws and regulatory and trading practices and mechanisms or to create an independent securities market and the attendant legal and regulatory paraphernalia. As to the first option, the Amman Financial Market and the various Jordanian securities laws and practices in force would be an attractive option to apply to the OT, at least for a transitional period. Investors in the OT and Jordan are already thoroughly familiar with the Jordanian market. Another important consideration is the long-standing investment of Palestinians in East and West Bank businesses. As to the second option, if it becomes a priority to have an independent securities market, a new companies law covering both the West Bank and Gaza and a securities market law would be priorities.

3.83 In the meantime, the investment bank discussed above could include, as one of its principal business activities, the establishment of a limited formal securities market through a window in the bank or through an independently capitalized subsidiary. At the outset, the bank could follow Jordanian law and practice, or IOSCO guidelines for securities market operations, with regard to the issue of securities, trade and settlement, and custody; this would put the operation of the securities market on a more objective basis. Technical assistance to deal with the development of an independent regulatory body and training its staff could be sought from an established regulatory agency or from a development agency with financial sector expertise. If a decision is made to proceed with the establishment of an independent securities market, technical assistance and training could be provided by an established stock exchange or a development agency.

3.84 Expansion of Industrial Estates. There is a severe shortage of available and affordable space for industry. The Palestinian business community and the CA agree that the best solution is the establishment of fully serviced industrial estates with reliable utilities; both parties have started to invest accordingly. However, the formula being followed at present in Gaza – private sector land ownership and piecemeal development with military government or municipal funding for infrastructure – combines to produce industrial sites (without buildings) that cost about \$400,000 per acre, or about 200 percent more than if the development were carried out by the Government, as the following figures demonstrate.<sup>64</sup> Where state land is available, the CA would consider plans for industrial estate development.

---

<sup>64</sup> Based on figures provided to the World Bank during meetings with the CA and business leaders in Gaza, January 1993.

Table 3.11: Industrial Estate Development Costs - Gaza  
(US\$ per dunum @ 0.22 acre)

	Public Land a/	Private Land b/
Land Cost	16,500	75,000
Utilities	13,500	13,500
Total Cost per dunum	30,000	88,500
Total Cost per acre	136,000	402,000

a/ Based on actual costs at the GOI-owned Ariz industrial estate.

b/ Based on actual costs at the privately owned Beit Hanun industrial estate, with the Government currently subsidizing about two thirds of the cost of utilities installation.

3.85 A mechanism must be found to provide access to industrial estates for the private sector at a reasonable price. This requires a solution to the problem of the high cost of land. No Arab body presently has the legal authority to zone land for industrial purpose in advance of purchase and, given the highly sensitive nature of the land ownership issue in the OT, the military government is unwilling to give advance zoning or sequester land for this purpose. A second major problem is the lack of capital to develop industrial estates that are adequate in scale and services for long-term industrial growth. None of the interested parties – municipalities, the Israeli Government, industrialists or private landowners – have sufficient funds to finance the development of an estate, so the landowners build financed by gradual land sales at high and even increasing prices.

3.86 These problems could be overcome by forming a partnership between the landowners and one or more interested parties, including financial institutions to fund the development of industrial estates. Landowners could contribute their land in return for shares in a company that would own, develop and manage one or more estates; fully serviced sites with reliable utilities could then be leased to industries at rates that would provide an attractive long-term return to the landowner-shareholders, yet be reasonable for the industrial tenants. Since the objective of environmentally safe, convenient industrial development has a strong public policy element, the Government might wish to become involved, either as a limited shareholder or by enabling industrial estates to issue tax-favored industrial development bonds. Given its importance and complex financing requirements, industrial estate development could be a prime area of activity for the investment bank recommended above during the next few years.

3.87 Tighten Up Lending Policies to Strengthen Credit Programs. For the past six to seven years, the credit institutions established by Palestinian and external donor agencies have provided funding for a broad spectrum of economically viable projects, needy people and disadvantaged groups within



Palestinian society. The poor loan recovery experience of the past few years has caused several of these institutions to take a more disciplined approach to the management of their business. Some have contracted with the Cairo-Amman Bank and the Bank of Palestine to handle loan administration. The three largest Palestinian credit institutions (ADDC, EDG and TDC) have decided to closely coordinate their lending programs and client selection and to specialize in complementary sectors in return for grants of ECU 15 million over the next three years. Each is also taking a more disciplined approach to collateral, utilizing multiple personal guarantors, promissory notes and even filing suit on occasion to force collections.

3.88 However, the interest rates charged are still heavily subsidized, and, while there are political objectives to these programs, this subsidized lending seems to have had a negative impact on credit discipline in the OT economy, even though the programs are small in aggregate. Now, however, with greater resources from the EEC, subsidized lending could deflect business from banks charging market interest rates. Three measures would enhance the credit discipline of the lending programs further, while leaving intact their socioeconomic and welfare objectives. First, they should move their lending rates to market interest rates over a specified period, say 12 months. Second, they should modify their lending policies so that the less risky loans no longer subsidize the more risky, and the interest rates charged are risk-adjusted. Third, they should seek to renegotiate the loan administration contracts with the commercial banks to include a risk-sharing formula, which would both enhance the amount of capital available and also link the administering banks more effectively to loan recovery. Finally, if the credit institutions with the three largest programs were to move toward market interest rates, they might, with adequate staff training and a strengthening of management, form the basis for an investment or development bank of the sort described above.

3.89 Technical Assistance and Training. Two forms of technical assistance are recommended; first, assistance with the design and implementation of the specific policy and institutional recommendations presented in this paper; and second, assistance and training of more general utility to the business sector or broad categories of users. The primary focus of technical assistance should be in the legal and regulatory framework of the banking sector and securities market. This assistance should concentrate first on adopting, and possibly modifying, existing banking and securities laws from other countries as an interim measure before embarking on the preparation of independent banking and securities laws. A second step would be the establishment of separate regulatory bodies focusing initially on bank supervision and securities market oversight, respectively. These bodies could also grant licenses to new financial intermediaries in their respective spheres of responsibility. We recommend that a package of technical assistance be provided to assist with the preparation of an appropriate legal framework and the organization, establishment and training of the staff of the regulatory bodies. This assistance could be combined in one package covering both the banking and securities markets to maximize coherence and coordination between the two sectors, or it could be provided separately if the development of the two sectors is likely to proceed at different speeds. The first step in this process would be to reach a consensus from interested parties on the scope and substance of financial sector reforms and then on the appropriate counterpart bodies and delivery mechanisms.

3.90 In addition, a number of crosscutting training needs, which would benefit the staff and management of the credit institutions and proto-governmental bodies in the OT, were identified in the course of the many discussions on the financial sector. Suggested courses include the following:

- Project economic and financial evaluation
- Financial analysis for agronomists
- Sectoral and subsectoral economic analysis, including DRCs
- Credit analysis
- Management of financial institutions

Most of these courses are included in the curriculum of the World Bank's Economic Development Institute (EDI). These EDI courses should be opened to selected Palestinian participants, either in Washington or in the regional courses taught in the Middle East. Other bilateral and multilateral development agencies may also have suitable courses for Palestinian participants, including the training program for the staff of the credit agencies in the West Bank and Gaza, which was recently initiated by the EC.

3.91 In addition to training in these financial and economic subjects, there is a need within the business community for advisory services to assist Palestinian companies in the areas of export marketing and the upgrading of industrial processes with technology appropriate to demand in the primary target export markets, including other countries in the region. The Dutch export promotion organization, CBI, is in the process of helping set up a Palestine Promotion Organization and training its initial staff.

3.92 A final recommendation is the establishment of a business advisory service to assist private firms with experience in finance, markets and modern production technology. This unit could provide a range of services, including the preparation of feasibility studies, investment proposals, strategic business plans and sales; and marketing programs and advice on technical matters, including the identification of appropriate technology, equipment selection, industrial organization, production processes, product selection and the like. Ideally, such a unit could be staffed by local and international specialists with both technical expertise and international experience in sectors of particular interest to local businesses, including tourism, food processing, building materials and service industries. There are probably many Palestinians with suitable international experience who could staff such an advisory unit.

### Conclusions and Recommendations

3.93 In the short term, several actions could be undertaken to develop the financial sector. The existing patchwork of Jordanian, Egyptian, Palestinian mandate, and Israeli legislation affecting financial institutions should be replaced with transparent and coherent legislation covering the West Bank and Gaza that sets clear criteria for licensing banks, insurance companies and other regulated financial intermediaries. A regulatory framework should be put in place that is consistent with international standards, establishing uniform rules on minimum capital, solvency and liquidity. Entry barriers should be removed, and existing banks should be allowed to expand in either the West Bank or Gaza. Measures could be introduced to enhance or supplement the collateral of local investors through: (a) a program to reestablish access to bilateral export credit programs for capital equipment imports by Palestinian

industrialists; and (b) an acceptable trustee/custodian for real estate mortgages. The inefficient, duplicative structure of small-scale, subsidized credit programs and institutions should be reformed towards market interest rates. Technical assistance should be made available in many areas related to finance.

3.94 In the longer term, issues of independent monetary authority and currency would have to be tackled. Policy options in these areas are discussed in the Macro Report.



## ANNEX IV THE GOVERNANCE SYSTEM

### Introduction

4.1 This annex describes the governance system in the OT, focusing on property rights and the regulation of commerce for private sector economic development. The primary intent is to identify institutional constraints to future development. There is no consideration in this chapter of non-economic security matters nor any attempt to draw conclusions about any party's property rights claims.

4.2 The current governance system in the OT is a constraint to economic growth. The economic laws and implementing institutions are antiquated and often inappropriate. Laws and institutions for property rights' definition, transfer and adjudication of disputes are either unavailable or unpredictable and unstable. Indigenous Palestinian capacity for administration has been severally eroded. The court system is generally ineffective and the quasijudicial committees established by the Israeli administration provide little or no effective recourse. Since there is no local police force, enforcement of commercial judgments is haphazard at best, thus undermining any basis for secured lending. Numerous reforms are necessary to create an environment conducive to investment. Many of these are discussed below in each of the relevant sections of this annex. However, two aspects of the governance system, in particular, pose the most serious obstacles to private sector development.

4.3 Palestinians in the OT are governed by a legal and administrative system that is antiquated, imposes disproportionate regulatory burdens and does not provide adequate recourse in case of property rights disputes. All policy making, legislative and regulatory authority, long-term planning, budget, material resources and infrastructure are controlled by Israelis. Furthermore, Israeli settlers in the territories are, in many respects, subject to a different system which is modern, provides incentives for investments and effective recourse for denial of property rights.

4.4 The second issue concerns the impact of measures taken by the Israeli authorities on the grounds of security (curfews, confiscation of land and building, the introduction of security settlements, house sealings and demolitions, uprooting of trees and restrictions on land use), on private sector development. The legal framework is not clear with respect to the Israeli rights to property and restrictions on economic activities.

4.5 The challenge for a transition is the crafting of a legal/administrative regime affording some measure of economic security for the residents and investors. The goal would be to establish a legal system that consists of widely known and relatively stable rules for the authoritative allocation of property rights and a belief by the population that rules will be enforced fairly and consistently over time.

4.6 A review and analysis of the existing legal and administrative systems suggest areas where specific steps might be taken toward the creation of an enabling legal system necessary for accelerating private sector development in the OT. Parts I, II and III below describe the current law, the courts and the administration. Part IV considers the economic effects of the system in the areas of land, tax, economic regulation and restrictions on movement.

## I. Applicable Law

4.7 Predictability, fairness and minimum protection for private property are the desired elements of a legal system facilitating economic growth. These elements cannot exist where the laws applicable are unclear. The question of applicable law in the OT is critical to resolving the obstacles to private sector development posed by the dual system and the differing views as to what actions security needs justify. As discussed below, there is an ambiguity and disagreement over the basic rules: the source and limits of the authority of the governance system. This ambiguity complicates every economic issue. It results in an administrative and regulatory system that is complex and neither stable nor consistent in application.

4.8 This section considers the legislation currently applicable in the OT. While successful conclusion to the bilateral peace talks necessarily will change various measures, it is unlikely and impractical to assume that all existing legislation would be swept away. Rather, it is more likely that any future governance system would evolve from the historical, traditional legal framework. Constructing a solid framework for future development requires a clear understanding of the existing system, its strengths, ambiguities, gaps, and inadequacies.

### Military Proclamations

4.9 At the cessation of hostilities in June 1967, Proclamation No. 1 announced that the Israeli military had assumed control of the OT. Proclamation No. 2 vested all military and government authority for each territory in the Regional Commander (RC) of the Israeli Defense Forces (IDF) who declared the law applicable to be that existing in the territory in June 1967, provided it does not conflict with the Proclamations and Military Orders (MOs), and subject to modifications resulting from the establishment of the IDF's government in the OT.<sup>1</sup> The Regional Commanders were abolished in 1981 and their functions assumed by the Area Commanders (AC). The Proclamations do not refer to limits imposed on the authority of the AC. In an interim period, and thereafter if the Israeli military retains any authority in the OT, the issue of what law and therefore what limits, if any, are applicable to the AC is critical since all other powers of all administrative bodies in the OT are derivative and dependent on the AC's powers.

4.10 Clarification and agreement on the applicable rules, commencing in the interim period, would contribute substantially to creating a significant measure of stability and security for the property rights of the OT and build a basis for private economic development.

### Pre-Existing Law

4.11 Prior to June 7, 1967, Jordanian law prevailed in the West Bank which was treated as an integral part of Jordan. In Gaza, from the termination of British Mandate until the inception of the

---

<sup>1</sup> Proclamation Regarding the Regulation of Administration and Law (Judea and Samaria) (No. 2) in "Collection of Proclamations and Orders (Judea and Samaria)," 3 and "Collection of Proclamations and Orders (Gaza)" p. 4, the former published in English in M. Shamgar (ed.), *Military Government in the Territories Administered by Israel 1967-1980: The Legal Aspects* vol. 1 (Jerusalem, 1982), Appendix C, pp. 450-451.

Egyptian Military Government, the law existing in Palestine on May 14, 1948 remained in force.<sup>2</sup> Thereafter, the Egyptian Military Governor ruled as an occupier and asserted his authority to publish orders changing the existing law in force. However, few changes were made and generally Mandate Law and Ottoman Law prevailed. Egyptian law was not introduced and Gaza was never treated legally as part of Egypt. Gaza did not have the benefit of Jordanian legal modernization from 1948 to 1967. In several areas of the law, notably, corporate law, the differences are significant and Gaza is clearly disadvantaged.

4.12 The pre-existing laws governing business transactions, property transfers and the professions are outdated. There are no modern laws or regulations establishing standards (health, safety, environment) for local production. In the West Bank, no modernization of the companies, contract and collateral laws have taken place since 1967 and the laws then existing are less than satisfactory now. The situation in Gaza is much worse. There, the commercial laws date to the Mandate period and are inadequate for modern commercial, trade, corporate and financial transactions. These laws inhibit the growth and flexibility of the Palestinian private sector reducing its flexibility to adapt to competition and making it less attractive to investors. The environmental regulations in the OT are essentially non-existent.

4.13 The Defense Emergency Regulations, enacted by the British Mandate, gave broad discretionary powers to military authorities which inter alia affect property rights. The AC continues to rely on these Regulations to justify actions which reduce the economic security of investors, e.g., by increasing uncertainty about the security of property rights.

#### Military Legislation

4.14 Since 1967, the RC has issued MOs amending the existing legislation. In many cases, such amendments have consisted of the introduction of completely new legislation or the cancellation of pre-existing law. To date approximately 1389 MOs have been issued in the West Bank and 1060 in Gaza, supplemented by regulations and instructions.<sup>3</sup> These measures are not easily accessible to Palestinians and are issued, compiled and interpreted in a non-transparent manner.

4.15 Approximately one third of the MOs are economic legislation, which is broadly drafted and often subject to wide interpretation. MOs affect economic life by imposing a system of licenses, permits, prohibitions, restrictions, fees, charges or taxes. Wide discretion is permitted to implementing authorities to grant the licenses or permits or impose a fee or lift a restriction established by the military government. The result, over time, has been the dilution of responsibility of local executive bodies and their substitution by the CA bodies in regulation of all economic activity including agriculture; land ownership, transfer, use and planning; spatial development; infrastructure development; utilities; water resources; tariffs and taxation; business and professional licensing. Some changes have contributed to development (introduction of auto safety measures, improved conditions for women). But for the most part, the MOs and the associated regulatory regime restrict Palestinian property rights and impose on them a comparative disadvantage in the costs of doing business and competing in the Israeli market.

---

<sup>2</sup> Order of the Egyptian Military Governor, *Official Gazette of the Gaza Strip*, vol. 1, p. 17. See also the Gaza Constitution, in English, in *17 Middle East Journal* 156 (1963).

<sup>3</sup> The exact number has not been verified by the Civad. The information in this paragraph is based on a review of most, but not every MO in English and Arabic and discussion with lawyers and businessmen, both Israeli and Palestinian, in both Gaza and the West Bank in January, 1993.



### Limits on Legislative Powers of AC In Respect to Economic Matters

4.16 What are the existing limits, if any, on the economic legislative powers of the AC? As noted by Justice Shamgar in the VAT Case,<sup>4</sup> the limits include those imposed by the Hague Regulations, Article 43 of which provides as follows:

"The authority of the legitimate power having in fact passed into the hands of the occupant, the latter should take all the measures in his power to restore and ensure, as far as possible, public order and safety, while respecting, unless absolutely prevented, the laws in force in the country."

4.17 The HCJ has held that the RC, standing temporarily in the place of the government until a new government is maintained, possess the right, under Article 43, to suspend or alter existing legislation or introduce new legislation - but with the limit that the purpose of all changes be to maintain "*l'ordre et la vie publique*" (from the Hague Regulations Article 43, governing French text). Thus, the RC can legislate only for two purposes: public order and safety and the maintenance of civil life for the population. When the RC asserts unequivocally security as his motive for action, the HCJ generally will not question the legality of his actions. But if security is not the primary motive, then the HCJ's view is that the AC can legislate only to serve the welfare of the population.

4.18 The RC's motive in issuing MOs (whether for security or the welfare of the population and how those terms are to be interpreted) has created tension between Palestinians and Israelis. Some of the MOs are related to security concerns; but many are clearly economic and the latter often take the form of new legislation. Palestinians commentators have argued that most of the MOs, issued during the 1977-87 decade, not directly related to security are contrary to the limits set by the Hague Regulations.

### Accessibility of MOs and Military Regulations

4.19 Perhaps, more problematic is the absence of any publicly available, unified code or compilation of laws. A collection of all MOs is apparently not readily available. On January 24, 1993, the Civilian Administration of Judea and Samaria published the *Economic Book of Law*, compiled by Moshe Rosenberg, Legal Consultant for Judea and Samaria. The Economic Book contains pre-existing law and MOs pertinent to income and property tax, public finance, appeal committees, customs, excise and revenue stamps, fees for permits, banking, currency and foreign exchange. This compilation is described as authoritative. It is available only in Hebrew, though an Arabic version is promised. A similar compilation is promised for Gaza. Missing from the compilation are MOs concerning land, water, utilities, agriculture, regulation of professions and trade, education, labor, insurance, transportation and tourism. The current Israeli publication does not approximate a gazette or code.

## II. The Courts

### Military Courts and Appeals Committees

4.20 Military Courts were established by Proclamation 3 (1967) replaced by MO 378 (1970).

---

<sup>4</sup> *Vat Case*, p. 29.

Military Courts have jurisdiction to try any criminal or security related offense under local law and the AC's enactments. According to internal Israeli regulations, when the Military Courts have concurrent jurisdiction with local courts (essentially all criminal matters), files must be handed over by local prosecutors to the Israeli military prosecution in two cases: (a) where the offense is of a security nature as determined by the Israeli military, and (b) where the accused is an Israeli citizen. There is no Court of Appeal for those convicted in a Military Court.

4.21 Two tribunals have been established in the OT to handle civil matters. The first deals with claims for compensation for injury caused to residents of the OT by the IDF and the second hears objections against decisions of the AC made pursuant to the MOs and the pre-existing law. Any resident who has suffered damage as a result of IDF action may file a claim with a Military Staff Officer whose determination is appealable to a three-man Board of Appeals whose presiding member must be a lawyer. Pursuant to MO 1101 (1984), to gain a hearing, a claimant must first obtain a certificate from the AC stating the damage was due to a military operation carried out because of security needs.

4.22 The AC established a system of quasi-judicial committees to review decisions made under certain specified MOs, or "any other matter with which the Regional Commander might empower them to deal."<sup>5</sup> The Committees so established have jurisdiction to hear objections to, but not reverse, administrative actions involving all those matters concerning which the AC took jurisdiction from previously existing or local officials or asserted a jurisdiction to regulate where there were no previous regulations.

4.23 The AC establishes Objections Committees and appoints the members for different types of cases - taxes, pensions, vehicle licensing, land registration, planning and use. Some cases (e.g., real estate) require a three man Committee while others may be heard by only one member. The chairman must be a lawyer trained in the subject matter. There is no requirement that the chairman be of any particular ethnic group or nationality. In practice, virtually every chairman is an Israeli lawyer or judge who serves on a Committee in fulfillment of his active military reserve duty obligation. Other Committee members may or may not have legal training (except for the Real Estate Committee, discussed below). The Committee may prescribe its own procedures so long as the appellant is assured the rights to be heard and to be represented by an advocate. There are detailed, published rules for procedure. Rules of evidence are flexible.<sup>6</sup> A committee may accept or reject consideration of an appeal for several reasons. In practice, according to both CA officials and Palestinian lawyers, most appeals are considered.

4.24 A Committee has the right to recommend interim measures. *Ex parte* orders can be given for a ten day period. Broad discretion is granted in this matter.<sup>7</sup> Decisions of a Committee are not final judgments but merely recommendations to the AC which he is free to accept or reject. However, according to the CA authorities, there has not been a single instance where a recommendation has not been accepted.

---

<sup>5</sup> MO 172(1967) as amended.

<sup>6</sup> MO 1209(1987).

<sup>7</sup> MO 1209(1987).

4.25 There are particular rules for dealing with real estate.<sup>8</sup> Where Israel declares land to be abandoned, absentee or state land (and thereby subject to transfer to Israeli or Jewish agencies by long term lease), Article 28 of the rules require, *inter alia*, an appeal to be filed by a claimant owner within 48 days from the day (a) an Israeli officer informed the local Mukhtar (appointed by the Israeli AC) that the land was to be registered as Israeli state land; (b) the appellant was told of the intent to so designate or (c) the day the parcel was demarcated by Israeli authorities in the field, whichever comes first. To be perfected in time, such an appeal must also conform to documentary requirements including (a) presentation of a map signed by an authorized surveyor and to the scale 1:20,000; (b) expert opinion as to improvements or cultivation; (c) copies of the claimant's registration on the Taboo (land register) and a valid power of attorney if the claimant speaks for another.

#### Local Courts

4.26 In 1967, the West Bank had courts of First and Second Instance and a Court of Appeal. A Court of Fourth Instance known as the Court of Cassation was in Amman. The latter, acting in the capacity of a High Court of Justice hears appeals against administrative decisions and can issue orders of prohibition, *mandamus*, *certiorari* and *habeas corpus*. The situation in Gaza was similar except that no Court of Cassation existed.

4.27 Upon entry into the OT in June of 1967, the powers of the Jordanian Minister of Justice and the Egyptian equivalent for Gaza were transferred to the AC who delegated most powers to the Officer in Charge of the Judiciary.<sup>9</sup> Judges in the OT are local Palestinians appointed by a Judges Appointment Committee composed of active or reserve status Israeli military officers. Similarly, the powers of transfer, promotion, salaries and benefits of all local judges are supervised by the same military officers. Palestinians have been invited but declined to participate on the Judicial Appointments Committee.

4.28 The jurisdiction of the local courts has been effectively limited to civil disputes between Arab residents of the OT, matters of personal status and minor crimes committed by Arabs against Arabs. MOs 109 and 172 removed to the Objections Committees appeals against most significant economic decisions of the CA. MO 841 (1983) effectively withdrew from the local courts virtually all criminal matters involving Israeli residents and any matter which the AC believes to be security related.

4.29 Since 1987, the local courts have deteriorated in service and effectiveness. Since the Palestinian police has resigned, there is no executive willing and able to enforce judgments of the local courts.

#### The Israeli High Court of Justice

4.30 The Supreme Court of Israel, in addition to its functions as an appellate court in criminal and civil appeals from judgments of Israeli District Courts, also sits as a High Court of Justice (HCJ). As an HCJ, its jurisdiction extends to claims of individuals against actions of the government. Since the

---

<sup>8</sup> See generally "Orders Describing Regulations of Appeals Committee," June 14, 1987, as amended (1990 and 1991), *op. cit. Economic Book*, pp. 178-186).

<sup>9</sup> MO 412(1970), as amended.



establishment of the military government in the OT in 1967, the HCJ has asserted jurisdiction over the person of the AC and their subordinates on the basis that the HCJ has jurisdiction over them wherever they are when they act at the behest of the Israeli Government.<sup>10</sup>

4.31 Scope of Review. The legal criteria by which the HCJ tests the acts of the AC and his government have been repeatedly clarified and revised. While several important issues remain unclear (due in part to no judgment having settled them), certain general principles have emerged.

4.32 Petitions for review have focused on two issues: (1) whether administrative acts and secondary legislation are valid under (a) the MOs; (b) existing law; and (c) applicable international law; and (2) whether a MO is itself valid as tested by the rules of international customary law (including the Hague Regulations but not Geneva IV).<sup>11</sup>

4.33 The HCJ has addressed the first issue at length and applies the criteria discussed above. As to the second issue, while it remains unsettled whether the HCJ has the jurisdiction to invalidate a MO, the HCJ generally has followed the 1973 opinion of Justice Kister that the MOs are to be regarded as primary legislation, since the AC is the sole source of legislative power in the OT. However, the AC's legislative/executive authority in implementing law is subject to two limits - those of his supervisor including the Israeli Minister of Defense and the rules of international law as accepted and applied by the HCJ in reviewing the AC's acts.<sup>12</sup>

4.34 Effectiveness. Palestinians have increasingly sought access to the HCJ. Approximately 200 petitions were filed in 1992 of which about 70 percent were resolved in some manner and 30 percent were dropped before any result was reached. Of the 70 percent resolved, about 60 percent were compromised in some informal way. Of the remainder, less than 10 percent resulted in decisions favorable in some way to the petitioner. By comparison, about 20 percent of petitions pursued to judgment by Israelis were successful in 1992.<sup>13</sup>

4.35 Most of the petitions brought in 1992 and since 1986 have involved the sealing and demolishing of homes. In most cases, residents sought orders to halt pending actions until the resident could present his case. In most of these cases, for which no HCJ decision was reached, the petitioner was granted the interlocutory order staying action. Almost all demolition orders (43) in 1991 were appealed. Of these, 20 percent in Gaza and 15 percent in the West Bank were changed, most to sealings.

---

<sup>10</sup> *Israel Rule of Law*, pp. 41-42. At the same time, it must be noted that no Attorney General has ever challenged the HCJ's jurisdiction to hear a petition of an OT resident and the possibility of such an objection continues, though with the passage of time and the frequency of accepted petitions it seems unlikely that jurisdiction could be defeated.

<sup>11</sup> *Vat Case*, p. 29. Petitions presented tend to be based on both grounds (e.g., in *Rishmawi et. al. v. IDF Commander, Judea and Samaria, et. al.*, unpublished H.C. 681(1992), the petition alleges, *inter alia*, that the tax MOs and regulations issued by the Respondents and the tax collecting activities of the Respondent are contrary to the Hague Regulations, Articles 43 and 48).

<sup>12</sup> *Hilu v. Government of Israel*, Piskei Din 27(2)169, English summary at 5 IYHR (1975) 384.

<sup>13</sup> Interview with Nili Arad, Chief of Department of Appeals in Attorney General's Office, Jerusalem, February 8, 1993. Ms. Arad indicated that statistics are not kept and the numbers and percentages are based on her best estimate. Ms. Arad heads a department of eight lawyers which reviews petitions to the HCJ.

The HCJ overturned one demolition order in the OT in 1991.<sup>14</sup> In 1990, there were 94 demolition orders, almost all of which were appealed to the HCJ. Of these, 10 percent in Gaza and 25 percent in the West Bank were changed, mostly to sealings. In all cases, the owners were not allowed to rebuild.

4.36 Israeli sources argue that the increasing use of the HCJ by Palestinians demonstrates its effectiveness as a check on arbitrariness by the AC and as a public forum for the airing of Palestinian grievances. The Attorney General's office has frequently intervened with the AC and the CA on behalf of petitioners with a result that numerous matters are settled or harsh measures mitigated. These sources agree that while the HCJ will rarely review an action if the AC asserts a motive of security or the general welfare of the population as justifying the action, it does review, on a case-by-case basis the application of the law to "determine whether such application is enforced to further legitimate reasons for the law or for reasons not related to the legitimate purpose. If it is the latter, then the HCJ will stop the AC's action in the particular case." The official commented further on the effectiveness of the HCJ as follows:

"We do not defend abusive rules. The legal system seeks to settle individual cases and informed advice, based on likely HCJ views, often leads to favorable settlements or better treatment. The HCJ at least affords the chance to be heard and that in itself is a benefit. We often check the cases to see if there are consistent decisions. The law is a military rule and the laws are not chosen by the ruled - but we try to see that the acts are within the rule of law."<sup>15</sup>

4.37 The HCJ does provide recourse for certain arbitrary actions which are abusive of the procedures established to implement the substantive laws. In this respect, the HCJ can be seen as holding the military government to its own procedures. The MOs are not applied arbitrarily in the OT. Complex, detailed procedures, affording in all cases, the right to be heard, are meticulously and scrupulously observed and enforced. On a case-by-case basis, the HCJ will correct factual mistakes or abuse of these procedures. Very often, the mere petition to the HCJ will result in informal measures which often mitigate the actions which the military takes.

4.38 The increasing frequency of Palestinian petitions to the HCJ can be ascribed to two factors: the HCJ and its procedures offer the single legitimate and effective institutional means for Palestinians to voice their complaints and seek redress; and the HCJ offers the chance of mitigation from actions which abuse the procedures and limits which the military government has set for itself.

### III. Administration

#### Israeli Military Administration

4.39 Upon entry into the OT, all powers of government respecting the region were vested in the regional commanders in each of the West Bank and Gaza. Their positions were assumed by the ACs each of which is appointed by the Chief of Staff of the IDF, who in turn, is subordinate to the Minister of Defence. The two ACs coordinate their activities through the General Headquarters' Coordinator of the Territories currently located in Tel Aviv.

---

<sup>14</sup> *Country Reports for 1991*, p. 1446.

<sup>15</sup> Both quotes from an interview with Ministry of Justice official, Jerusalem, February 8, 1993.



4.40 Until November 1981, all military and civilian matters were administered by one organization in each area, in Beit-El in the West Bank and Gaza City for Gaza. Following the Camp David Agreement's calls for the "withdrawal" of the military government from the OT, the AC for the West Bank issued MO 947 (1981) (the equivalent was issued for Gaza) which established the Civilian Administration formally separating it from the military headquarters which was physically withdrawn outside the West Bank. Under Article 3(a) of MO 947, the AC transferred to the Head of the CA certain powers listed in Schedule 2 of the MO. The AC, wherever located, retains all primary legislative, administrative and other rights. The CA is given power to legislate subsidiary regulations relevant to certain, but not all, pre-existing law. The CA is, in every significant way, subordinate to the higher authority of the AC.

4.41 The chief powers of the Head of the CA are to administer a body of law, including the Schedule 2 MOs, through the making of appointments and the issuing of licenses and permits. He has no power to add, delete, or amend the MOs or to alter the structure of the arrangement. His authority is to administer and issue such subsidiary legislation (regulations and notices) as necessary. His powers are nevertheless considerable. The MOs listed in Schedule 2 grant broad discretion to the CA in granting licenses and permits, regulating trade, collecting taxes, customs and duties; regulating certain important sectors such as tourism, agriculture, banking; and delegating judicial and police powers to those who serve on the Objections Committees, the local courts and the local police.

4.42 As of February 1, 1993, there were 13,456 Palestinian and 507 Israeli civilians in the West Bank CA. The Palestinians are concentrated in education (73.6 percent of all Palestinians and almost 100 percent of all staff) and health (14.5 percent of all Palestinian and 95 percent of all staff). Israelis are concentrated in tax (20.3 percent of Israelis and 100 percent of all staff), customs (20.1 percent), telecommunications (5.1 percent) and antiquities (5.3 percent).

#### Local Administration

4.43 The Israeli administration divided the West Bank into seven districts, each with a Military Governor. Twenty-five Palestinian towns in the West Bank and four in Gaza have municipal status which is the most important form of local government under the Jordanian Municipalities Law of 1955. Since 1981, when nine West Bank mayors were deposed by the CA and most others suspended operations, most municipalities are run by Israeli appointed officials. Municipal elections have not been held since 1976. In the West Bank, there are 82 village councils, operating under the Jordanian Village Management Law (1954). These provide such services as waste collection and are funded by the CA. In addition, there are the camps which fall under the jurisdiction of the United Nations Relief and Works Agency (UNRWA).

4.44 In Gaza City, the appointed Gaza City municipal council was removed (Gaza's last election was held in 1946). Some municipalities are run by Israeli military officers, some by Palestinians appointed by CA and a few by mayors elected in 1976. The legal powers of the municipalities are broad under the British Palestine Municipal Law of 1934 and include building and business licensing, health, sanitation, fire, schools and markets within municipal borders.

4.45 The powers of the municipalities and other local governments are curtailed by several factors. First, except for minor tax privileges and revenue from the resale of electricity, they depend entirely on the CA for their budget, approval of the rate of taxation, and approval of municipal ordinances. The municipalities are not permitted to borrow money or collect contributions without



advance approval of the CA.

4.46 The CA controls building and business licensing. The High Planning Committee for each of the territories, composed entirely of Israelis, has the authority and has used it frequently to amend or revoke all municipal zoning and planning measures. This body exerts an effective veto on all municipal decisions which impact land use, including permits to build any commercial or industrial structure. However, the municipalities can grant permits within the approved zoning plans.

#### IV. The Economic Effects of the Legal and Administrative System

##### Land

4.47 The Ottoman Land Code, supplemented by British Mandate, Egyptian and Jordanian measures and MOs governs ownership of real property in the OT.<sup>16</sup> At the advent of the British Mandate all land in Palestine was divided into two categories: waqf (charitable or religious trust land administered by the Islamic Shari'a courts) and mulk (being all land not waqf). The Land Code considered all mulk land as being owned in the first instance, by the sultan. Substantial land was given in perpetuity to residents and taxed accordingly. It was generally residential, urban or village property and a title deed ("taboo") was given to the owner and was easily transferred by changing the title in the local register, maintained, in part, for the tax collector's convenience. Non-urban, non-residential land was divided into three categories: miri, matrouk and mawat land. Miri land could be considered available for private, exclusive use if cultivated. If the land remained fallow or not used for three years or more, it could be categorized as maktul and made available to another user (and thus be a continuous source of tax revenue). Matrouk land was for public use such as roads, parks and pasture. Its ownership remained with the sultan but its use was recognized as available for a particular group or village or district which was charged with its keeping. Mawat land was vacant land not in any person or group's possession or use. It was considered land that lies at such a distance from a town or village that a human voice cannot be heard at the nearest inhabited place.<sup>17</sup> The Ottoman Land Law had no concept of "state" or "public" land but such a concept was introduced by the Mandate in the 1922 Order-in-Council.<sup>18</sup> The 1922 Order defined public lands as "all lands in Palestine by virtue of Treaty, Convention, Agreement or Succession and all lands which are or shall be acquired for the public service or otherwise". The prior ownership rights of the Sultan were transferred to the British High Commissioner.

4.48 The British made few alterations in the system but did commence a land settlement process on the principle of registering to private owners not only residential land but also cultivated land (miri land). Matrouk land was to be recognized, through the device of planning, as being available for

---

<sup>16</sup> Discussions of the Ottoman Code and its application can be found in Raja Shehadeh, *Occupier's Law: Israel and the West Bank* (rev. ed.), (Washington, D.C.: Institute for Palestine Studies) (1988), and in Benvenisti, *West Bank Data Base Project*, pp. 32-36.

<sup>17</sup> Art. 103 of Ottoman Land Association, cited in, "Land Laws of Palestine," *Journal of Palestine Studies* (1982) p. 79.

<sup>18</sup> "1922 Order-in-Council," cited in *Laws of Palestine*, London (1933), vol. III, p. 2569 as quoted in Shehadeh, *Occupier's Law*, p. 24.

the exclusive use of particular municipalities or districts. Particular provisions were made for mawat lands to be identified and registered in the name of the High Commissioner in trust for the inhabitants. Land required by the British for their immediate governmental needs was requisitioned, registered and put to use for the purposes taken.

4.49 In 1948, the Egyptian military government continued the British Mandate settlement procedures in Gaza. In the West Bank, Jordan introduced the Law of Settlement of Disputes over Land and Water, No. 40, 1952 and by 1967 had registered approximately 13 percent of the West Bank as land belonging to the Crown, pursuant to the Law of Land Expropriation for Public Purpose, No. 2, 1953. Jordan also introduced a law to classify miri land as mulk, i.e., individually registered land with ownership to remain, regardless of use, freely inheritable and transferrable.<sup>19</sup> Pursuant to its reform legislation, Jordan organized land settlement in the West Bank and began to survey and formally register all land. The procedure was complex but afforded considerable due process to claimants, especially for pasture and cultivatable land.

4.50 By 1967, the process of land settlement in the OT was incomplete. About 40 percent of the land in the West Bank and 70 percent in Gaza had been registered in private ownership. Land settlement and registration in the West Bank has been suspended due to problems with ownership verification.

4.51 Upon entry into the OT in 1967, Israel moved to assert control, but not outright ownership over land registered in the name of the Jordanian and Egyptian governments<sup>20</sup> and land and property owned by residents who left the area before the Israelis entered.<sup>21</sup> Absentee property passed to the Custodian of Absentee Property who has the right to lease or otherwise dispose of the use of the land, provided rents (as he determines value) are deposited for the owner. It is administered by personnel from the Israel Lands Authority. Most absentee property registered before 1967 to an absentee Palestinian has been leased to Palestinians, though a portion has been leased to Israeli settlers, primarily in the Jordan Valley.<sup>22</sup> More recently, land passing to the control of the Custodian has been leased by him to Israelis even when the land is held jointly with Palestinian individuals. However, ownership of land leased to Israelis by the Custodian or by the military government is unsettled.<sup>23</sup>

---

<sup>19</sup> Law to Transfer the Land from Miri to Mulk, No. 41, 1953.

<sup>20</sup> MO 59(1967).

<sup>21</sup> MO 58(1967).

<sup>22</sup> Benvenisti, *West Bank Data Base Project*, 30. Even where the "absentee" has been located within the OT, he has not been able to recover the land [see case of Francois Albina H.C. (16/82)]. In most cases the absentee is prohibited by other MOs from returning and cannot recover his property. Absentee land and land bequeathed by or to an absentee may not be subdivided. In practice, if any of the heirs of an estate are absentee, then none of the land is subdivided.

<sup>23</sup> Mr. Drori, who served as a legal advisor to the West Bank Regional Command from 1970 to 1974 explains the situation as follows:

"The military government is only the administration of the government lands previously owned by Jordan, as stipulated in regulation 55 of the Hague Convention of 1907. As such, it is required to preserve these lands and has usufruct (the right to enjoy their "fruits") regarding them. The military government may set

4.52 Military Order 291 (1968) concerning Land and Water Settlement, suspended all settlement activities then underway. Since then, land settlement for Palestinians has halted. Even cases then pending have not been resumed.<sup>24</sup>

4.53 From 1967 to 1979, Israel took possession of land by three methods: requisition of land for security or military purposes, sequestration of land for military training and expropriation of land for public purposes. From 1967 to 1977, the Israeli Government took the position that the requisition of private, i.e., registered land, and its transfer to Israeli settlements was legally justifiable under the Articles of Hague Regulations for security purposes. The Allon Plan envisaged settlements in certain strategic areas.<sup>25</sup>

4.54 The amount of land requisitioned is estimated at 35,000 dunams.<sup>26</sup> Land seized for training has included unused and cultivated land. The total area closed is fluid at any time but amounts to about 1 million dunams. Prior to 1980, the closing of an area was prelude to requisitioning and transfer to Israeli settlement. The Kiryat Arba and Bega'ot settlements are often cited as examples. Finally, the military government has expropriated for public purposes considerable privately registered Palestinian land relying on Jordanian law ("Expropriation of Land for Public Purposes," No. 2, 1953) as extensively amended by MOs 131-32 (1969).<sup>27</sup>

4.55 The Office of the Custodian, in late 1979, began a survey of West Bank land to determine the extent of private (i.e., registered land) and government land (defined by the Israeli Land Authority and by the Israeli Regional Councils in the West Bank as land not registered and not cultivated continuously). All land was deemed state land unless it is either registered or under continuous cultivation over ten years. In both cases, the burden of proof was placed on the Palestinians that the land was not state land.

4.56 The survey results charted about 40 percent of the land as "state land".<sup>28</sup> By 1986, virtually all this land was transferred to the Custodian and put under the administrative jurisdiction of the

---

up army bases or such other similar instruments as are necessary on government lands, but it may not sell these lands — for the simple reason that it does not own them. Therefore the settlers now living on government lands are not the owners either. They merely have permission from the temporary administration of the lands (the Commissioner for Government Property) to stay on the lands and only for so long as the lands are administered by the commissioner — that is, as long as the occupation continues." Moshe Drori, "The Israeli Settlements" in Elazar, ed., *Judea, Samaria, and Gaza: Views on the Present and Future*.

<sup>24</sup> The AC argues that to resume land settlement would prejudice the absentee (*Israeli Rule of Law*, 47), but in fairness, the lease of absentee land to Israeli settlers demonstrates that the Custodian can and does take action in respect of the land and thus could have and still could represent the absentee interest if the earlier settlement proceedings were to resume.

<sup>25</sup> *Beit El Case*.

<sup>26</sup> Benvenisti, *84 West Bank Data Base Project*, p. 31.

<sup>27</sup> Drori, "Israeli Settlements," p. 53.

<sup>28</sup> Benvenisti op. cit., p. 32 and confirmed by Civad January 1993.



Israeli Councils in the OT. According to CA officials, as of February 1, 1993, approximately 40 percent of the West Bank has been declared as state land, of which 70 percent has been leased (usually for 49 years) and registered in the Special Land Registration to private Israeli or Jewish persons or entities, some residing in the OT and some outside. Records are kept in the Israel Land Administration in Jerusalem but are not public. The comparable figures for Gaza are 30 percent and 60 percent.<sup>29</sup>

4.57 Land Use. Planning and building, together with the licensing process involved is critical to economic development in the OT. The basic law applicable in Gaza is the Mandate Ordinance of 1936, as modified by MOs; and in the West Bank, the Jordanian "Cities, Town and Buildings Planning Law".<sup>30</sup> The Jordanian law provided for a Supreme Planning Council ("SPC"). MO 418 established the SPC for the West Bank comprising six Israeli staff officers and it was to this SPC that the powers of all other land use planning councils (except municipal) were transferred. In addition to the powers vested in the SPC by Jordanian law, MO 418 grants the SPC the additional power of amending, canceling or suspending any plan or permit, assuming the powers of any other council, including municipal councils, granting, amending or dispensing with the need for permits required by the law which include building permits, change of zoning or use, granting permits for development plans which must be approved for certain subdivision of land.

4.58 The SPC has sub-councils, called Village Planning Councils, which process applications for permits in villages. MOs 418, 604, 860 and 1043 all concern "Specific Planning Committees" which are the sub-councils set up for the Israeli Councils in the OT. These committees act pursuant to Israeli planning regulations and standards which are different from those applied to Palestinians. The CA Head has delegated his authority in respect of planning to these sub-councils with the land under their jurisdiction. Thus the settlements are free of the CA's day-to-day control and operate autonomously, using Israeli standards and procedures. The Palestinian population is subject to the CA's day-to-day controls administered by its Central Planning Department (CPD), acting under the supervision of the SPC. CPD makes decisions on all Palestinian plans and building permits. It also has its own inspectorate division which enforces demolitions against Palestinian buildings built without permits approved by the CPD.

4.59 In the period 1977-1984, the pattern of planning became settled. For the Israeli settlements, there are separate administrations, standards and budgets and the process is well advanced. By mid-1987, 274 plans had been processed, 86 approved, 110 deposited and 78 pending approval. For Palestinians, "the planning process remained haphazard, irregular and disorderly."<sup>31</sup>

4.60 The municipalities have responsibility for preparing their own plans for submission to the SPC. Their jurisdiction is limited by their boundaries, for the most part held within 1967 limits, despite population growth. Most of the municipalities are understaffed or lack mayors due to the cancellation of elections and the refusal of many Palestinians to take Israeli appointments. In Nablus in particular, where there is no mayor or council, there are significant planning constraints. In Hebron, the only plan

---

<sup>29</sup> As of 1987, the declared state lands in the West Bank have been estimated at 1.85 million dunams or 34 percent of the total territory. [Benvenisti, Meron, West Bank Data Base Project, 1987 Report (Jerusalem) p. 37].

<sup>30</sup> Jordan Law (No. 79), 1966, though the latter was not applied prior to (1967). The planning bodies in both regions required by these laws are appointed by the Civad pursuant to MO 418 (1971).

<sup>31</sup> Benvenisti 1987, *West Bank Data Base Project*, p. 35.

existing for Palestinians is the Mandate Era Plan. Planning has not progressed and building permits have been given on an ad hoc basis.

4.61 In both Hebron and Nablus, there is need for expanded industrial space. Much of the industry is currently crowded within residential areas, often with housing built over one or two shop floors. In Nablus, an industrial zone has been approved by the SPC and funds allocated. In both Gaza and the West Bank, since the development is to take place within the existing municipal boundaries on private plots (Palestinian development on any land other than private registered land, i.e., state land is not permitted), the cost of the land in the zone is \$150,000 per dunam (Gaza) which is discouraging to new business and not sufficient incentive for much existing small industry to relocate.

4.62 The high cost of the industrial space for Palestinians, inflated artificially by the CPD planning practices, puts Palestinian economic development in the OT at a severe disadvantage when compared to Israeli prospects in the OT. In 1992, Israel estimated that it cost an average of 55,000 NIS to develop 1,000 square meters of industrial land in the 27 zones marked for settlement (i.e., Israeli, but not Palestinian development). Subsidies from the Israeli government reduced the actual costs considerably to Israeli investors. In 1992, an "approved" enterprise (one registered in Israel and approved by Israel's Investment Board for incentives) paid only NIS 15,697 per 1,000 square meters and an enterprise not eligible for concessions paid NIS 30,632. In addition, the Israeli enterprise had available a menu of four investment incentive packages providing a grant of up to 38 percent of investment in fixed assets and a reduction of tax from 45 percent to 25 percent; or tax exemption for 10 years, and on state loan guarantees in different amounts for different projects. In February 1992, the Israeli government declared that Israeli enterprises in the OT that did not enjoy the "approved status" would be eligible for government loan guarantees of up to 30 percent of fixed property costs.

4.63 Transfer and Permits for Land Use. Land registered in the name of a single Palestinian owner may be re-registered in another single name without difficulty. However, any subdivision or transfer must receive approval of the CA planning authorities which, according to Palestinian sources, is rarely given. Israeli sources claim that subdivision requires a parcellation plan and can only be done in the absence of a plan on a case-by-case basis. These sources agree that parcellation plans are rarely approved since few have the deed needed and many who do, do not satisfy other documentary requirements.

4.64 Owners of cultivated land and land for which no Taboo (deed) was given are unable to transfer or divide land legally (or pledge it or transfer it by inheritance) since CA authorities require proof of a deed to effect the transfer. Since the land settlement process, especially in the West Bank, was only partly completed by 1967 and then suspended by the AC a significant amount of land is not registered (approximately 60 percent in the West Bank and 30 percent in Gaza). The rest cannot obtain one and thus cannot legally subdivide or present a parcellation plan. In practice, Palestinians rarely try to subdivide their land fearing confiscation by entry into the land by the Custodian. The result is that in case of death or where children subdivide a parent's land, the new owners' ownership rights are ambiguous. They cannot get a valid building permit. The choice is to live in overcrowded buildings or build without a permit. Faced with such dilemmas, many just go ahead and build anyway. But they face dire consequences - demolition of their building (whether home or business and often both) if the CPD learns of the unauthorized building and chooses to order it demolished.

4.65 Within municipalities, the local councils have the right to develop parcellation plans to facilitate subdivision. However, in mid-1988 the CPD stopped its approval of any parcellation plan until

the applicant submitted further detailed plans, none of which the CPD approved as of February 1, 1993. The result, in several large towns (Ramallah and Hebron), is complete cessation of legal development.

4.66 Assuming the issue of a buildable plot is settled, obtaining building permits is difficult for Palestinians. According to local attorneys the procedures for obtaining a permit are complex and determined by internal and unpublished regulations of the CPD. The long procedure is described by Coons (pp. 149-155). Apparently, the time required to process the documents is a minimum of six months, with an average of one year and at a cost of \$2,500.

4.67 Other land use restrictions are considerable and include requirements for permits to plant trees or certain crops. As with all requirements for permits, the process is complex and discretion is left to CA employees. There are no mechanisms for forcing a decision and frequently the process drags on for years.

### Taxation

4.68 The main taxes imposed on Palestinians in the West Bank and Gaza are income tax, value added tax, stamp, vehicle and (in the West Bank only) education and land tax. Israeli and Jewish residents are taxed according to Israeli laws.

4.69 Commencing in the late 1970s, several key changes occurred in CA's income tax administration which led to considerable tension which continues now. First, the time given to a taxpayer to pay upon assessment, appeal or determination of appeal was reduced by half or more. Second, under pre-existing law, income tax other than that deducted at the source was assessed annually and in arrears. In 1978 such assessments were made monthly and based on the income tax assessed the previous year or based on the tax assessor's view of what that tax could or should have been paid irrespective of the current year's actual income.

4.70 With respect to the incidence of taxation, a change of rates and tax brackets from 1978 to 1988 resulted in an increase in the tax burden of tax on individuals, especially at the lower levels of income.<sup>32</sup> A continuing source of irritation is the CA's "best judgment" method of tax assessment. For both the VAT and income tax, a taxpayer is obliged to keep books of account in accordance with the detailed regulations. When this taxpayer fails to keep such books, the CA tax assessor may refuse to accept the taxpayer's tax return and treat the taxpayer as having not filed. In that event, the assessor may determine the tax due on a "best judgment" basis. The CA tax assessors point out that "best judgment" is the method that also applies in Israel and is not arbitrary but controlled by guidelines. However, there are no guidelines developed specifically for the OT. The tax assessors use guidelines provided by the Israeli Income Tax Commissioner based on models developed for the higher income Israeli economy. Once the assessor has made a "best judgment" assessment, the taxpayer has the burden of proof in the Objections Committees that the amount is incorrect. There is no appeal of the Committee's decision.

4.71 Consequences of failure to keep books according to the CA's standards and pay taxes are severe. First, under MO 1263 (1988), the CA Inspectors have the right to impose fines for a range of

---

<sup>32</sup> See Marc Stephens, *Taxation in the Occupied West Bank, 1967-1989*. Ramallah: Al Haq, 1990, p. 83 and "Tax - Another Source of Income for the Territories," Gideon Esket, *Yediot Ahronot*, May 1991 and Meron Benvenisti, *Haaretz*, April 17, 1991, p. 2.



offenses. Further penalties are added for failure to pay fines or for a violation of more than 15 other matters listed in amendments to MO 1263 (1988). In addition to fines and penalties, under MO 1285, the tax assessor may temporarily confiscate a taxpayer's property, including property in the hands of a third party, for non-payment of taxes, fines, penalties, without a requirement for any court order or higher administrative review. Finally, under MO 1262 (1988) (suspended but not abrogated in late 1992) 23 different CA services or licenses are "contingent on the production of evidence which in the opinion of the official, indicates that the applicant has done everything required of him, by all tax laws, and has paid all the tax which he owes at that date."<sup>33</sup>

4.72 The administration of the VAT has been a particular problem for a number of OT firms and even for the international agencies (including USAID) working in the OT. The international agencies report that VAT Refunds are typically not paid to Palestinian businesses or are paid late.<sup>34</sup> Several agencies report that Israeli tax officials use tax measures arbitrarily to harass businesses. Examples include vehicle confiscations, withholding for long periods large refunds due for VAT, and insistence (on threat of imposition of further large fines and penalties) on immediate payment of large tax assessments arrived at by the "best judgment" method.

#### The Reform Measures

4.73 In 1991, in conjunction with several liberalizing measures, the CA acted to simplify the tax regime and provide incentives for investments in Palestinian areas. The 1991 reforms reduced the number of tax brackets from 11 to 5, reduced the upper tax bracket of 55 percent to 48 percent and made minor changes in deduction rates.

4.74 The investment reform measures are contained in MO 1342 (1991) and basically provide a tax holiday to an "approved enterprise" for income from an "approved investment" (in both cases as approved by the CA's new Investment Center). The tax holiday is for three years from the tax year in which the enterprise had chargeable income, as determined by the Director of the Investment Authority appointed by the Head of the CA. The provisions grant the Director broad discretion in maintaining and revoking the "approval" status of an enterprise, an investment and the holiday itself. The MO (Article 29) also grants the Director or his designee, the right to receive, on demand, all documentation and evidence relevant to the implementation of the MO. The MO also permits the Director broad discretion to cancel the holiday and assess, in arrears, all the taxes, fees and duties up to an amount that would have been paid if no holiday had been given, either with interest on the amount in arrears or by an addition of 25 percent whichever is greater. Several OT private firms said the new investment incentive is not attractive because it grants too much discretion, particularly for retroactive assessment, to the Director who answers to the Head of the CA. Given past CA enforcement practices, there is no confidence in the business community that the tax incentive would not later become yet another source of intimidation for non-business reasons.

---

<sup>33</sup> MO 1262(1988).

<sup>34</sup> It has been estimated that Palestinian producers routinely lose an estimated 8-12 percent of the value of their finished products due to failures by Israeli authorities to refund the VAT paid on imported raw materials (Mark Tagor, Organization Canadien pour du Solidante et Developpement, Marketing and Trade, Statement to Press Conference June 9, 1991 by the Co-ordinating Committee of International NGOs.)

## CONCEPTUAL FRAMEWORK

Industry Structure, Conduct and Performance. The dominant paradigm in Industrial Organization Economics posits causal relationships between industry structure, entrepreneurial conduct and firm performance. Adapting this view in a dynamic context, we may state that industry structure (number of firms in an industry, their size distribution, and market concentration) is related to both the conduct of entrepreneurs and the resultant performance of business in terms of profit, growth and market share.

The term "entrepreneurial conduct" includes patterns of capital investment made by firms, the productive efficiency of operations in matching demand conditions with supply side endowments, and the development of intangible skills and competencies. Firm performance, which is a consequence of these activities, in turn modifies future conduct through the development of experience and learning. Conduct, also, through the expansion of investment in line with growth of the firm's market power, alters the shape of an industry.

Accordingly, our analysis focuses on these three facets of private sector industry.

Market Failure and Industry Evolution. The development of oligopolistic features in an industry is sometimes viewed as a market failure, the inability of the "invisible hand" of market forces to allocate resources evenly across players. This view is, however, partial at best. Most industrial development occurs through the formation (and eventual dissolution and re-formation) of oligopolies as the more efficient players expand and erect competitive barriers against new entrants. Industries evolve over time, as different players (including foreign firms) gain or lose in competitiveness.

The evolution of industries is driven by two forces —

1. Macro-level forces such as aggregate demand, supply, income and so forth, as well as institutional pressures produced by governmental incentives and regulation, and
2. Micro-level competitive forces operating at the level of individual firms.

Both types of forces are analyzed in this report.

The Regulatory Environment. The business environment can be characterized along several dimensions — fluctuating or stable demand and supply conditions, evolving technological contexts, shifts in competitive behavior, political system changes, and the regulatory system. Regulation forms the most salient of these dimensions in the Territories.

1. By raising or lowering barriers to firm entry or expansion, it directly affects industry structure.
2. By manipulating the incidence of taxation, it has an impact on the firm's performance.

3. Finally, its results are perceived by business owners and managers to form incentives or disincentives to conduct – across the different opportunities for choice that may become available over time.

Exhibit 1 summarizes the theoretical framework that we have used to study the economic impact if the regulatory and taxation system.

Industry Evolution at the Micro-level. At the level of the individual firms that make up an industry, two determinants of industry evolution exist:

1. firms' learning behavior (i.e., the development of productive capabilities)
2. firms' investment behavior.

Both behaviors are closely inter-related, and need to be studied together. While capability development, in the sense of innovation and improved skills forms the basis for industry development, the actual mechanism for change is found in firms' investment patterns.

Industry evolution parallels the development of firms. As a firm conducts its operations, it undergoes a process of learning. If this process results in enhanced capabilities, it may choose to expand in the industry or to diversify into new industries. A firm also learns through failure, which causes it to eventually divest from an industry.

From the point of view of individual firms, investments are costly to reverse. Thus industries appear static in the short run, as decision-makers within firms tend to evaluate the presence (or absence) of relatively stable profitable opportunities before entering (or exiting) their markets and industries.

Industry evolution proceeds in stages. At a particular level of investment, a firm accumulates learning that will enable them to progress to the next stage of investment (or dis-investment). For a growing firm, the sunk cost of its existing investments acts as an anchor. It allows the firm to explore related opportunities for growth at limited risk while it evaluates and prepares for the next stage. In this sense, the level of investment attained by a firm functions in a manner analogous to an option contract – it enables the firm to hold open future growth choices, while deferring the actual decisions until it evaluates opportunities and builds capabilities needed for success at the next stage. As and when market opportunities are confirmed, and are matched by accumulated capabilities, the firm will progress to the next level of investment, by striking the "shadow options" it had gained at the previous stage. The process of industrial evolution is thus path-dependent, incremental and exploratory, and mirrors changes in competitiveness of firms within and outside the industry.

Our analysis at the micro-level, accordingly focuses on the competitiveness of Palestinian firms.

Competitiveness. The development, at the firm-level, of some relatively enduring competitive advantages over rivals forms the first step in industry evolution. Firms do not exist as "black boxes" that mechanically adjust investment, output or price response to demand and supply. Adjustment occurs by means of a continuous and variable process of cognition. It involves managerial perceptions

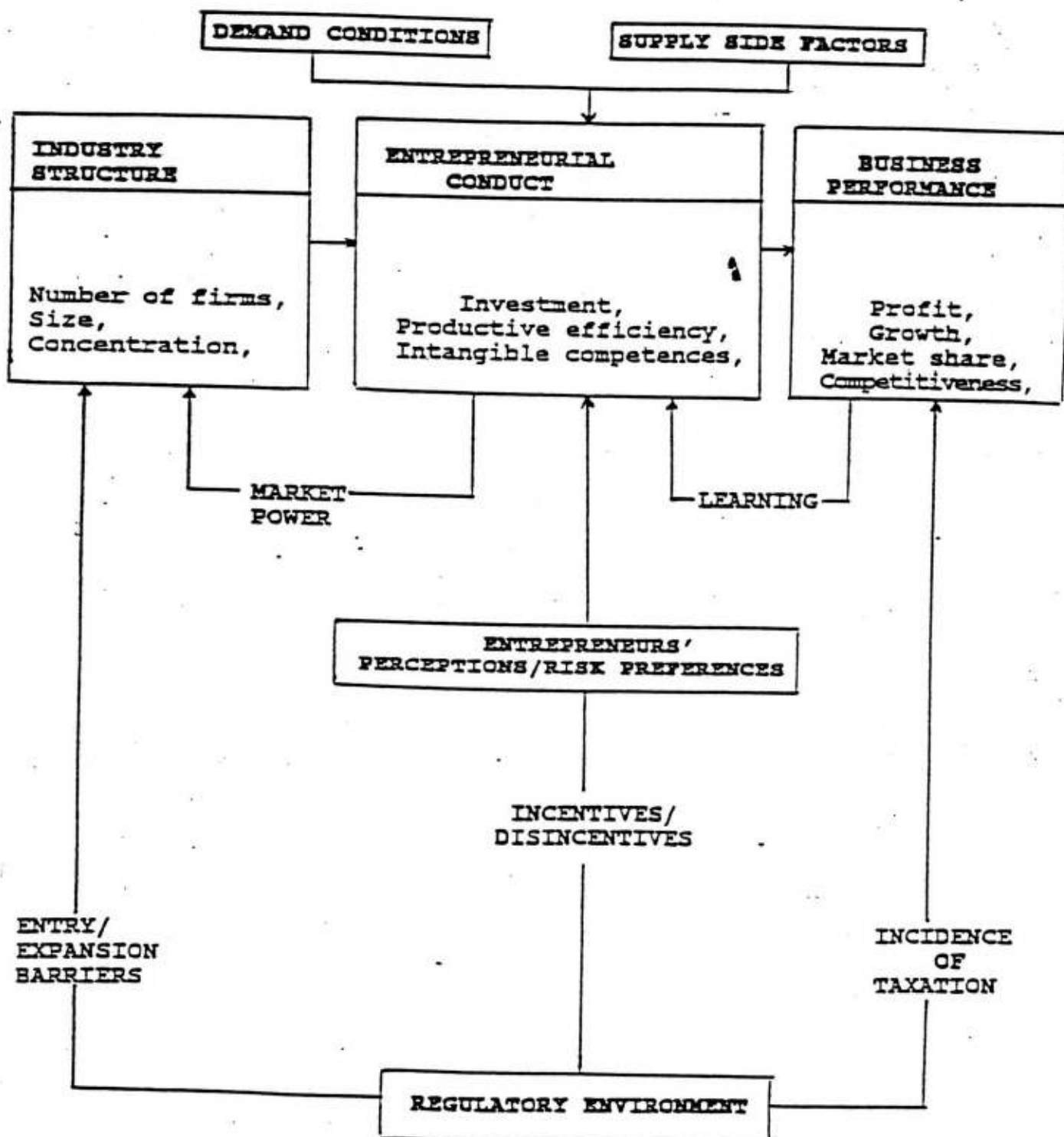


of internal capabilities and opportunities and constraints, rational expectations about outcomes contingent upon those perceptions, and often simply irrational and opportunistic actions. A firm's history has a major role in determining its central capabilities or core competencies Prahalad and Hamel, 1990). Firms do adjust eventually to market signals, but each firm adjusts uniquely. It is no more than the simple truth that organizations define their own realities, quite differently from one another even in identical circumstances, depending on the perceptual lenses of their owners and managers.

"Competitiveness" is a multidimensional construct. In our analysis, we have concentrated on three key aspects – static efficiency has been examined by Domestic Resource Cost Analysis, dynamic efficiency has been analyzed through the study of investment patterns and growth trends, and comparative advantage is assessed through an examination of the core competencies developed by Palestinian firms.

EXHIBIT 1

FRAMEWORK FOR ANALYSIS



## METHODOLOGY OF MISSION SURVEY

Data Sources: This report is based on a "triangulated" analysis of multiple sources of data:

1. Primary Data - a field survey of 100 businesses representing a broad spectrum of industries and locations reflecting the Palestinian private sector in the area,
2. Fact-finding discussions with Chambers of Commerce in most cities in the West Bank and Gaza,
3. Discussions with officials of the Israeli Civil Administration,
4. Structured interviews with several groups of entrepreneurs and legal and accounting professionals,
5. In-depth cost-studies of 18 selected firms, and
6. Secondary sources in the form of published statistics and prior economic studies relating to the region. However, few direct references are made, since the objective of this report is to bring new data to light, not merely repeat existing knowledge.

Coverage: Our survey covered the following industries: agro-industries - olive oil extraction and soap manufacture; food processing - meat, canned vegetables, snacks, dairy products, confectionery, soft drinks; leather goods - tanning, sports and dress shoes, leather luggage; manufacturing - process industry - pharmaceuticals, chemicals, cosmetics, detergents, cooking gas; engineering and machining industry - metal fabrication, wood and steel furniture; molding industry - plastic housewares, glassware, ceramic pottery; textiles - knitting, weaving, hosiery and apparel, fashion garments; trade -importing, wholesale distribution, retail sales; service industry - construction - stone and marble quarries, house building and road construction; service industry - automobile repair/gas stations; service industry - tourism - travel agents, hotels, restaurants, and tour/bus operators.

Locations<sup>1</sup>: The following locations were surveyed: East Jerusalem, Ramallah, Bethlehem, Beit-Jala, Beit-Sahour, Nablus, Jericho, Al-Bireh, Tulkarem, Hebron and Gaza.

Age, Size and Organizational Form: The sample ranged from firms employing fewer than 8 employees to those with over 100 employees. In age, they ranged from firms less than 2 years old to firms well over 40 years (one was actually over a century old). While the majority of enterprises were sole proprietorships, partnerships and public firms with over 100 shareholders were also well-represented. A summary of our survey sample is shown in Exhibit 2.

---

<sup>1</sup> Firms in East Jerusalem were included because most tourism related enterprises run by the Palestinians are located there. The inclusion of these enterprises in this survey is not meant to make any judgement on the status of East Jerusalem.



Exhibit 2  
COMPOSITION OF QUESTIONNAIRE SURVEY SAMPLE

INDUSTRY	(%)	LOCATION	(%)
<u>Manufacturing/Services</u>			
Agro	4	EAST JERSUSALEM	16
Food	13	<u>WEST BANK</u>	
Leather	5	Ramallah	11
Manufacturing (Process)	10	Bethlehem	10
Manufacturing (Machining)	6	Nablus	15
Manufacturing (Molding)	8	Tulkarem	11
Textile	15	Hebron	18
Trade	7	GAZA	<u>19</u>
Construction	7	TOTAL	<u>100</u>
Sub-Total	<u>75</u>		
<u>Tourism</u>			
Hotels	6		
Restaurants	15		
Travel/Tours	4		
Sub-Total	<u>25</u>		
TOTAL	<u>100</u>		
<u>ORGANIZATION FORM</u>			
Proprietary	66		
Partnership	25		
(Subcontractors 20)			
Public	9		
TOTAL	<u>100</u>		
<u>SIZE (number of employees)</u>		<u>AGE (years)</u>	
Less than 8	15	Less than 5	11
9 to 20	29	6 to 10	14
21 to 50	40	11 to 20	36
51 to 99	12	21 to 40	35
100 and over	4	41 and over	4
TOTAL	<u>100</u>	TOTAL	<u>100</u>

Statistical Methodology: We took a stratified sample across the major industries and locations. The survey instrument used open-ended multiple choice questions with adequate replication of the information sought to provide confirmation of the data collected. Responses took the form of Likert scales, ranked attributes, and estimation of Index Numbers. While participants were not willing to divulge financial figures at this stage of our data-collection (in-depth cost studies were possible at a later stage for selected firms), our questionnaire sought to:

- a) identify broad trends in asset growth, sales, profits, training of personnel (in Index numbers),
- b) understand the capital and cost structure (in percentage terms) of the surveyed businesses,
- c) identify the major operating and regulatory restrictions faced by businesses in the region (through Likert scales and ranked attribute types of responses),
- d) obtain estimates of capacity utilization and the cost impact of various restrictions (in percentage terms), and
- e) gain some idea of the types of products manufactured, sold and exported.

Given the basically qualitative nature of the data, hypothesis testing was appropriately accomplished through a non-parametric cross-classification analysis. Analysis involved Hildebrand's Del Statistic (Hildebrand et al, 1974, 1977). The Del statistic is distributed normally and is analogous to the R-squared measure in traditional regression analysis (i.e., showing the proportion of variation between groups that is explained by the hypothesized structural differences among them - see Exhibit 4).

**EXHIBIT 3**  
**WORLD BANK MISSION**  
**SURVEY QUESTIONNAIRE**  
**PRIVATE SECTOR & TOURISM**

All information will be kept strictly confidential by the World Bank Group. While we will, of course, be sharing our broad findings at the aggregate level, we will not divulge any names or other identifying information at the individual level to any person of agency outside the World Bank Group under the circumstances. Thank you for your cooperation.

**A. PERSONAL**

1. Your Name
2. Contact Address and Phone Number

**B. BUSINESS DESCRIPTION**

3. Type of Business
4. Location
5. Number of employees and workers
6. Year in which business was established

**C. CAPITAL**

7. Please give the percentage figures for your sources of capital at the commencement of the business

- |  |       |
|--|-------|
| a. Family savings  | _____ |
| b. Family Remittance from abroad                         | _____ |
| c. Finance from Government of Israel                     | _____ |
| d. Finance from Government of Jordan                     | _____ |
| e. Finance from Government of Egypt                      | _____ |
| f. Finance from other Arab Governments                   | _____ |
| g. Loans from Private Israeli Bank                       | _____ |
| h. Loans from Private Arab Bank                          | _____ |
| i. Loans from non-governmental Palestinian Organizations | _____ |
| j. Other (specify)                                       | _____ |



8. Please give the percentage figures for your sources of capital for expansions of your business during the following years.

1965 70 75 80 85 88 89 90 91 92

- |  |       |
|--|-------|
| a. Family savings  | _____ |
| b. Family Remittance from abroad                         | _____ |
| c. Finance from Government of Israel                     | _____ |
| d. Finance from Government of Jordan                     | _____ |
| e. Finance from Government of Egypt                      | _____ |
| f. Finance from other Arab Governments                   | _____ |
| g. Loans from Private Israeli Bank                       | _____ |
| h. Loans from Private Arab Bank                          | _____ |
| i. Loans from non-governmental Palestinian Organizations | _____ |
| j. Other (specify)                                       | _____ |

9. Give the percentage increases/decreases in new capital and finance during the following years (compared to the year mentioned before. For 1965, compared to year of commencement).

1965 70 75 80 85 88 89 90 91 92

#### D. BUSINESS PERFORMANCE

10. Give the percentage increases/(decreases) in sales revenue during the following years (compared to the year mentioned before. For 1965 compared to year of commencement).

1965 70 75 80 85 88 89 90 91 92

11. Give the percentage increases/decreases in profit/(loss) during the following years (compared to the year mentioned before. For 1965, compared to year of commencement).

1965 70 75 80 85 88 89 90 91 92

#### E. MARKET

12. Please give an idea of the percentage increase/(decrease) in the market demand during the following years (compared to the year mentioned before. For 1965, compared to year of commencement).

1965 70 75 80 85 88 89 90 91 92

- 13a. Please give your projections of market demand over the next five year period (assume normalization of business conditions).

Appendix B

- 13b. Do you think that you could develop an export market for your product/services, or offer services to foreign nationals in the future (assuming non business related restrictions are removed?)
- a. Definitely yes
  - b. Highly probable
  - c. May be
  - d. Not likely
14. Give your opinion about the level of competition among Palestinian businesses in your market:
- a. Too many competitors
  - b. High competition
  - c. Fair amount of competition
  - d. Not much competition
  - e. Almost no competition
15. Give your opinion about the level of related and supporting industries and services essential for your business (e.g.) suppliers, maintenance...etc.):
- a. No problem
  - b. Adequate supporting industries
  - c. Poor supporting industries
16. Give the percentage breakdown of your sources of raw materials:
- a. West Bank and Gaza \_\_\_\_\_%
  - b. East Jerusalem \_\_\_\_\_%
  - c. Israel \_\_\_\_\_%
  - d. Jordan \_\_\_\_\_%
  - e. Egypt \_\_\_\_\_%

- f. Other (please specify) \_\_\_\_\_%

**F. EMPLOYMENT**

17. Give the percentage of trained staff you have had during the following years:

1965 70 75 80 85 88 89 90 91 92

18. How would you describe the level of trained workers or employees in your organization:

- a. Excellent
- b. Good
- c. Adequate
- d. Less than adequate
- e. Poor

19. Give the percentage of time over the last three years that your employees/workers were absent from work, or you have to close your operation for non business reasons.

90 91 92

**G. OPERATIONAL RESTRICTIONS**

20. Give the main reasons why you have not raised capacity of your operation over the past five years:

- a. We have raised capacity
- b. Lack of demand for business
- c. Lack of permit/licence to operate
- d. Lack of funds
- e. Feeling that the business is too risky
- f. Other (please specify)



21. Give the main reasons why you may have turned away business over the past five years:
- a. We have not turned away business
  - b. Business was fully booked/operating at full capacity
  - c. Lack of permit/license to operate
  - d. Lack of funds
  - e. Feeling that the business was too risky
  - f. Other (please specify)
22. Give the main reasons why you may have not given your employees/workers enough training in the latest techniques, or have not hired highly trained staff.
- a. We have given enough training/hired trained people
  - b. Inability to afford highly trained people
  - c. Trained candidates usually prefer to go abroad for employment
  - d. Limited access/poor access to training programs and modern technology.
23. Which of the following restrictions, if any, apply to your ability to operate successfully:
- a. No problem
  - b. Availability of land and water
  - c. Permits/licences to start business
  - d. Lack of capital
  - e. High level of compition from Palestinian local business
  - f. High level of competition from Israeli business
  - g. Competition from other countries
  - h. Restrictions on transportation of inputs and raw materials
  - i. Restrictions on transportation of finished products

- j. Restricted access to markets
- k. Restrictions on exporting
- l. Payment of advance taxes
- m. Restrictions on expansion of business
- n. Other (please specify)

24. Give us an idea about the major restrictions you face in importing your requirements, if any:

- a. No problem
- b. Restrictions on transportation by land bridges
- c. Restrictions on transportation by air
- d. Restrictions on transportation by sea
- e. High import taxes/duties/customs/inspection costs
- f. Restrictions on obtaining permits/licenses
- g. Other (please specify)

26. Give us an idea about the major restrictions you face in exporting your products, if any:

- a. No problem
- b. Restrictions on transportation by land bridges
- c. Restrictions on transportation by air
- d. Restrictions on transportation by sea
- e. High import taxes/duties/customs/inspection costs
- f. Restrictions on obtaining permits/licenses
- g. Other (please specify)

27. How would you rank the major restrictions on your ability to operate successfully; (1=low, 10=high).
- a. Obtaining permits/licences to start up a business \_\_\_\_\_
  - b. Shortage of raw materials \_\_\_\_\_
  - c. Lack of capital \_\_\_\_\_
  - d. Political risk \_\_\_\_\_
  - e. Obtaining permits for land and water \_\_\_\_\_
  - f. Import/Export permits \_\_\_\_\_
  - g. Higher level of subsidies/incentives to Israeli competitors \_\_\_\_\_
  - h. Advance tax payments \_\_\_\_\_
  - i. High guarantee or bond required for permits \_\_\_\_\_
  - j. Procedural and administrative delays from government \_\_\_\_\_
  - k. Other (please specify) \_\_\_\_\_
28. Please give us an idea of your average cost structure

Sales

Imported raw materials

Local raw materials

Skilled employees/workers

Unskilled employees/workers

Administrative expenses

Transportation expenses

Finance expenses

Cost of indirect taxes

Direct taxes



29. Please give us an idea of your average assets/liabilities

Total assets

Own capital

Borrowings

Fixed assets and land

Current assets

Current liabilities

30. What is your estimate of cost impact of the following items?

Delays/Problems Due to

% of sales

- No banking/credit system

- Important procedures

- Export procedures

- Transportation (internal)

- Income tax procedures

- Licensing procedures

- Land purchase

- Less training available for employees

- No market/technology information

- Other (please specify)

31. The above costs are broken down as which of the following (Low=1, High=10)

Higher administrative

Higher salaries/wages

Higher raw material costs

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

State which item

( )

( )

( )

## Appendix B

Higher finance costs	_____	(	)
Lower capacity utilization	_____	(	)
Lost export sales (external)	_____	(	)
Lost domestic sales	_____	(	)
Pressure not to sell in Israel	_____	(	)
Pressure to do subcontracting to Israeli firms	_____	(	)
Other (specify)	_____	(	)

32. Give the main reasons for your ability to succeed/survive in the market.

1. Own capital
2. Trained employees
3. Ability to adjust to administrative procedures
4. Market knowledge
5. Technology
6. Low competition
7. High competition
8. Protected/small OT market
9. Protected Israeli market
10. Other (specify)

## H. ADDITIONAL QUESTIONS FOR MANUFACTURERS

32a. Describe the form of your organization:

1. Partnership
2. Proprietary company

3. Public company
4. Joint venture with an Israeli firm
- 32b. What percentage of your production is subcontracted to Israeli firms?
- 32c. Give your reasons for subcontracting to Israeli firms.
33. Your product serves as:
  - a. Raw material for the Israeli firm (Yes/No)
  - b. Semi-finished product
  - c. Component
  - d. Finished product
34. Do you export your product?
35. If yes, to which countries?
36. Does an Israeli firm export your product as their own?
37. If yes, to which countries?
38. Give us names of your different product lines.
  - a. \_\_\_\_\_  
Subcontracted? (Y/N) \_\_\_\_\_  
Directly exported? (Y/N) \_\_\_\_\_  
Is it exported as an Israeli product? (Y/N) \_\_\_\_\_  
Is it raw material for an Israeli firm? (Y/N) \_\_\_\_\_  
Is it a semi-finished product for an Israeli firm? (Y/N) \_\_\_\_\_  
Is it a finished product ? (Y/N) \_\_\_\_\_  
Average percentage profit margin = \_\_\_\_\_



b. \_\_\_\_\_

Subcontracted? (Y/N) \_\_\_\_\_

Directly exported? (Y/N) \_\_\_\_\_

Is it exported as an Israeli product? (Y/N) \_\_\_\_\_

Is it raw material for an Israeli firm? (Y/N) \_\_\_\_\_

Is it a semi-finished product for an Israeli firm? (Y/N) \_\_\_\_\_

Is it a finished product ? (Y/N) \_\_\_\_\_

Average percentage profit margin = \_\_\_\_\_

c. \_\_\_\_\_

Subcontracted? (Y/N) \_\_\_\_\_

Directly exported? (Y/N) \_\_\_\_\_

Is it exported as an Israeli product? (Y/N) \_\_\_\_\_

Is it raw material for an Israeli firm? (Y/N) \_\_\_\_\_

Is it a semi-finished product for an Israeli firm? (Y/N) \_\_\_\_\_

Is it a finished product ? (Y/N) \_\_\_\_\_

Average percentage profit margin = \_\_\_\_\_

d. \_\_\_\_\_

Subcontracted? (Y/N) \_\_\_\_\_

Directly exported? (Y/N) \_\_\_\_\_

Is it exported as an Israeli product? (Y/N) \_\_\_\_\_

Is it raw material for an Israeli firm? (Y/N) \_\_\_\_\_

Is it a semi-finished product for an Israeli firm? (Y/N) \_\_\_\_\_

Is it a finished product ? (Y/N) \_\_\_\_\_

Average percentage profit margin = \_\_\_\_\_

49. What percentage of the following inputs do you get from Israel?

- A. Raw materials
- B. Components
- C. Semi-finished
- D. Spare parts
- E. Labor (employees and workers)
- F. Quality inspection
- G. Marketing
- H. Advertising
- I. After sale service
- J. Transportation and distribution
- K. Clearing and forwarding

**H. CAPACITY**

40. What percentage of your capacity have you used during the past five years?

41. What percentage of sales revenue have you spent on training staff and employees in the past five years?

#### EXHIBIT 4 COMPUTATION OF DEL STATISTIC

The general procedure for computation of the Del statistic is as follows (Hildebrand, Laing and Rosenthal, 1974, 1977):

Observations are arranged in a matrix designed to show the a priori categories for analysis. Under each hypothesis a prediction rule is established. This prediction rule will classify the observations in some cells as "errors." These are given a weight = 1. The other cells are given a weight = 0. The cell probabilities and marginal probabilities are computed by dividing cell values and row and column totals by the number of observations in the matrix.

$$\text{Del}(V) = 1 - \frac{K}{U}$$

$$\text{where } K = \sum_i \sum_j (w_{ij} P_{ij})$$

$$\text{and } U = \sum_i \sum_j (w_{ij} P_i P_j)$$

where  $w_{ij}$  are cell weights,  $P_{ij}$  are cell probabilities, and  $P_i$  and  $P_j$  are row and column marginal probabilities.

The hypothesis  $V > 0$  is tested against normal tables using the following statistic:

$$Z = \frac{V}{\sqrt{v}}$$

$$\text{where } v = \text{variance of Del} = \frac{\sum_i \sum_j (w_{ij} P_{ij}) - (\sum_i \sum_j w_{ij} P_{ij})^2}{n[\sum_i \sum_j (w_{ij} P_i \cdot P_j)]^2}$$

For each test, the adequacy of the sample size was checked using the following rule of thumb:

$$\frac{5}{n} \leq U(1 - V) \leq 1 - \frac{5}{n}$$



## DRC AND ERP ANALYSIS

1. In addition to the survey questionnaire, we performed detailed cost analyses of 18 selected firms across a wide spectrum of industries (reported in the section on Static Efficiency in this report). First, we estimated the quantity of output assuming 100% utilization of existing capacity at the 1-shift level of operations. Next we computed the value added by the firms under these relatively ideal conditions (to be expected of a post-settlement context). Value-added in this case includes the cost of purchased inputs and other manufacturing costs, as well as the cost of plant and equipment (i.e., replacement cost multiplied by the average cost of capital rate). The value-added component was evaluated at domestic prices and international prices.

$$\text{DRC} = \frac{\text{value added at Domestic Prices}}{\text{value added at International Prices}}$$

This ratio takes a value greater than one (unity) when the industry being sampled is relatively inefficient at free-market world prices. A DRC value below unity implies that the industry being sampled is efficient (and therefore competitive) at world prices.

2. Effective protection refers to the overall impact of economic policies on an industry. The effective date of protection (ERP) for a sampled industry is computed as follows:

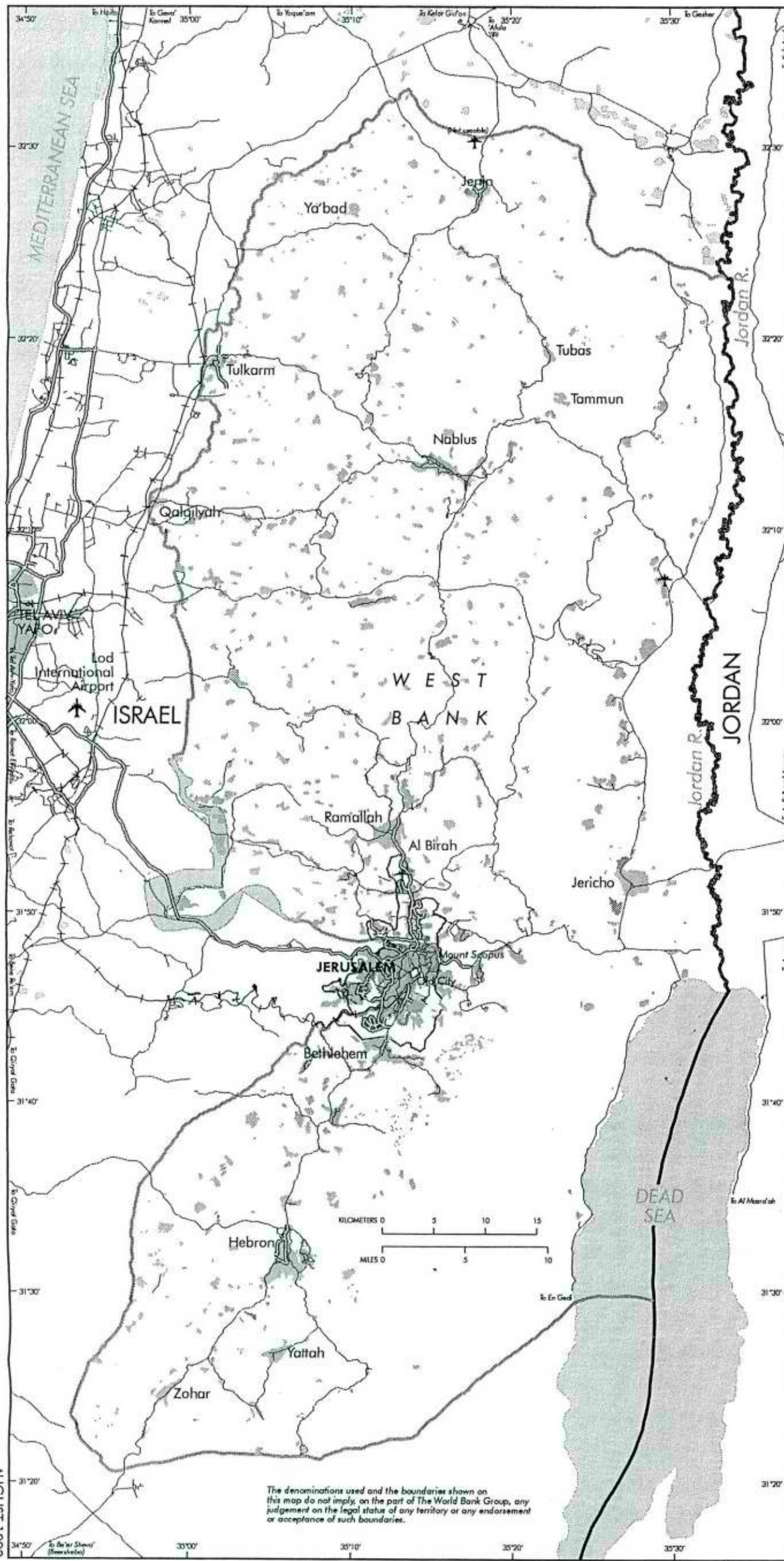
$$\text{ERP} = \left[ \frac{\text{Value added at Domestic Prices}}{\text{Value added at International Prices}} - 1 \right] \times 100$$

A positive ERP indicates the degree of protect on available under the current trade regime, while a negative ERP indicates the absence of protection

## REFERENCES

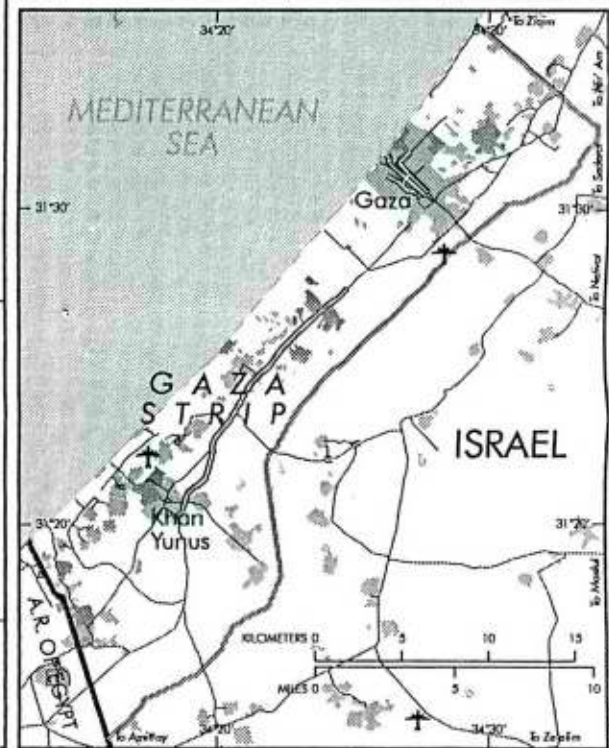
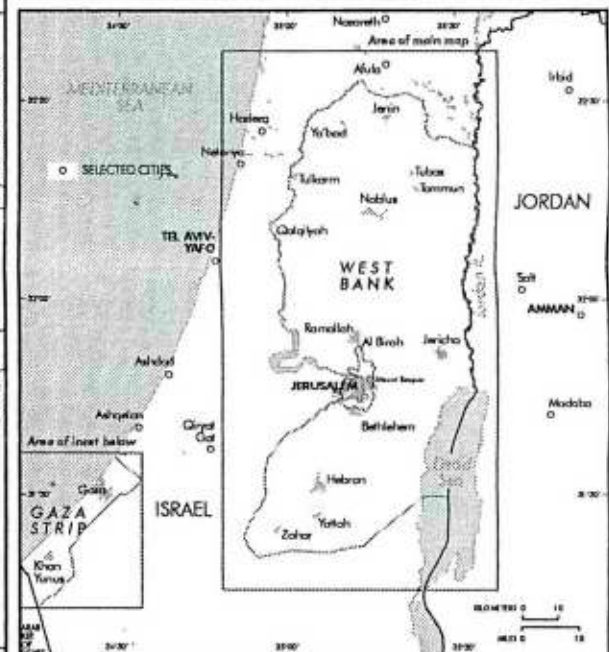
- Abed, George T., ed. The Palestinian Economy: Studies in Development under Prolonged Occupation. Routledge, New York, 1988.
- Abu-Shokor, A.F., S.A. Saleh, and A. Alawneh. Industrialization in the West Bank. An-Najah National University, Nablus, 1992.
- Bank of Israel, Research Department, various issues from the 1980s.
- Hildebrand, D., J. Laing, and H. Rosenthal, "Prediction Logic: A Method for Empirical Evaluation of Formal Theory," Journal of Mathematical Sociology, 3, 1974: 163-185.
- Hildebrand, D., J. Laing, and H. Rosenthal, Prediction Analysis of Cross-Classification. John Wiley, New York, 1977.
- Kesselman & Kesselman (CPAs), Guide to Investment in Israel (1992/93 edition). Kesselman & Kesselman, Tel Aviv, 1992.
- Okasha, Mahmoud and Sami Abou Dharifa, Field Survey of Gaza Industry. Arab Thought Forum, 1992.
- Policy Research Incorporated, Development Opportunities in the Occupied Territories: Finance and Credit by , Clarksville, Maryland, October 1992.
- UNCTAD, The Palestinian Financial Sector Under Israeli Occupation, UNCTAD/ST/SEU/3/Rev.1, United Nations, New York, 1989, p. 35 (referred to as the UNCTAD Study).
- Zakai, Dan, Economic Development in Judea-Samaria and the Gaza District (1981-1982, 1983-1984 and 1985-1986)





# OCCUPIED TERRITORIES WEST BANK AND GAZA STRIP TRANSPORTATION NETWORK

- AIRPORTS / AIRFIELDS
- MAJOR HIGHWAYS
- TWO OR MORE LANES,  
HARD SURFACED ROADS
- RAILROADS
- BUILT-UP AREAS
- UNRWA REFUGEE CAMPS
- ISRAELI SETTLEMENTS
- ARMISTICE DEMARCATION LINES, 1949
- NO-MAN'S LAND AREAS,  
ARMISTICE DEMARCATION LINE, 1949
- JERUSALEM CITY LIMIT, UNILATERALLY  
EXPANDED BY ISRAEL JUNE 1967;  
THEN ANNEXED JULY 30 1980
- INTERNATIONAL BOUNDARIES



The denominations used and the boundaries shown on this map do not imply, on the part of The World Bank Group, any judgement on the legal status of any territory or any endorsement or acceptance of such boundaries.