Beyond Conflict: The Economic Impact of Peace on Palestinians and Israelis

The Portland Trust

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The Portland Trust was founded in London in 2003 by Sir Ronald Cohen and Sir Harry Solomon. Sir Martin Gilbert is its third Trustee and its Chief Executive is Jonathan Kestenbaum.

The Portland Trust is committed to driving initiatives that promote economic development, moderation and the resolution of conflict in the Middle East.

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Foreword

These are times of uncertainty for the Middle East in general and for the Israel-Palestine conflict in particular. The Intifada of the past four years has harmed the interests of the majority on both sides of the conflict and great effort must now be invested to restore stability.

As part of this effort, the Portland Trust has responded to a suggestion from the British Government to assess the role which the Palestinian private sector can play in generating growth, sustainable employment and higher living standards. The suggestion arose out of a growing belief that the economic dimension of the conflict deserves as much attention as the political one, since economics play an important role in driving or reducing instability.

This report by the Portland Trust is a considered assessment, by means of analysis and interviews, of the ways in which private enterprise can make a significant contribution to Palestinian economic development. It quantifies a substantial peace dividend and concludes that the Palestinian private sector is capable of playing a major role in creating employment, and achieving a very significant improvement in Palestinian living standards. To do so, it would require relatively small amounts of capital. Interestingly, it shows both the Palestinian and Israeli business communities to be pragmatic and moderate with regard to efforts to move beyond conflict.

The Portland Trust is already building on several conclusions of the report. We are identifying the distribution mechanisms which would allow capital to reach the Palestinian private sector; we are investigating the economic aspects of disengagement from Gaza; and we are defining the potential for integrating the Palestinian economy into the region.

We believe that recent events in the region have created an opportunity to harness the economic drivers of peace to support political efforts to arrive at a solution to the conflict.

Sir Ronald Cohen
Chairman

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Executive Summary

This report examines the economic underpinnings of peace between Israel and the Palestinians.

In particular, it focuses on the pivotal role the Palestinian private sector can play in generating growth, sustainable employment levels and better living standards. These are all necessary components of a lasting and stable peace. It estimates the quantifiable impact of peace on different aspects of the economy and for the Palestinian people at large.

The study is based in part on a new survey of some 70 businesses in the West Bank and Gaza, covering both past performance and future prospects. We also conducted interviews with official providers of finance, international investors and bankers and Palestinian and Israeli policy makers and politicians. During this process we discovered that, against all the odds, the vigour of a Palestinian enterprise culture remains substantially intact.

The report takes into account recent recommendations relating to the Palestinian economy and its future, produced by international expert bodies such as the Aix Group, World Bank, IMF and the Rand Corporation. These previous studies paid attention primarily to macroeconomic issues such as free movement of labour/goods, effective regulatory frameworks and financial transparency, as well as broad economic opportunity for the West Bank and Gaza.

This report also integrates experience of private and public capital flows in other post-conflict environments.

Its political starting point is a two-state solution. In this context, an emerging Palestinian state will need to diversify progressively from its overwhelming dependence on Israeli goods and labour markets. This implies a higher degree of economic separation than was envisaged at the time of the Oslo Agreements in 1992. In particular, the report envisages a free trade area replacing the customs union with Israel, and significantly lower numbers of migrant workers to Israel than at its peak in the late 1990s.

Reliable market access and good logistics are crucial to Palestinian economic survival. This has major implications for infrastructure requirements, which would be mainly funded by offical aid. It also entails greater Palestinian access to the outside world and this, by definition, will have to address Israel's security concerns. We assume that this crucial question, which underpins business responses to peace, can be resolved as an integral part of final status negotiations.

Our analysis, based in part on World Bank estimates, revealed that international aid to Palestine in the immediate wake of a peace agreement and for 3-5 years thereafter will be up to $2 billion per year (nearly $500 per capita), twice current levels. Of this, about half may initially be available for reconstruction, and the rest allocated for humanitarian relief and budget support to the administration.

This intensive relief and reconstruction window may be short-lived, as international concern will inevitably shift elsewhere. But it is possible that the strategic importance of the Middle East and the espousal of the Palestinian economic case in the West may have already placed it in a special category. There must be concern that recovery and expansion may be constrained by bottlenecks in land, labour and materials as much as lack of finance. There is a real risk that a large aid-fuelled construction sector will generate inflationary pressures throughout the economy, just at the time that Palestinians need to establish international competitiveness.

Therefore, at best, aid can be used to accelerate the additional institutional and infrastructure underpinnings needed for private sector-led growth, and to provide a much-needed transitional wage boost, but not to create sustainable jobs. Conversely, international experience shows that foreign private investment flows can lag several years behind a political settlement, but then begin to surge as confidence is visibly restored.

Public sector employment, a source of social protection over the crisis years, has reached saturation point by international and even regional standards, and will need to grow more slowly than the economy as a whole. The real anchor for durable job creation and incomes in the new Palestine must therefore be the domestic private sector. This is overwhelmingly composed of small and family-operated businesses with five or fewer workers. Intermediate and large-sized firms account for less than half of private employment.

Palestinian entrepreneurs have proved remarkably resilient throughout the crisis years. There is optimism among them that their firms will rebound strongly when the conflict is resolved.

But there is much work to be done for the regional economy as a result of the conflict. Overall, the businesses in our sample cut back employment by a drastic 80 per cent between 1999 and 2004, much faster than the national industry average. However, small and family-owned firms scaled back much less than the average and larger firms. Family businesses have proved more able to absorb the pain of recession without shedding labour, and Palestinian firms have demonstrated these survival skills more than most.

Looking ahead to prospects after peace, it is these small firms that expect the most significant rebound. They plan to increase output faster than larger enterprises, and to expand employment much faster. They are more flexible, but also arguably more optimistic, not having downsized as sharply as larger firms in the first place.

The scale of the peace dividend seen through their eyes is significant. Replicated on a national scale, their output response would generate increased value-added of some $800 million within five years. This represents about a quarter of today's GDP, i.e. additional income of over $400 a year for every Palestinian adult. It implies additional private sector investment of some $100 million a year.

Even more striking are the employment effects of peace under this framework. Nearly 1.2 million new jobs could potentially be added within five years of peace, almost twice the current total number employed. An increase on this scale would absorb all those registered as unemployed today, many of the disguised unemployed, and most of the rapid growth in that labour force expected over the intervening years.

Where would all these people be working in the future? The new Palestinian state will have neither abundant land nor natural resources on which to base its competitiveness. But it does have a major advantage in terms of significant historic and religious sites, and a well-educated and polyglot population sited at a major communication crossroads.

The report finds that output will initially increase fastest in tourism, then in industry, and thereafter in other services. The report reviews several specific sectors of the economy for the opportunities they may offer. These include construction (initially aid-funded), tourism (especially religious tourism), gas, stone and marble, agro-processing and some niche manufacturing activities.

Finally the report documents, perhaps for the first time, Palestinian business leaders and other expert witnesses as they voice their frustrations and their hopes for recovery.

They suggest necessary changes in the attitude of the negotiating parties and the international community. Their overriding message to diplomats, politicians and aid officials is to work with the private sector, not apart from it or at cross-purposes with it, and to base their interventions on what is needed to create jobs sustainable in the long-term, not in some artificial construct.

High on the list of their concerns is improved physical infrastructure and mobility, but they also want better enforceability of contracts, especially in the area of property rights, and a business-friendly, accountable bureaucracy. They would like to see a strong banking sector willing to take more exposure to domestic businesses. And they do not want charity. Like people everywhere, they want a chance to show what they can do for themselves. A basic framework of infrastructure and institutions need to be set in place with international aid. Beyond that, they see a risk of perpetuating aid dependency.

"Looking ahead, I believe that donor money is perfect for infrastructure but the economy as a whole would be better served if a major part of inflowing funds were to go to the private sector."
Mohammed Masrouji

A number of efforts are underway to harness the enterprise culture of the Palestinians in secure surroundings such as industrial parks. These appear attractive but are not the main answer. That will come from Palestinian entrepreneurship, which has proved remarkably resilient. It is this entrepreneurship that will become the engine of growth, underpinning the peace process and driving economic development.

"To my mind, peace is a man with two legs. One is called security the other is economic development. The man is crippled if he loses either leg."
Samir Hasboun

Introduction

This report identifies opportunities and challenges in the economic environment. In particular, it estimates quantitatively the impact of peace on different sectors of the economy and for the people at large.

It is based in part on a new survey of over 70 businesses in the West Bank and Gaza, covering both past performance and future prospects. It includes interviews with official providers of finance, international investors and bankers on their future involvement, and with Palestinian and Israeli politicians on the economic potential and its challenges.

Section 1 sets out the leading political and economic scenarios underpinning peace and reconstruction, and looks at how these may diverge from the arrangements foreseen more than a decade ago at the time of the Oslo Agreements.

Section 2 examines the role of international aid, and to a lesser extent international private capital, in the reconstruction process. It reviews tentative estimates of the likely scale of this assistance, derived from opinion inside the aid community and from comparative experience in other post-conflict environments. It considers the transitional impact of aid on the economy, especially via the construction sector and via support of public sector employment.

Section 3 looks at what the survey findings tell us about how the Palestinian private sector has adapted to conditions since 1999 and how it is responding in terms of planned output, employment and investment. We use this data to estimate the value of a "peace dividend"[1].

Section 4 considers the most promising sectors of the Palestinian economy today from the

1 Other studies apply different analytical models. See World Bank 2002 on trade regimes and labour mobility, IMF 2001 on economic projections using a growth accounting framework

perspective of their attractiveness for investment and growth. It also looks at industrial park schemes as an illustration of public-private, cross-border partnerships that could contribute to growth.

Section 5, finally, listens to Palestinian business leaders and other knowledgeable observers and participants, Palestinian and Israeli, as they voice their frustrations as well as their ambitions for recovery. It summarizes their recommendations for the most useful policy stance by the international community and the negotiating parties, so that the peace process is grounded in creating sustainable jobs.

The appendices contain a brief political chronology, graphs and tables that highlight key regional economic indicators as well as an explanation of the research methodology used.

Section one

Political and Economic Scenarios

A two-state solution to the conflict might comprise different economic frameworks

A higher degree of economic separation than envisaged at Oslo should be assumed

The political environment in the Middle East is more complex and volatile than at any time in recent history.

The "peace process" – a cornerstone of United States policy in the region for three decades – continues to dominate international concerns[1].

The past four years of conflict and instability in the Middle East have given rise to social dislocation on a huge scale in the West Bank and Gaza as well as constant threats to Israel's civilian population. Unemployment in the Palestinian territories has ballooned, incomes have tumbled, and civil infrastructure has been strained to the brink of collapse.

Across the Palestinian territories, gross national income fell by 6.8 per cent in 2000 and by more than 16 per cent in both 2001 and 2002[2]. More than half the population is estimated to be living below the poverty line on less than $2.1 a day[3]. Unemployment, the main driver of poverty, rose to 26.3 per cent by the end of the first quarter of 2004[4].

Nonetheless, there has emerged a consensus that the stalemate between Israel and the Palestinians should not continue. The United States and Israel have accepted the case for Palestinian statehood. In June 2002 President Bush issued a statement encouraging leadership change for the Palestinians which in turn could, under certain conditions, bring a Palestinian state into being.

This initiative generated intense diplomatic activity producing the endorsement by President Bush in March 2003 of the Road Map for Peace.

After much negotiation, and reservations on both sides, the Road Map process was accepted. No sooner had it been endorsed however, it began to falter.

With the American administration more deeply embroiled in Iraq, the Israeli Palestinian dispute took second place. In parallel, Israeli politics were changing. In December 2003 Israeli Prime Minister Ariel Sharon made a groundbreaking public speech at the influential Herzliya Conference.

Sharon, for decades viewed as a supporter of a Greater Israel, engaged in a major policy change. He proposed a unilateral Israeli withdrawal from Gaza and parts of the West Bank. The dynamics of the conflict were being dramatically changed.

Most policy-makers understand that a two-state solution could come in several guises, including total separation, involving as little co-operation as possible; a limited degree of co-operation between the two sides; and full co-operation. We presuppose a higher degree of separation between Israel and a future Palestinian state

1 Appendix 1 reviews the chronology of this process between 1991 and 2004

2 IMF: West Bank and Gaza: Economic performance and reform under conflict conditions, 2003

3 World Bank: Twenty Seven Months – Intifada, Closures and Palestinian Economic Crisis, 2003

4 Palestinian Central Bureau of Statistics (www.pcbs.org)

than was envisaged more than a decade ago at Oslo. A fuller economic and political partnership may evolve in years to come, but not soon.

Three key discussion areas for looser or closer integration are: trade, labour and monetary policy. At present, the West Bank and Gaza trade almost exclusively with Israel under an existing customs union. Many high-level officials and business leaders we have spoken to on both sides would prefer a free trade agreement between the two states, allowing both sides to make independent tax and trade agreements with other countries, and this is the outcome we assume as most likely[5]. Some Palestinian ministers and their advisors have also considered moving further, to a non-preferential trade regime, putting Israel on an equal footing with the rest of the world. This has other advantages but also entails additional costs[6].

The Palestinian territories use three currencies, the Israeli Shekel, the Jordanian Dinar and the US Dollar. Over time, a Palestinian state would expect to have its own currency, which would also provide a significant new source of sovereign revenue. However, a premature shift to a fully independent monetary and foreign exchange regime could introduce the risk of macroeconomic instability; perception of that risk, even if it does not materialise, could drive away investors. Interviews we conducted with ministers suggest such a change is not an immediate priority. We assume the status quo continuing for many years after peace.

It is clear too that Israel will no longer provide a wholesale employment safety valve for the Palestinian workforce, at least in the short term. In 1999, 135,000 Palestinians were employed in Israel. By 2003, in light of Israeli security needs, this had fallen to around 50,000[7]. It is not obvious that a return to a larger scale preferential labour migration relationship with Israel would be in the Palestinians' best economic interest either. It would have the likely side effect of pulling domestic unskilled wage rates up too fast and thereby undermining both export competitiveness and internal incentives for education and training. We assume only modest growth of Palestinian migrant labour in Israel after peace.

In addition to these policy areas, there is the need for the new Palestinian state to gain adequate independent access to the outside world by air, sea and road links, and enough territorial contiguity to facilitate efficient movement of goods and people, which increased trade and services require. This will involve new investments in infrastructure eventually running into billions of dollars, and it is expected that most of them will need to be funded by international aid (see next section).

5 Aix Group, January 2004

6 Private interviews with Palestinian Authority (PA) ministers; see also World Bank: Twenty Seven Months – Intifada, Closures and Palestinian Economic Crisis, 2003

7 EIU: Country Profile 2004 Palestinian Territories

Over and above the cost involved, greater access and reduced fragmentation within the West Bank and Gaza require a serious improvement in Israel's security situation as well as a reconciliation of these security concerns with the need for sovereign Palestinian trade access routes and economic autonomy.

We assume that this crucial issue will be resolved during final status negotiations and it is this assumption that underlies the favourable reaction of businesses interviewed.

Section two

International Aid and International Private Capital: Prospects and Limitations

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The new state could expect to receive between $1.5 and $2 billion in aid per year after a peace agreement. This aid will probably last no more than 5 years

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Neither aid nor the Palestinian public sector can provide durable job growth

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Foreign investment will be important to long-term economic development

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An emerging Palestinian state expects local entrepreneurial activity to be boosted by capital from donors such as the EU, the US, the Arab League, and international financial institutions.

This capital would mostly be in the form of grants and highly concessional loans. The Palestinian Authority (PA) would also hope for international private investment flows, especially in the form of foreign direct investment.

According to the World Bank, donors were providing around $500 million of aid annually during the mid and late 1990s. Since the outbreak of the Intifada in September 2000, this has risen to just under $1 billion a year in 2002, falling back slightly to some $900 million in 2003.

This aid was mostly allocated to emergency support, including budget support to the PA as it fell into chronic deficit. In 2001 and 2002, budget support accounted for 58 per cent and 45 per cent respectively of total aid disbursements. Additional amounts were provided to help meet operating needs of specific sectors, like hospitals. Last year, after the Israeli government resumed payment of Palestinian tax revenue, budget support was reduced to 28 per cent of total aid[1].

In the immediate aftermath of peace, billions of dollars will still be needed for welfare assistance, budget support and basic infrastructure repairs and long-deferred maintenance. Long-term development investment would follow after these essential needs had been secured[2].

Forecasting the amount of incremental international aid that would flow to a newly independent Palestine is in any case not an exact science. Nonetheless, in interviews for this report, the World Bank country office tentatively estimates that the Palestinian state could expect to receive between $1.5 and $2 billion a year for at least the first three years after a final settlement had been reached.

Official aid flows

By comparison to recent post-conflict reconstruction efforts[3], especially in the Balkans, a total aid effort for the new state of the order of $1.5 billion or even $2 billion per year is not an unreasonable estimate, especially considering the substantial aid levels already mobilised today in the absence of a peace agreement. Aid per capita per year to Kosovo, for example, has ranged between $300 and $440, depending on definitions, since 2000. Assuming a Palestinian population of four million in the immediate aftermath of peace, $400 per capita would equate to $1.6 billion in aggregate, which is within the range estimated by the Bank.

Even so, such figures need to be treated with caution for several reasons. For example, whilst

1 World Bank: Twenty Seven Months – Intifada, Closures and Palestinian Economic Crisis, 2003 and Palestinian Ministry of Planning

2 Interview with Nigel Roberts, Country Director, the World Bank and other World Bank officials for this report

3 Appendix 2

country reconstruction needs may be accurately estimated at the outset (though they might be trimmed later, as the potential for lower-cost solutions is revealed), absorption capacity tends to be overestimated and disbursements therefore often lag behind expectations. This yields a lower actual expenditure figure per year for the same overall needs and related commitments.

Comparative analysis of other post-conflict situations over longer periods confirms that inflows of official aid tend to peak two to four years after the conflict has ended, with notable exceptions such as Lebanon. In most cases, aid has amounted to a much lower share of GDP (a peak of 14 per cent in Lebanon, for example) than is implied by the above estimates for the West Bank and Gaza. However, existing aid to the West Bank and Gaza is already nearly double the highest share of GDP ever reached in Lebanon[4].

In our interviews the Bank suggests that, immediately after a peace settlement, around $600 million of aid would continue to be needed in budget support for the PA. A further $350 million to $400 million would go towards humanitarian needs and the rest, between $500 million and $1 billion per year, would help to reconstruct and develop the new state. This assistance would be used to help finance a variety of infrastructure-related projects. The Bank points out however that, given that the West Bank and the Gaza Strip are relatively small fragmented areas, there is a limited amount of work that can be done at any one time without completely disrupting such fragile infrastructure as currently exists.

Table 2.1 Major Foreign Aid Commitments to the PA 2001 (US$ Mil)

	Commitments	% of Total Commitments	Disbursements	% of Total Disbursements
Arab League	577	47.0	388	41.8
EU	304	24.8	245	26.4
US	242	19.7	114	12.3
Total incl. Others	**1,228**	–	**929**	–

Source World Bank, cited in EIU Country Profile, 2004

More generally, there is a risk that an aid-fuelled construction sector can trigger shortages of labour, land and materials throughout the new economy, and so raise inflation. This damages the competitiveness of trade-oriented activity and may create macroeconomic problems of its own. This is the “Dutch disease” effect, usually associated with sudden inflows of foreign capital from natural resource exports or similar causes.

Perhaps the main lesson from this cross-country experience with aid flows in the reconstruction period is that aid alone cannot become the basis for sustainable job creation. It can only lay the groundwork for the kind of infrastructure and institutional development which underpins and “crowds in” private sector investment flows.
It is worth noting the precarious state of Palestinian administration finances and its current dependency on external budget support. This is expected to become less severe as

4 Such comparison is also biased by a Palestinian economy undergoing dramatic depression, with GDP down a third or more from 1999 levels, tending to overstate aid dependency in the longer term revenue generation improves. It has already improved in 2003 since the Israeli authorities have resumed remitting all border taxes they collect on behalf of the PA[5].

On the expenditure side, the PA already faces a very heavy wage bill, reflecting one of the highest levels of public employment relative to population of the whole region. Civil service jobs have been an important part of the Palestinian social safety net during the crisis years. But they have probably reached saturation point, and will not grow in line with the economy in the future. This means that, even if it is not necessary for the public sector to shed jobs involuntarily, it cannot be an important source of future job creation.

International private flows of capital

Cross-country experience of post-conflict situations also indicates that private flows start later than official flows, and tend to become substantial only some 5-6 years after conflict ends. This pattern was evident for Lebanon, for example, in the mid 1990s. It takes time to re-establish confidence in the new institutional framework, and while official aid performs a necessary role, it is not in itself sufficient to mitigate investor risk.

In the interviews we conducted with international investors many readily acknowledged an appetite for investment in a future Palestine[6], although this seemed conditional on a robust set of Palestinian institutions and the settlement of security issues.

The special role of the Palestinian diaspora, relatively large in comparison to the resident population, might accelerate inflows of private capital compared to other country experiences. It is difficult to draw conclusions about the size of such an effort as little is documented about the savings patterns and investment propensity of this diaspora. Repatriation of migrants' capital usually varies inversely with length of absence, which would not tend to favour Palestine.

Optimistic predictions in other cases, based on plausible assumptions about the size of the wealth stock held abroad, and how large an impact that might make if repatriated to the origin country, have not materialised.

Private international flows are almost always smaller in aggregate than official aid in the first decade of peace. Outflows can even exceed inflows in the immediate aftermath of stability, as owners of capital, resident and not, take advantage of a window of relative stability and exchange rate appreciation to transfer savings abroad, which were locked up during the conflict. It follows from this analysis that it is the domestic private sector, that will provide the backbone of job creation for the new Palestine. It is on this sector that the next section focuses.

5 Israeli authorities suspended tax repatriation following allegations of Palestinian corruption and in response to terrorist attacks

6 See Section 5

Section three

The Palestinian Private Sector as the Engine of Growth

Small and family owned firms dominate the Palestinian private sector

These firms are resilient and under the right conditions will generate employment and growth

The peace dividend in jobs, growth and investment is impressive

Our research reveals a surprisingly resilient Palestinian private sector, determined to succeed and thrive whatever the external environment.

It is illustrative of the spirit of enterprise in Palestinian firms that they have survived and prospered amid conditions of severe political instability. The sector is confident that output and earnings would increase rapidly under more settled conditions.

Our report focuses on private enterprises, not only because entrepreneurship is the engine of opportunity for the Palestinian people but also because small and family-owned firms are the backbone of the Palestinian private sector. Less than 1 per cent of registered firms have more than 19 employees, whereas over 90 per cent have less than 5 employees. Average firm size in 1999 was 4.9 employees.

We found that even during the conditions of instability and uncertainty of the last four years the family firm, with a handful of workers, has been able to ride out the crisis conditions more effectively than established larger enterprises with bigger payrolls.

Between 1999 and 2004, industry census data from the Palestinian Central Bureau of Statistics (PCBS) show total employment contracting by 10 per cent and output by 39.5 per cent. By any standards this must be regarded as a dramatic change in economic conditions which has severely damaged living standards throughout the Palestinian territories.

In the course of our research we conducted interviews with over 70 businesses in the West Bank and Gaza. The sample covered a wide range of businesses in the manufacturing sector, tourism sector and other services, such as trade and retail. Compared to the economy as a whole, our sample over-represents large firms: our average firm size in 2004 was 15.3 employees.

Impressively, those small firms which have withstood the maelstrom of violence and economic decline during the Intifada years have the brightest hopes for the future.

This demonstrates an unrecognised resource of confidence and enterprise which suggests that the prospects for an independent Palestine, cut free from the constraints of security and its own extremists, would be much more favourable than has been recognised.

The fastest recovery is likely to come in tourism, which was virtually destroyed by the images of violence. But our sectoral analysis of the Palestinian economy also shows a bright future for industrial sectors from communications to the quarrying of specialised marbles and building materials for which there is global demand. The service sector is relatively underdeveloped but its prospects will improve as confidence in tourism and industry picks up.

Our study identifies the prospect of job creation on an unexpected scale if the right conditions are in place, resulting in a genuine, durable peace dividend to benefit the Palestinian people. There is the possibility of an enticing future in which full employment could be restored, contributing to the end of the social dislocation that has helped fuel anger on the streets and undermine the commercial and social cohesion of Palestinian society. The analysis quantifies the peace dividend at potentially $850 million per annum, a substantial enhancement in relation to the modest size of the existing Palestinian economy[1]. This amounts to $460 of income per adult per annum. It offers hope that enterprise will, over time, lift territories with well educated populations and an entrepreneurial culture out of dependency and into a new era of growth and enterprise.

The interviews for this study were conducted mostly by experienced journalists guided by academic researchers, at business premises. In-depth qualitative interviews (vivid extracts of which are quoted in Section 5) helped to establish rapport with the interviewee, and were followed by specific questions on (a) actual employment today and in 1999 (b) intended percentage increase in employment in the case of a reduction in conflict and (c) percentage decrease in production since 1999 and again, intended percentage increase in production in the event of greater stability.

Economic contraction, 1999-2004

Our sample firms reported a disturbing and dramatic fall in employment of nearly 80 per cent overall, a much stronger contraction than the industry census reveals. This is because large firms, which were over-represented in our sample, have shed proportionately more labour than small firms. Indeed we found a statistically significant, strong relationship between size of firm and magnitude of contraction.

The contraction of output, however, is more or less independent of firm size. Firms in our sample cut back production by some 52 per cent, a little more than the industry census total, but this difference is not statistically significant, nor is the relationship between the fall in output and firm size.

The intuition behind these numbers is that very small firms, especially family firms starting with little or no wage labour, are better able to withstand serious falls in output and revenue without shedding labour than are larger, more formal employers. Family members are not likely to be made redundant regardless of productivity and profitability considerations.

1 Detailed working of the research methodology is shown in Appendices 5 & 6

Prospects for expansion after a peace settlement

Across the sample, firms are looking forward to large increases in output and employment in the years immediately after a peace settlement. Our research demonstrates that small firms (with 1-4 employees in 2004) predict a 400 per cent increase in employment, while medium-sized firms (5-19 employees) and larger enterprises (more than 19 employees) predict an increase in employment of around 240 per cent[2]. This difference is statistically significant.

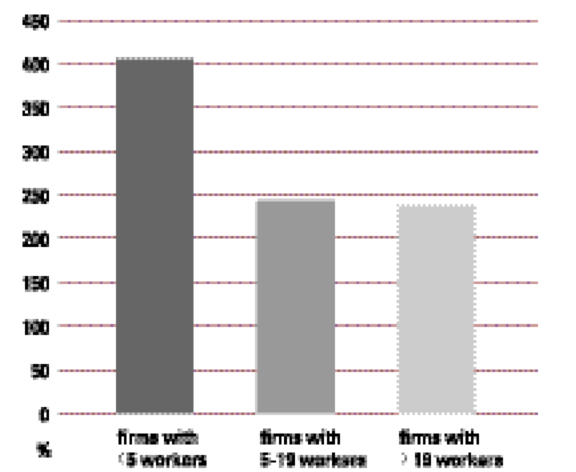
These huge rates of increase, such as 400 per cent, are calculated on the diminished 2004 employment base, which has already fallen by 80 per cent on average since 1999 for our sample of firms. Adding back a fourfold increase onto the surviving 20 per cent would exactly restore the cuts, but no more than that. It is the fact that small firms, which experienced much smaller cuts, are expecting the fastest growth, which delivers a large potential net boost over 1999.

Our interpretation is that larger firms are rather more cautious in their re-hiring practices, having learned a painful lesson from forced redundancies in the present deep contraction. Very small family firms may also be seeing the need to hire wage labour for the first time, after making do without it, as family labour reaches its natural limits in an upturn.

The average output increase expected by our sample after peace is 90 per cent. Again, this has the effect of almost making good the ground lost since 1999. However, there are interesting sectoral differences. Tourism is the most optimistic sector with an increase in output of 127 per cent, followed by the manufacturing industry (93 per cent), which presumably hopes for an easing of import and export restrictions that have hampered production and sales in the last few years. The rest of the services sector is the least bullish about expanding output (69 per cent).

Estimating the peace dividend for overall employment in the West Bank and Gaza

Figure 3.1
Percentage predicted rise in employment for firms in the sample



Source Portland Trust, 2004

2 See Appendix 6

According to the employment census of 2002, total private sector employment in the West Bank and Gaza was 366,000. The census also indicated that there were 71,340 small firms with fewer than 5 employees and 7,232[3] larger firms with at least 5 employees. Assuming the average employment level across all small firms is 2.5 employees, this implies that employment in small firms is about 178,000, and in large firms 188,000. As we have shown in our survey, if all the small firms increase employment by 400 per cent, and all the large firms by 240 per cent, we arrive at an estimated peacetime employment dividend of 1.16 million extra jobs.

This has stunning implications. If job creation were to be as buoyant as estimated then the spare capacity in the Palestinian economy could be rapidly removed and entrepreneurs and investors could focus on moving production up the value scale.

The PCBS employment census gives the total adult population for 2002 as 1,856,000, of whom 486,000 were employed, 221,000 were officially unemployed and seeking work, 1,149,000 were outside the labour force, and 50,000 worked in Israel. A substantial number of those reported as outside the labour force are likely to be "disguised" unemployed[4].

Our firms were also reporting increases they expect to achieve within a few years of peace, rather than instantaneously, the guidance they were given being about five years. This means that there would be seven or more intervening years of extra entrants to the labour force since 2002, claiming some 200,000 additional jobs, by the time firms had actually reached their expected expansion point. The estimated increase in labour demand is therefore likely to be roughly equal to the number currently (officially and unofficially) unemployed, plus new entrants to the labour market.

The peace dividend: gross output value-added and income

Taking the sector-specific output increases expected by firms in our sample, and applying them to the aggregate output levels in the 2002 PCBS industry census, we get the following results as shown in Table 3.1:

Table 3.1 Gross output and value-added (US$ Mil)

Sector	2002 gross output	Projected extra output	Projected extra value added†
Industry	976.9	908.5	341.4
Tourism	32.1	40.8	16.5
Services††	1025.0	707.3	494.3
Total	**2034.0**	**1656.6**	**852.2**

Source PCBS, 2002

† Gross output minus intermediate input costs, assumed here to be proportional to output

†† Trade, retail, etc, not financial

3 Palestinian Central Bureau of Statistics Employment Census, 2002

4 This report has made neutral assumptions on the impact that refugees/migration might have on the labour market and capital flows

The estimated value of the peace dividend to the Palestinian economy, in value-added terms, is therefore some $850 million per year. Using the estimated 2004 adult population of some 1.85 million, this would yield extra income of about $460 per adult, or as much as 25 per cent of present levels.

An uplift of this magnitude would be an enormous boost to Palestinian prosperity. It might be the start of a fundamental change in the economic underpinnings of the Middle East which as a region has lagged behind others in the developing world. Most critically, it could begin to combat perceptions that the Palestinian people do not have the skills and resources to lift themselves onto a higher economic and commercial plane.

Investment

The survey did not cover investment directly, but increased private investment after peace can be inferred from planned gross output increases and investment ratios from other countries and for the West Bank and Gaza in the past.

The investment to output ratio in the West Bank and Gaza in 2002 was a mere 1 per cent[5]. This is very low by international standards, indicating that firms are spending less than the amounts required to replace depreciated capital. 1999 showed a still low 2.1 per cent, indicating that Palestinian businesses were already cautious of investing even before the Intifada. However in 1994, the earliest year for which data is available, the investment ratio was 6 per cent, which is in line with international comparisons.

Applying such a ratio to the extra gross output figure of 1.65 billion, we generate a figure of just under $100 million a year for additional business investment triggered by peace.

Israel and the peace dividend

The peace dividend for Israel has been extensively researched elsewhere and is beyond the detailed remit of this report. Some general comments would be appropriate, however, particularly in relation to shared interests in tourism for both peoples. It is worth noting that there is further analysis being conducted on the linkage of tourism between the two countries.

The Israeli economy is considerably larger than the Palestinian territories and annual GDP was NIS 466 billion in 2003, equivalent to $100 billion[6]. Yet it has also suffered from the long years of conflict and, in particular, from the latest Intifada. Since the outbreak of the Intifada, the cost of capital flight in terms of lost productivity in Israeli industry is calculated at around $1 billion per annum[7]. The result is that there is less capital in

5 Palestinian Central Bureau of Statistics Industry Census, 2002

6 Israel Central Bureau of Statistics (www.cbs.gov.il)

7 How does violent conflict affect investment decisions? Evidence from Isreal. Journal of Peace Research, 2004

the Israeli economy and less to invest in domestic business. Such capital flight equates to 1 per cent of GDP.

International capital has also been withdrawn from the economy as overseas investors have either diverted money elsewhere or reduced ongoing capital flows. This amounts to at least $1 billion annually, or a further 1 per cent of GDP[8].

The recent conflict has also precipitated a steep decline in the tourist sector. In 2000, 2.67 million tourists visited Israel. By 2003, this number had fallen to just 899,600. Some of this decline can be attributed to the aftermath of the September 11 terrorist attacks in the US and some of it can be attributed to weaker global economic conditions.

Nevertheless, the decline in tourist numbers was sharper from Europe (1,559,700 to just 376,500) than from the US (950,200 to 357,000)[9], implying that the Intifada has played a significant part in tourists' reluctance to visit Israel.

Total revenue from tourist hotels fell over the same period from $1.46 billion to $958.5 million[10]. Although this includes expenditure from Israelis as well, it does not include monies spent by tourists on goods and services other than hotel, food and accommodation.

Unemployment has also risen sharply since the outbreak of the Intifada, climbing from 166,000 or 7.8 per cent of the work force in 2001 to 250,700 or 11.6 per cent of the work force in 2003. Some of this rise will be tourism related but other sectors of the economy, such as construction, have been affected too. In addition, the Intifada has created cost in terms of military expenditure, the destruction of buildings and losses by the tourist industry.

According to our estimates, local and international capital flight accounts for at least 2 per cent of GDP and rising unemployment accounts for a further 2 per cent of GDP. Losses to the economy from tourist revenues will have had a significant impact too.

We estimate that the Intifada has had an impact on the Israeli economy equivalent to between 4 per cent and 5 per cent of GDP[11].

As the Intifada cools and world economic prospects improve there are indications for both Israelis and Palestinians that an upturn is on the way. Tourism, a key to recovery, has started to pick up from the low levels of recent years.

Perhaps more critically inward investment into the high-tech area, decimated by the burst of the dot.com bubble and security concerns, also has begun to pick up.

8 Israel Central Bureau of Statistics

9 Israel Central Bureau of Statistics

10 Israel Central Bureau of Statistics

11 Ongoing and recent work by Professor David Fielding and the Israel Central Bureau of Statistics

Conclusion

The cost of the Intifada to the Israeli and Palestinian economies has been profound. It has resulted in a collapse of tourist revenues, a decline in inward investment, sharp increases in unemployment and widespread social dislocation. Soup kitchens have become apparent in some Israeli cities and the Palestinian population has become ever more dependent on UN food aid and subventions.

In our view the peace dividend would begin to address the issues of economic decline in Israel and Palestine. Under peace, lost revenues – up to $5 billion annually – could be expected to return to the Israeli economy in relatively short order. In some instances, such as tourism or foreign capital inflows, the boost to the economy from peace could be even greater.

In total therefore, we estimate that peace would boost Israeli and Palestinian output by around $6.6 billion annually and place the region back on the road to recovery.

Section four

Comparative Advantage: Key Sectors of the Palestinian Economy

Palestinian comparative advantage is rooted in its educated workforce and strategic location

Growth areas are predicted in key sectors across the economy

The employment prospects outlined in the previous section may seem excessively optimistic, given the bleak present picture.

Yet they are thoroughly grounded in the experiences and expectations of a wide range of real businesses from most branches of industry and services in the West Bank and Gaza.

This section looks briefly at the specific sectors where an emerging Palestine can develop a competitive edge, create jobs, and attract higher levels of investment over time.

Like Israel, the West Bank and Gaza do not have plentiful supplies of land or natural resources. They do however have a potent geographical advantage, being at the crossroads of the Arab world, the Western world and Israel.

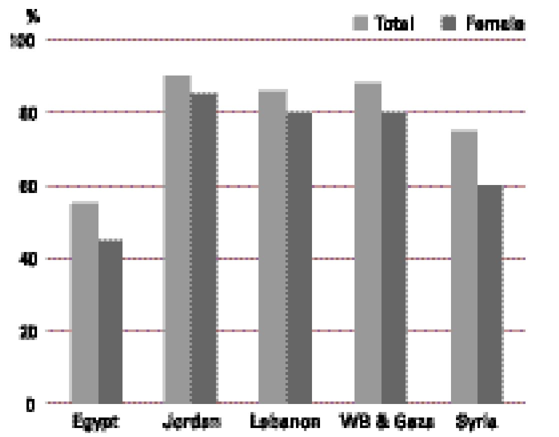
This location could provide the new state with trading and economic potential under more peaceful circumstances.

Education & literacy

Commercial progress depends heavily on the skills and culture of the domestic workforce. Palestinian claim to an educated workforce is well founded. Literacy levels are on a par with those of Jordan and Lebanon, putting all three countries at the top of those in the Middle East and North Africa. There are now 100,000 university students at 11 universities in the Palestinian territories.

Recent statistics reveal that almost 90 per cent of the population can read, compared to less than 60 per cent in Egypt and around 75 per cent in Syria. Palestinians also have a linguistic advantage over most of the region, often being able to converse in English and Hebrew as well as Arabic.

Figure 4.1 Regional Literacy (%)



Source UN ESCWA Statistical Abstract, 2001

Sectors

Fortunately, there are a number of industries in which the Palestinian territories are likely to have a comparative advantage. These sectors could lead the way towards sustainable economic development in a new state of Palestine. In each instance, there are genuine grounds for optimism as the Palestinian entrepreneurial culture has continued to develop these industries despite ongoing political instability.

i Construction and construction materials

The construction industry is likely to be the most immediate beneficiary of peace. Foreign aid will be directed towards the creation and rebuilding of roads, buildings and other infrastructure, such as desalination plants and sewerage works. This will prompt an ongoing need for cement, stones, tiles, piping and other building materials.

From 1998 to 2000, when the Palestinian economy was experiencing a modest recovery, the domestic construction industry employed more than 50,000 people annually[1]. By the end of 1999, the construction sector made up 13 per cent of GDP[2]. But in the first two years of the Intifada, the sector experienced the steepest decline of the entire economy, with employment falling by 49 per cent[3].

Official donors to the Palestinian territories and local business leaders expect that the urgent need for improvements to infrastructure would trigger an influx of capital, following a final settlement with Israel. They would look for additional aid of between $500 million and $1 billion a year for three years or more, as discussed above[4]. This would, in turn, create substantial employment opportunities, particularly in the West Bank cities of Tulkarem, Jenin, Nablus, Ramallah, Bethlehem and Hebron, which have strong ties to the sector.

The way in which contracts to rebuild parts of the West Bank and Gaza are packaged, awarded and implemented would need to be worked out carefully by local and international policy-makers and donors. International construction companies competing for contracts would however be expected to harness the local supply of unemployed labour, and subcontract extensively to smaller local firms.

The initial boom is likely to mean that the construction industry becomes one of the chief short-term employers of Palestinians. Over the long-term, the sectors outlined below probably have more durable job creation and economic potential.

ii Tourism

This offers some of the most attractive growth opportunities of the Palestinian economy. There is a burgeoning tourism sector worldwide for whom the cultural and religious sites of the region are important, not only as tourist areas but also as destinations for pilgrimage. Indeed, with

1 Palestinian Economic Policy Research Institute, 2000

2 Palestinian Central Bureau of Statistics and IMF staff estimates

3 IMF: West Bank and Gaza: Economic performance and reform under conflict conditions, 2003

4 Private interview with Nigel Roberts, Director of the World Bank, 2004

over 2 billion Christians, Muslims and Jews having an affinity to the Holy Land, the scope for religious tourism is immense.

There are various forms of non-religious tourism also. In the 1990s, a casino opened in Jericho in the Inter-Continental Hotel. The hotel employed 1,600 Palestinians and was immensely popular with Israelis, as well as some overseas tourists. The hotel is now virtually closed but it is expected to re-open under more peaceful circumstances. There is potential to open similar complexes in the West Bank. In addition, coastlines around the territories have potential as prime sites for recreational tourism.

In the post-Oslo years tourism was beginning to pick up, but the recent political unrest has seriously affected the sector. Between 1996 and 2000, the number of tourist arrivals in the West Bank and Gaza increased steadily from 230,000 to 336,000[5].

There is no data on more recent trends, but plunging Palestinian hotel occupancy ratios and the overall decline of tourism in Israel (down to 0.89 million visitors in 2002 from 2.67 million in 2000) point to a complete collapse of this sector in the territories[6].

In 1999, the 317,000 visitors to Palestine spent $258 million, or $814 per person[7]. This compares favourably with Morocco and Egypt, where the average tourist spend is $513 and $767 respectively, although in Israel the spend is more than $1,000.

Given a cessation of violence and modest infrastructure rehabilitation, we can expect the new state to regain pre-conflict levels of tourism receipts. Over the longer-term there is even greater potential. In the 2000 boom year, for example, Egypt received $4.3 billion in tourist revenues. Despite the higher per capita spend, Israel's peak revenue from tourism was only $2.8 billion.

It would not be far-fetched to imagine the combined turnover of the Palestinian and Israeli industries - which are inherently interconnected - eventually equalling or exceeding Egypt's, and a new Palestine capturing a rapidly rising share of that increase. Further work is being undertaken to establish projections of tourism growth under different scenarios.

Table 4.1 Tourism activity: main indicators (% change from 1999)

	2000	2001	2002	2003
No. of operative hotels	16.5	-7.7	-20.9	-17.6
Average number of workers	46.6	-11.1	-26.6	-26.8
No. of guests	5.9	-81.0	-83.8	-80.2
No. of guests nights	13.5	-79.4	-81.1	-77.7
Average occupancy of rooms	11.1	-77.2	-77.3	-67.0
Average occupancy of beds	13.5	-79.4	-81.1	-73.6

Source Palestinian Central Bureau of Statistics.

5 Palestinian Investment Promotion Agency (www.pipa.gov.ps)

6 Israel Central Bureau of Statistics (ICBS) Statistical abstract of Israel, 2003

7 Stastistical Economic and Social Research and Training Centre for Islamic Countries (SESRTCIC) database (www.sesrtcic.org)

iii Stone and marble

The Palestinian Territories are renowned for their natural limestone, characterised by bright attractive colours that are in demand internationally. The raw material used in the production of the stone and marble products is 100 per cent local and reserves of this material should serve for the next fifty years. Indeed, recent excavations produced a large supply of marble in the West Bank. There are 260 stone quarries situated across the West Bank supplying approximately 1.8 per cent of the world stone and marble market in 2002[8].

Industry experts estimate annual sales revenues for this Palestinian industry to be around $450 million, accounting for 5 per cent of GDP[9].

The sector employs 15,000 skilled workers[10] with annual revenue per employee exceeding $30,000. Much of the industry is based in Hebron and Bethlehem, which is seen as a global centre for this type of product. Key companies in the industry include Al-Somoud Co., the largest Palestinian producer and manufacturer of raw materials.

Exports from the sector as a whole total nearly $100 million a year and annual growth averages 8 per cent. Global demand for marble and stone is forecast to expand substantially. In 2000, 635 million square metres of natural stone were used worldwide. By 2010, this is expected almost to double to 1,220 million square metres[11].

iv Agriculture and food processing

Agriculture has traditionally been one of the mainstays of the Palestinian economy. Between 1998 and 2000, it accounted for around 9 per cent of GDP and employed some 60,000 people[12]. While the landmass of the West Bank and Gaza is small at 646 kHa (urban Los Angeles is 545 kHa), it boasts many different agro-climatic zones.

This diversity allows the cultivation of a wide range of crops which can be grown year round - the warm winter months in the Ghor zone of the Jordan Valley make the cultivation of winter crops possible, while the semi-coastal and mountain zones of the northern West Bank region have a moderate summer climate, suited for vegetables. Productivity levels are favourable in comparison to neighbouring Arab countries.

Olives grown in the West Bank have been the principal cash crop, while citrus fruits and bananas have been grown for export. There have been efforts to shift agricultural production to higher value-added goods for export. In recent years, strawberries and cut flowers have been cultivated for sale to Europe, but closures in the West Bank and Gaza since 2000 have restricted development.

8 AMEInfo (www.ameinfo.com)

9 Palestinian Investment Promotion Agency (www.pipa.gov.ps)

10 AMEInfo (www.ameinfo.com)

11 www.marbleandmore.com

12 Palestinian Central Bureau of Statistics

Exports of olives and olive oil to the US and Europe (under free trade arrangements to be confirmed, perhaps governed by quotas) are an area that could offer growth potential. In 2002, the Palestinians produced 27,744 tonnes of olive oil. This could increase substantially, if backed by investment in production facilities. In general our survey showed a belief that greater access to world markets, in particular European and Arab countries, will encourage agricultural exports and stimulate the economy.

The domestic food-processing sector competing with imports was one of the most rapidly developing sectors in the Palestinian economy before the latest Intifada. Its local market share increased from 25 per cent in 1996 to 45 per cent in 2000. Market studies reveal that the average family spends up to 45 per cent of its income on food, indicating the importance of this sector and the need for a competitive local industry to provide high quality food products.

v Information Technology and Telecommunications

IT companies began to emerge in the Palestinian territories at the beginning of the 1990s. Now there are 80 IT companies and more than 150 small computer stores[13]. Some software companies have already developed outsourcing projects for regional and international companies and the emphasis on outsourcing is increasing.

The IT sector is one of the few to have benefited from the recent conflict. Internet usage has tripled in the past three years and businesses have relied increasingly on electronic communication. Software packages and services are being exported to other Arab countries and sold locally. IT has benefited from some import of Israeli expertise and from the educational achievements of the work force.

Telecoms will require massive investment - much of it private finance. The Palestinian Telecommunications Company (Paltel) has a ten-year licence to operate fixed line services and a twenty-year agreement on mobile services. Paltel gave Ericsson a $40 million contract for a GSM network. This sector is expected in our survey to grow dramatically as conditions become more settled.

vi Natural gas

Natural gas was discovered off the Gaza coast in 1999. In the same year, the Palestinian Authority awarded the exploration concession to British Gas for $40 million. Two test wells drilled in the second half of 2000 (Gaza Marine 1 and 2) confirmed a major gas discovery whose reserves are estimated at around 50 billion cubic metres of natural gas. These reserves could be worth up to $5 billion[14].

13 The Palestinian IT Association

14 Alexander's Gas & Oil Connection (www.gasandoil.com)

Senior Palestinian government officials have described the discovery as the largest single prize for business in Gaza. In recent years, the field has been the subject of protracted contractual negotiations. There are hopes, nevertheless, that in a more peaceful climate, up to 1.7 billion cubic metres of gas could eventually be sold annually to Israel, which currently relies on an Egyptian-based venture for some of its natural gas.

vii Industrial Parks

A focus of current economic transition is the creation and re-establishment of cross-border industrial parks. In the 1990s, four industrial parks were constructed on the borders between Israel and the West Bank and Gaza - Erez, Karni, Nitzanei Shalom and Atarot. In early 2000, these employed more than 9,000 Palestinians working in over 300 different plants[15].

The Intifada placed enormous strain on these parks and Israeli security concerns have provoked closures. These zones might also provide a further stepping-stone towards full statehood[16].

In effect, industrial parks operate as economic microcosms, working in their own environment with their own mini-regulations.

Historically, co-operation there between the Israelis and the Palestinians has been good and they have been able to exploit both Israeli technological and marketing know-how and the comparatively low wages of the Palestinian population[17].

International businesses would be encouraged however to create their own industrial zones or participate in multinational parks. Three new industrial zones - Rafah, Mukiabela and Kadouri have already received planning permission and a further two, at Tarkumia and Lev HaSharon are under consideration. It is estimated that these could eventually provide employment for around 90,000 Palestinians.

Industrial parks are one of many policy hybrids imaginable to bridge the transition to full statehood. They could help to manage the twin needs of providing substantial Palestinian employment on the border with Israel, with adequate logistical access for intermediate and finished products in a way that satisfies Israeli security needs.

What is less clear is what such constructs would achieve over a longer-term horizon, perhaps in a radically different trade regime and when the security concern is no longer paramount.

The view is increasing that the parks should be near Palestinian populated centres and export

15 Israeli Co-ordination of Government Activities Ministry

16 Private interviews for this report with Salam Fayyad and Mohammed Shtayyeh

17 Israeli Co-ordination of Government Activities Ministry facilities in order to allow easy flow of labour and goods.

Our survey has confirmed the view that, in the early years of statehood, these parks could conceivably increase industrialisation, create jobs and stimulate investment.

Section five

The Private Sector: Voices and Views

Business and political leaders look to avoid a culture of aid dependency

Palestinian business leaders tend to be pragmatic and moderate

Infrastructure, accountability, regulation and access are the key demands of the business community

Optimism is the essence of entrepreneurship, driving business to thrive in almost any environment.

We conducted interviews with more than 70 individual businesses inside the West Bank and Gaza to find out how they are coping now and what they believe to be the principal challenges involved in transforming the territories into an economically viable Palestinian state.

We went to considerable lengths to ensure that the interview methodology was structured carefully and represents as thorough a process as could be conducted under the circumstances. An interviewing group was established, all members of which were experienced in qualitative interviews of this type. Mindful of the challenges of this methodology we note the following:

1 Whilst not all the answers are reliable predictors of future behaviour, similar methodologies have been used in other reconstruction surveys.
2 The interviewees were selected on a consistent basis, mindful of size of business, geographical location and need for independence.
3 The interviewers were trained and used consistent materials designed by The Portland Trust's academic advisory board[1].

Our research reveals that the spirit of entrepreneurship is alive and well, particularly in the West Bank. There is a stronger history of successful commerce in this region than in Gaza and there is a stronger belief in the potential of tourism. In Gaza itself, a grain of optimism persists but present day security constraints and uncertainty about the future have clouded confidence.

Even so, for Palestinians, policy-makers and international investors, the central question focuses on the potential strength of companies in the territories. In other words - how strong could these businesses become under peaceful circumstances?

Interviews conducted with the leaders of local businesses, aligned with the views of senior public figures and international investors, provide some telling insights.

More detailed individual viewpoints follow this introduction. Some key themes however emerged in almost every interview conducted:

- Business needs access to reliable physical infrastructure
- The Palestinian Authority needs to develop business-friendly bureaucracy and systems of governance
- A strong Palestinian banking sector is vital to support growing businesses

1 For further details see Appendix 5

- The providers of international aid should work in partnership with existing businesses to create durable commercial opportunities.

These are businesses' important demands, but even under current circumstances there is resilience, which allows a large number of small firms to continue trading.

In fact, our survey reveals that a cadre of dynamic entrepreneurs has almost come of age during recent years. These business leaders are ready to take full advantage of the opportunities that might become available under independence.

Commercial voices from the West Bank and Gaza

Like businessmen everywhere, the entrepreneurs of the Palestinian territories are desperate for a return to some kind of political and economic normality so they can go about building their businesses. Our voices demonstrate that, despite all the hardships, commerce has proved adaptable in difficult circumstances as a result of which the traditional Israeli market has shrunk. Many businessmen have reached out to a more international market. Others dependent on tourism have had to downsize to meet the new circumstances, but have survived. Conflict conditions produce surprising responses and the survival instinct is one which comes through the words of the Palestinian commercial leaders.

It does appear that there is a realistic chance of these businesses prospering and adding output and jobs in better times. Here are voices which emerged from interviews conducted especially for this report. These voices drown out those who see peace as a means to gain access to greater subventions rather than as a gateway to stronger growth, greater employment and a lift in living standards[2].

Walid Najjab founded the leading independent management consultancy MCS in the area. He is also a non-executive director of a number of local companies including the Palestine Electricity Company. "Our politicians must continue the process of reforms, in which a more rigorous regulatory framework can be put in place allowing entrepreneurs to successfully conduct their business.

The bureaucracy of the country can be slow and Israeli security checks can be onerous. But there are still major reforms needed in the legal system and changes that could help our accountancy system as well."

Samir Hasboun is Chairman of the Bethlehem Chamber of Commerce and Industry, representing 45,000 members. He also co-authored the Aix Group Economic Road Map in January 2004.

2 All interviews conducted in the West Bank and Gaza

"To my mind, peace is a man with two legs. One is called security the other is economic development. The man is crippled if he loses either leg. I believe the local economy would dramatically improve as part of a peace dividend and I have four messages for international investment partners. We need trade not aid. In God we trust, in calm we believe. Most Palestinians want to do business, not politics. This is not Iraq, investors are safe here; there has never been an attack on business people.

With three years' stability we could expect the 28 hotels in Bethlehem to flourish again, the 300 workshops [handicrafts, wood carving and tourism related] to revive and local agricultural, industrial and finance businesses to improve. For instance, there are 26 registered money-changers in the city. We need stability. We will deliver the enterprise."

Voltaire Kharoufeh is export manager of the Nassar Jerusalem Stone company. Over the past twenty years, the business has grown from a one-man operation into a business with an annual turnover of $14 million. "We cannot afford to blame the violence for delays. Our clients don't care about that. Our company's products are sold internationally from China and Japan in the east to the United States in the west. We must focus on servicing clients whatever is happening politically. The business used to export 50 per cent of its wares to Israel and 50 per cent internationally. That has changed during the Intifada. Today it is 35 per cent to Israel and 65 per cent internationally.

The key to our resilience is our financial strength, the quality of our machinery and the contacts we have developed with clients throughout the world. The important thing is being big enough to handle problematic situations, problematic politics and problematic economics.

We make sure we employ drivers who are Israeli Arabs and can therefore get goods safely to Haifa port. In times when security is tighter than usual, we also use a tract of land that is partially under Israeli control and partially within the Bethlehem precinct, so it can complete back-to-back transfer of raw materials when a closure is enforced.

We work on the assumption that the instability may continue but we would really benefit from a stable market and political stability. Under those conditions we could double sales capacity."

Khaled Osaily is chief executive of the Osaily Group of companies and a captain of industry in Palestinian society. He is also a member of the Palestine National Council and the Palestinian Monetary Authority Board. He has been the deputy mayor of Hebron since 1976. "To invest here you need to know how to open different doors. If you are British or American, Palestine is a good place to invest, providing you have access to your government and contacts. You need access to all the players - Israel, Egypt, Jordan, America as well as the Palestinian Authority to invest successfully in the region. There are financial opportunities but they cannot be really successful without the proper political environment. That means political stability. But I am optimistic. We are in the worst environment and still our heads are above water. The future can only be better.

I am pleased about the proposed withdrawal from Gaza, but Gaza cannot exist without access to Israel. The link with Israel is even more crucial because if there is open access to Egypt there will be a flood of Egyptian products, cheap products, into Gaza. Without interaction with Israel, neither Gaza nor the West Bank can progress. It is worth remembering in the long-term that even the Berlin Wall came down. There will one day be no walls, no boundaries even between us. It will be like Europe, or the US. The only question is when it will happen. One thing is for sure - we have to live together.

Donor money came to create temporary jobs, provide food on the table. We need money-generating projects. Donor money is good for infrastructure, for supporting the PA, for paying salaries. But I hate donor money because it inhibits us. We are not beggars. Create jobs, create projects. Do not make us get used to getting things free of charge. Make projects that earn money. Without donor money you could not build infrastructure or streets, an electricity grid, a telephone company and such like. But on its own donor money is a waste of time."

Jawdat Suhail of the eponymous marble and stone company says: "My company has lost huge sums in recent years. In 2003 I invested $500,000 from my own pocket to keep the business going. In 2004, I may have to close it altogether. Three of my quarries are closed. We export through Ashdod and Haifa to Europe and China and go via the Allenby Bridge into Jordan, but we do have difficulty fulfilling our commitments."

Sami Abu-Dayyeh owns the Ambassador Hotel in East Jerusalem and is also a shareholder in the Jericho Resort hotel. "2001 was a disaster, 2002 was slightly better, 2003 saw another setback because of the war in Iraq, but now we are making strides. Hotels are usually a very dicey venture in this region but if there is peace, the sky's the limit. At the Ambassador, we sustain a 30-40 per cent occupancy rate, mainly from NGO officials and their guests. But when we have a fully-functioning government and stability we will see an upsurge in bookings equivalent to what the King David Hotel has on the Jewish side of town.

We just need to wait out the time until the tourists come back, and they will. Once they are back, the return would be high, enabling an investor to recoup his outlay in a short time. The Intifada means that recovery, and the return of the millions, might just take little longer. I have no qualms about advising in favour of an investment in Jerusalem or elsewhere in the Holy Land."

Sam Bahour is the General Manager of the Plaza Shopping Centre in El Bireh in the West Bank. His father left El Bireh for the US in 1956 and Sam Bahour was born in Youngstown, Ohio. Many of the staff are returnees from the United States and elsewhere in the Palestinian diaspora who wish to help build and reap the benefits of potential peace. The company is 51 per cent owned by the Arab Palestinian Investment Company. "We are a reality check in Palestine. We are open and we've managed to find a set of retailers despite the situation. The Plaza has 28 tenants and there are ten more in the pipeline. Providing my community with economic and recreational facilities, with clean products, is as much a national priority as anything else. We raised $10 million, we have hired 100 people and we are steadfastly providing basic needs for Palestinians.

We are also training people, providing university-type training where our own colleges fall short. We lack much know-how and many managerial skills. I'm aware of the lack of human resources so I'm grasping the moment now, in a hurry to get ready to move more quickly once times are better.

A few years ago I was in Dubai trying to interest potential investors to come in on the Plaza project. I sensed a reluctance. I was back there recently after the opening and I can tell you it was a hell of a good feeling to be able to say 'we still need you' but to know that we have already done it.

The biggest challenge now comes from dealing with tenants and it stems from the lack of a good legal basis for commercial relationships. The legal environment exists here, but there is a lack of implementation.

Looking ahead, the end of military occupation is not an end in itself if there is no open and free border with the outside world. Our leadership over-emphasises the withdrawal dimension of the projected pull-out. You have to look to the fine print, which means asking will borders be open and will the economic exchanges be freer than they are now?"

Jalal Mahmoud Abu Shareh owns and operates a sewing workshop in Gaza. Before the latest Intifada, he employed 120 people. Today, most of his 60 staff are part-time, working in the production of garments that are principally sold into the Israeli market place. "My business faces increasing competition from China but Gaza's location alongside Israel and close to Europe could be a major asset should the political situation change radically. I could be in Tel Aviv within an hour meeting suppliers and customers, but it is not going to happen until the politics improve. The best I can say about the present situation is that we are alive in our business, surviving.

I am currently unable to deliver a single shipment to Israel or receive fresh fabric from suppliers. Also, I have to pay my workers on a daily basis. If I was committed to full monthly wages I would have had to sell my home to pay them."

Hani el-Shawa is the chairman and general manager of the Bank of Palestine in Gaza City. "We are survivors. Our banking system is 100 per cent bona fide and does not have any major problems. But there are difficult situations. Recently, for instance, the Palestinian Authority insisted that we freeze the assets of several Islamic charities with links to Hamas, and through which funds are channelled from abroad. But there is counter-pressure from Hamas supporters in Gaza. We went through a series of street demonstrations followed by warnings of sit-ins inside the bank unless the funds were released according to a Palestinian high court decision.

Also there is continued tension with Israel. Sometimes, we cannot get our cash out through the Erez checkpoint. We have literally loads of excess notes in our vaults. That is unhealthy, not to mention the risks and the loss of interest. The Israelis cite security reasons but, for the health of the Gazan economy, it makes little difference if the reasons are valid."

Mazen Sinokrot chairs Sinokrot Global Group, a family business involved in food manufacturing and processing, farming and tourism. Mr Sinokrot is also chairman of the Palestine Food Industries Association and has a number of other industry roles. "Before 2000, our annual economic growth was 7 per cent plus and unemployment fell to below 12 per cent. If we can do it under the difficult conditions we have been through, then surely we can do it anywhere, at anytime. But we obviously require political stability to ensure growth and we need good strong economic institutions that will deliver services in both the public and private sectors.

We need to strengthen the legal impediments against corruption. Nonetheless I believe there are reasons to invest here. We can offer customs exemption, exports benefit from bilateral trade agreements with Israel and Arab countries, the added value of Israel having few trade ties with the Arab world while Palestine enjoys preferential status from the Arab League, trade agreements with Europe, the US [no quotas], Canada and Turkey, an established banking infrastructure with no restrictions and more than 100 Palestinian companies that meet ISO certifications and comply with Israeli standards."

Mohammed Masrouji is president of Jerusalem Pharmaceuticals, which is listed on the Palestinian Stock Exchange. He is a long established Palestinian entrepreneur and he chairs the Palestinian Businessmen Association, which has 400 members across the West Bank and Gaza. He is also chairman of the National Insurance Company. "The business atmosphere is not good, because of the occupation. But, despite the situation, the country is developing, with promising opportunities for potential investors in Palestine. *Looking ahead, I believe that donor money is perfect for infrastructure but the economy as a whole would be better served if a major part of inflowing funds were to go to the private sector.* There are surely benefits to be reaped.

The situation cannot get worse, it can only get better. I myself am investing here. I see that there are indeed sound and promising projects. Partnership between Palestinians and outsiders is essential. They would be hard pressed to cope with the complicated situation on their own but investment on a small scale can be beneficial either through share purchases or joint ventures with Palestinian companies that are short of capital. The advantage is that one can make good business from investing just a few millions; there is no need for hundreds of millions."

Nader Tamini owns the Jalal Tamini Ceramics business in Hebron. He is also chairman of the Traditional Industries Association in Palestine. "Only politics can affect the economy, it can never be the other way around. We have some big problems now, not just with Israel but also internally. It is all very well to reward someone who served the Palestinian cause for, say ten years. Give him a house, give him a truck, that is appropriate. But appointing such a man, just because he has been loyal, to a responsible ministerial job or to a top business job or to become a senior police officer without the proper qualifications is devastating for the establishing and the building of our state.

If there was a resolution to the conflict, the business potential is enormous. We are in the Holy Land. With peace, millions of tourists would flock here. The development of my enterprise would become more Israeli-oriented because it's easier to get to the local market than to export."

Businessmen here, as everywhere else, are focused on profits, not politics. In interviews with us they called on the political leaders of a new Palestinian state to focus on two key areas: physical infrastructure and regulatory infrastructure.

They are calling for better utilities, better roads and greater freedom of movement. Equally, they need stronger accounting, taxation and legal frameworks. If such developments take place, Palestinian entrepreneurs would feel able to realise their potential. Until then, they rely on resilience and hope.

Official voices from the West Bank and Gaza

Even though this report focuses on entrepreneurship and the private sector, the link with public policy is a recurring theme. As a result, we conducted special interviews for this report, excerpts of which are published here, to gauge the readiness of Palestinian political leadership to support private enterprise.

Ahmed Qurei is Prime Minister of the Palestinian National Authority. "Helping Palestinians prosper economically is very definitely a way of helping Palestinian leaders in their efforts to conclude a political settlement. Industrial zones along the Israeli-Palestinian borders could be a key ingredient in helping both sides to prosper and reap the peace dividend together. When the economic situation gets better, there is more private work, less unemployment, and people benefit from international help and outside investment. We as leaders also benefit, because when things are better for our people we are freer to pursue our efforts to reach political arrangements."

Salam Fayyad is the Palestinian Minister of Finance. He is also chairman of the Palestine Investment Fund, the Board of Insurance and the Salaries Fund. "We know that sustainable economic development does not come from donor money. It comes from private sector capital. Fortunately there are lots of motivated Palestinian businessmen and there is a lot of goodwill from non-Palestinians and the Palestinian diaspora. Unlike other developing countries, our development will not be constrained by a lack of capital. Our public finance system is much improved and our business managers are competent and resourceful.

Over the long-term, what we need to do is stop thinking about sending workers to where the industry is [Israel] and start thinking about bringing capital to where the labour is. Industrial zones would be a good stepping-stone in the right direction. The number one priority for us is access. We need unimpeded access to the outside world."

Maher al Masri is the Minister of National Economy in the Palestinian National Authority. His family is renowned as one of the great trading families of the Palestinian region. "I used to have the vegetable oil franchise in Nablus. To retain the franchise I had to meet the terms of the contract to get the product to Jordan. If that meant getting up at 4am to have enough time to deliver the product to market, so be it," he says.

Entrepreneurs the world over have undergone the 4am moment - the pre-dawn time when they have to overcome seemingly insurmountable hurdles to achieve - yet these hurdles are particularly acute in the West Bank and Gaza. *"Do not underestimate the private sector here. It has become a global leader in crisis management. We always find a way to get our products to market. We have to be self-reliant."*

Mohammed Shtayyeh is the Director of the Palestinian Economic Council for Development and Reconstruction (PECDAR). "This is an area rich in history. We have a real competitive edge in this respect and any investment would yield results. We need to build the infrastructure to back up our historical sites but there is huge potential in tourism.

We also have a lot of fertile agricultural land and can grow food throughout the year. We are superbly placed for businesses needing access to cities in Israel, Jordan and Egypt.

Our people are highly trained and we have a lot of artisans too, practising traditional crafts such as leatherwork. Industrial zones have worked well in the past and I think they can be very beneficial."

Abdel Rahman Hamad is the Palestinian Minister of Public Works. He was responsible for negotiating the 1999 contract with British Gas for the exploration and development of two off-shore natural gas fields in the Mediterranean. "The gas deal serves as a good example of the sort of partnership that our future state would like to embark on with other states, including Israel. The sale of our gas to Israel could be worth $120-$150 million to our economy annually, and because our gas is cheaper and the specification of our gas is better than the Egyptian gas which they currently buy, the benefit would be mutual.

The natural gas connection could also serve as an example of joint ventures between us and the Israelis. For instance, 40-60 per cent of an electricity power plant which we contemplate setting up with our gas once exploited could be sold to consumers in Israel."

Three years of conflict, instability, economic decline and dependency might have been expected to lead to profound scepticism among Palestinians.

Instead of the prosperity, joint ventures with Israel and surging income levels they might have hoped for, the infrastructure and administration of government has been disrupted. They themselves have been severely criticised for not treating donor funds and tax revenues with the necessary probity.

Despite this, many we interviewed believe they can harness the natural advantages of geography, an educated workforce, and an entrepreneurial approach to business to combat their extremists.

There is a close linkage drawn between peace and the economic underpinnings of any agreement. Indeed, this was the glue which came unstuck post-Oslo when so much promise turned to dust. The voices of Palestinian moderates suggest they remain unbowed despite the traumatic conditions endured. Indeed, even after the trauma of the Intifada they still see a possibility of working with the larger Israeli economy, should conditions stabilise. For them, throwing off the shackles of aid and dependency and becoming self-reliant appears to be as important as statehood itself.

Common themes from Israeli guardians of capital

Israeli businesses have been more closely involved with the West Bank and Gaza than any other nation for the past four decades. Partnerships, joint ventures and other initiatives were particularly in evidence, following the Oslo Accords. Since the outbreak of the latest Intifada, co-operation has been virtually non-existent. Nonetheless, interviews conducted with Israeli entrepreneurs for this report reveal that they believe there is potential in a post-conflict environment. They are clearly aware of the talent pool available.

“The Palestinians will be able to do skilled work as we know they are talented and quick to learn,” says one entrepreneur.

“The Palestinians have more professional expertise than many other states in the region and they could be a bridge between Israel and the Arab countries,” says another. Like the international guardians of capital, Israelis are concerned about the strength of the regulatory framework and security issues in the West Bank and Gaza.

“You will not find a more motivated Israeli businessman than me as far as the Palestinian cause is concerned. But I am deterred by the lack of predictability and the lack of accountability. The basic institutions are not there. The legal system is not there and what does exist does not have the confidence of the international community. If these obstacles were overcome, I would much rather do business with the Palestinians than anyone else,” says one entrepreneur.

“Once you have a predictable system in the West Bank and Gaza, it will be politically fashionable to be commercially associated with the Palestinians,” says another.

Our research indicates a seam of mistrust running between Israeli and Palestinian businesses, with many on both sides disillusioned by past experiences, particularly over the past three years. “There is a lot of suspicion on both sides and it is difficult to do business without trust,” says one venture capitalist.

Against that, there is an acknowledgement that the two nations have a deep-seated knowledge of one another. Under peace, this could be put to great commercial use.

“Despite all the problems of the past few years, there is plenty of potential,” says one entrepreneur.

“If we can mix Israeli technology and know-how with Palestinian labour and expertise, there is a huge market for our combined products in the Arab countries. In peace, this could be done,” says a senior commercial adviser[3].

Common themes from international investors and bankers

International companies and financiers see the development of post-conflict economies as a three-stage process. First, humanitarian needs are addressed. Second, infrastructure needs are addressed. Third, commercial avenues are explored.

In many instances, the first and second stages are conducted almost simultaneously, so the private sector is involved virtually as soon as conflict has ceased. But companies tend to rely, in the early days, on guarantees from governments, multilateral aid agencies and export credit organisations.

The pace at which post-conflict economies can attract private sector capital without explicit or implicit third-party guarantees depends on several factors. Our research indicates that private capital inflows do not generally become substantial until five or six years after conflict has been resolved. In Lebanon, for example, private capital involvement amounted to 2.77 per cent of GDP four years after the end of the civil war in that country, rising to 3.2 per cent the following year.

According to extensive interviews with company directors, banks and private equity firms, the most crucial determinants of private sector interest are the strength of the regulatory framework, the local skill sets and security[4].

“The Lebanon took only a few years but its development was well managed. Commercial investors gain confidence quite quickly if they see that infrastructure projects are going well and there is international commitment to an area, such as there was in Lebanon. Also, its banking industry was remarkably robust,” says one financier.

3 Interviews were conducted with Israeli businesses responsible for capital flows of more than $10 billion

4 Our report conducted interviews with international guardians of capital responsible for capital flows of more than $30 billion

Regulatory strength is a recurrent theme. Companies and financial institutions are extremely reluctant to do business with the Palestinians until and unless they can be sure that the necessary commercial frameworks are in place.

“Companies need the right structures in place and they need to know that consistent and enforceable regulations are in place,” says one entrepreneur.

“The rule of law has to be in operation. You have to have a system in which, if anything goes wrong, you can sue. If you do not have that, you cannot go forward. In the interim, it might be an idea to have an independent court of appeal. If such a court was staffed by independent judges, that might engender more confidence among business leaders. This happened in Hong Kong as part of the agreement between the UK and China and it gave business some comfort at the time of the transfer and subsequently,” says another.

A second theme is security. “When we prepare to launch a fund, we like political insurance. We look to see which organisations are already in the region. We look for organisations such as the World Bank to be present. As a commercial investor, you need to know you can get as good a look into a region as anyone else, and you do not want to be going into uncharted territory,”says one private equity director.

“Without a sense of security for the employees of a company in the region, it is unlikely to invest in West Bank and Gaza,” says one corporate executive.

Prospective investors would also be looking for evidence of local enterprise and talent. “We need to find local competence with local knowledge and local experience. Conceivably you could get an individual from the Palestinian diaspora with investing experience and local knowledge and experience. These are all key to launching a commercially viable business,” says one venture capitalist.

“We would be relying quite heavily on local partnerships or knowledge so we need to be sure that the skills are there and the people are willing to do business with us,” says one entrepreneur.

It seems that there would be an international appetite for investment in a future Palestine, provided its institutions were robust and security issues with Israel had been settled.

“Companies and financial institutions are far more willing to move into post-conflict situations than they used to be, provided they can see a way to make money,” says one investment banker.

The most impressive aspect of the voices of Palestinian commerce is the sheer practicality of the comments. The business leaders are not men engaged in the high flown rhetoric of the peace process, or letting their imaginations run wild as to the immediate economic uplift of a peace followed by a Palestinian state. Theirs is a calculation about routes to market, taxation, access to finance and re-opening trade dialogue and interaction with Israel even after all that has come between these two population groups in recent times. It adds further to the optimism of an enduring peace dividend.

Summary

Our research and the voices of Palestinian enterprise suggest that a new, moderate Palestinian state has the opportunity to be economically viable.

Despite four years of violence and extreme Palestinian elements capturing attention, a promising commercial sector remains in place and is surprisingly ebullient about future prospects.

No one should underestimate the task of converting the spirit of enterprise and optimism we found in the Palestinian territories into real investment, growth and employment opportunities. But it does appear that businesses, both small and large, are anxious to expand their production, take advantage of Palestinian geography and education and restore the output and productive base of the economy.

It is clear that this will not be achieved without external assistance. In the first instance, post-conflict aid will be required to rebuild the physical, commercial and administrative structure of the state. As this recedes, the business ambition of the Palestinian small and medium-sized commercial sector should take over and private capital flows from both the West, the Palestinian diaspora and the rest of the Middle East can be attracted.

We have been impressed by the resilience of entrepreneurship in the West Bank and Gaza. Our economic analysis, based on an in-depth survey of Palestinian businesses, suggests that in response to a two-state solution to the Middle East conflict, a business renaissance is entirely feasible. The upturn will come from a low base. Violence and terrorism have taken a shocking toll on the region's economy and there has been a worrying 39.5 per cent decline in output and 16.3 per cent increase in unemployment in the Palestinian territories, with the public sector absorbing some of the unemployment slack.

But in the context of a two-state solution there would be a sharp improvement in job prospects among small and larger enterprises. The most modest businesses, with 1-4 employees in 2004, predict a sharp 400 per cent rise in employment levels, a noteworthy tribute to their ambition, with larger firms also forecasting an uplift. The impact on growth would be substantial with output increasing by 90 per cent. This would restore production levels to those seen prior to the Intifada when the Palestinian economy was beginning to see the benefits of the peace process.

In practical terms, an uplift in jobs on the scale uncovered by our research could lead to the creation of 1.16 million jobs and go a long way towards alleviating the social dislocation and human misery caused by widespread unemployment. In pure monetary terms, it is estimated that the peace dividend is worth an impressive $850 million a year to Palestinians – a sum which would generate $460 of income per adult. Much of the growth would come from the industrial sector, with industries like specialist stone and marble leading the way. A strong restoration of tourism income, devastated on both sides of the political divide by conflict, also looks possible and is particularly beneficial because of the foreign currency inflow it attracts.

Over the short term, aid will support the rebirth of the economy of the new Palestinian state and it can be expected that, given the strategic importance of the region, large donor funds will be mobilised. But such assistance can only provide short-term comfort. The real challenge comes from mobilising the business skills, confidence and enthusiasm of local enterprises so they rapidly switch gears, expand investment and their work forces in anticipation of greater returns. This, it must be hoped, will be the start of a virtuous circle which will see the new Palestinian state start to attract private sector capital flows, as donor aid declines.

The scale of the confidence building task ahead after four years in the economic and business wilderness is enormous. However, with the right environment the numbers are encouraging. The voices of Palestinian businesses are a powerful antidote to the extremists and suggest a chance of building regional prosperity.

Main Findings

1 A two-state solution, which has de facto been agreed by all parties, could comprise different economic frameworks. A higher degree of separation from Israel should be assumed than envisaged at Oslo.
Page 13

2 Final status talks will likely involve replacing the customs union with a free trade area and a much lower access to Israeli labour markets than previously envisaged: but monetary and foreign exchange policy should be left unchanged for a time.
Page 14

3 External Palestinian access and internal territorial contiguity are indispensable to its economic survival and hence to peace, but must be squared with Israeli security needs. Donors will have to finance large infrastructure costs related to these needs.
Pages 14-15

4 The new state could expect to receive between $500 million and $1 billion additional aid per year after a peace agreement. This support will probably not last more than 3-5 years.
Page 17

5 The increment would go mainly to construction of infrastructure, which will be constrained by shortages of land and materials, as much as finance. There is a real risk of inflationary pressures from construction damaging the rest of the economy.
Page 18

6 Neither aid nor the Palestinian public sector can provide durable job growth.
Page 19

7 Foreign investors will be critical to long-term economic growth but will lag several years behind official assistance. The Palestinian diaspora might play a significant role, but this is hard to predict.
Page 19

8 Small and family-owned firms dominate the Palestinian private sector. They are extremely resilient.
Page 21

9 Employment among small firms shrunk less than large firms in 1999-2004 and they plan to increase the number of their employees faster after peace.
Page 21

10 Both small and large firms reduced their output by similar amounts. However, our analyses show that output is roughly planned to double after peace. Tourism is the most optimistic sector.
Pages 22-23

11 The response of the private corporate sector can be estimated at the national level as capable of generating up to 1.2 million extra jobs, which can absorb all open and disguised unemployed and new labour market entrants in the intervening period.
Page 24

12 The peace dividend in output and income terms would be around 25 per cent of GDP, corresponding to some $100 million in extra private investment a year.
Page 25

13 Palestinian comparative advantage is centred on having an educated and polyglot workforce at an important regional and international crossroads.
Page 29

14 Growth areas after the peace agreements include: construction and construction materials; religious and recreational tourism; stone and marble quarrying; agriculture and food processing; IT services; and gas.
Pages 30-34

15 Industrial parks may provide a stepping-stone towards full statehood that reconciles economic and security needs for a transition period. Their longer-term merits depend on trade and other policy options adopted by the PA.
Page 34

16 Businessmen ask for access to reliable infrastructure and better mobility; for a business-friendly, more predictable, accountable and more transparent bureaucracy; for better enforcement of property and other legal rights; for a strong banking sector able to take on more exposure to small and medium businesses; and above all for official aid sources to work in partnership with existing businesses to create viable opportunities.
Pages 37-38

17 "Do not underestimate the private sector here. It has become a global leader in crisis management."
Page 45

18 Businesses and political leaders fear a culture of aid dependency.
Page 46

Appendices

Appendix 1

A Chronology of the Peace Process

Six months after the end of the Gulf War in 1991, James Baker, then US Secretary of State, announced the staging of a Middle East peace conference in Madrid. Negotiations were to be based on "total withdrawal from territory in exchange for peaceful relations." This was the first time that the prospect of an independent Palestinian state appeared on the international political agenda and it attracted contributions from everyone in the region.

Talks were based on a two-stage formula. It was hoped that within five years of 1991, there might be interim self-government arrangements for the Palestinians, to be followed by negotiations on permanent status issues.

The prospect of a permanent status solution acted as a catalyst for a series of discussions and the following year a change in Israel's government put the debate firmly on the agenda. Yitzhak Rabin became Prime Minister. Here was an elected Israeli leader focusing on finding a political solution that would lead to the creation of an independent Palestine, existing side by side with Israel.

The fruits of this work emerged the following year, when Rabin and Yasser Arafat, then head of the Palestinian Liberation Organisation, signed the Oslo Accords. According to the 'Declaration of Principles on Interim Self-Government', both sides agreed to recognise their mutual legitimate and political rights, and strive to live in peaceful coexistence and mutual dignity and security. Arafat became head of the newly created Palestinian Authority.

The timetable of Oslo was not met, due at least in part to Rabin's assassination in 1995, but it provided a framework of mutual recognition. Indeed, the prospect of potential political stability between the Israelis and the Palestinians prompted many international aid organisations and multinationals to consider more keenly the economic requirements and opportunities of the area. A number of economic-focused conferences took place, the first of which was held in Casablanca in 1994. This was a time when many policy-makers were hopeful that negotiations could resolve both Israel's security requirements and the Palestinian desire for an independent state.

Yitzhak Rabin's assassination in 1995 and ongoing Palestinian terrorism was a serious setback to these hopes but there continued to be sporadic progress towards a negotiated settlement.

In 2000, Israeli Prime Minister Ehud Barak and the PA President Yasser Arafat met at Camp David for two weeks of talks. Once again, discussions failed to lead to a permanent settlement. Both sides increasingly recognised that, despite the failure at Camp David, the expectation was still for a two-state solution.

The Palestinian uprising (Intifada) which started in September 2000 put an end to the policy of negotiated agreements and violence became prevalent. In March 2002, President Bush sponsored an historic UN Security Council resolution, proposing the creation of a Palestinian State. Three months later, he outlined his vision for the creation of a provisional Palestinian state by June 2005. Known as the Road Map, this involved contributions from the Middle East Quartet - the US, the EU, the UN and Russia.

In December 2003, Israeli Prime Minister Ariel Sharon made a groundbreaking speech where he supported the creation of a democratic, economically viable, Palestinian state. He revealed his disengagement plan, involving Israel's withdrawal first from Gaza, then from parts of the West Bank.

Related security issues and the type of economic agreement that might be codified between Israel and the Palestinians are the cause of much debate. Nonetheless, the plan has received the support of President Bush and has at its heart the creation of a two-state solution.

For further research please see:

1 Declaration of Principles on Interim Self-Government Arrangements September 13, 1993

2 Gaza-Jericho Agreement Annex IV
Protocol on economic relations between the Government of the State of Israel and the P.L.O., representing the Palestinian people Paris, April 29, 1994

3 Agreement on the Gaza Strip and the Jericho Area, Cairo May 4, 1994

4 Israeli-Palestinian Interim Agreement on the West Bank and the Gaza Strip Washington, D.C., September 28, 1995

5 Protocol Concerning the Redeployment in Hebron (as initialled on January 15, 1997)

6 The Wye River Memorandum October 23, 1998

7 The Sharm el Sheikh Memorandum on Implementation Timeline of Outstanding Commitments of Agreements Signed and the Resumption of Permanent Status Negotiations, September 4, 1999

8 Protocol Concerning Safe Passage between the West Bank and the Gaza Strip signed in Jerusalem October 5, 1999

9 A Performance-Based Roadmap to a Permanent Two-State Solution to the Israeli-Palestinian Conflict April 30, 2003

10 Disengagement Plan of Prime Minister Ariel Sharon April 16, 2004

Appendix 2

Reconstruction Costs

2.1 Reconstruction Costs: Selected Countries

Table 2.1 Reconstruction Costs: Selected Countries

	Total Cost	Period	Annual per Capita for Period	Annual per Capita for Total Period
	(US$ Billion)	(Years)	(US$)	(US$)
Afghanistan	32.4	2002-10	150	1,300
Bosnia - Herzegovina	5.6	1996-02	247	1,479
DR Congo	8.6	2001-07	21	148
El Salvador	1.8	1993-96	79	315
Iraq	43.8	2004-07	404	1,617
Kosovo	2.4	2000-04	300	1,200
Timor-Leste	1.0	2001-04	278	1,111

Source World Bank staff estimates (2004)

Notes

Afghanistan Includes re-costing, which now shows $28 billion over seven years (2004-10). Total includes some security costs (wages for police and army, some reform/training for them), but it doesn't include the cost of the international force (ISAF) and the cost of coalition forces; numbers around $10-15 billion year are usually quoted, but unclear how long this will last.

Bosnia - Herzegovina Based on disbursements over the period. Initial reconstruction estimate was $5.2 billion for 1996-2001.

DR Congo Estimates do not correspond to needs but to an assessment of what maximum financing may be made available for the period - needs are much higher.

El Salvador $1.1 billion actually disbursed by donors; government contributed an additional $1.1 billion, so total cost was $2.2 billion; or $386 total per capita, and $97 per capita per annum.

Iraq Includes government institutions; civil society; rule of law; media; health, education, employment creation; infrastructure; agriculture and water resources; private sector development; mine action; and oil. If security and police, culture, environment, human rights, foreign affairs, religious affairs, science/technology, and youth/sport are included, the total cost rises to $55.3 billion, and the total per capita cost to $2,039 and $510 per annum.

Kosovo Excludes UN Interim Administration costs. Adding UN, total cost would be $3.5 billion; $1,750 per capita over the period, and $438 per capita per annum.

Timor -Leste Excludes UN Mission costs and peacekeeping, which were substantial.

Post-conflict reconstruction costs are difficult to estimate precisely. Discrepancies arise due to differences between cost estimates generated in needs assessments (often revised at a later stage), pledges, commitments and actual disbursements. Reconstruction estimates may include some security related programs and the costs of running UN Missions, while others only include non-security and non-UN related costs. It is also difficult to distinguish between post-conflict reconstruction and regular development assistance, and the point at which post-conflict reconstruction ends and the country transitions to regular donor funding. The estimates presented here are a reasonable approximation to the range of reconstruction costs the World Bank have encountered over the past ten years and have been pieced together from various sources and reviewed by the respective country teams.

Appendix 3

Regional Economic Indicators

3.1 Economic Performance

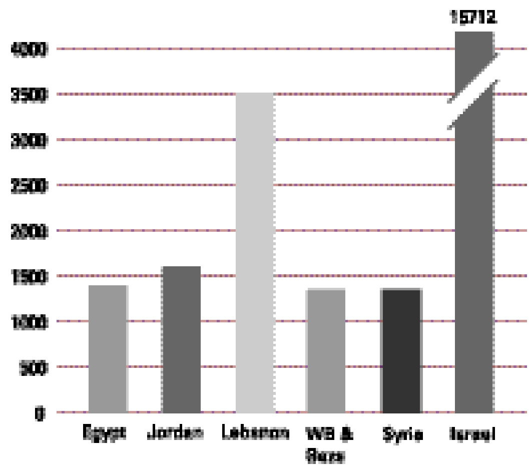
Table 3.1 Economic Performance

	Unit	Egypt	Jordan	Lebanon	WB & Gaza	Syria	Israel
Population	Mil	71.5	5.3	3.7	3.6	17.5	6.6
GDP (constant 1995 base)	US$ Bil	88.6	8.2	12.5	4.2	22.4	103.7
GDP per capita (constant)	US$	1357.8	1573.4	3519.1	1284.1	1336.6	15712.0
FDI inflows (current)	US$ Mil	509.9	100.3	249.3	11.0	205.0	1.6 (Bil)
Aid per capita	US$	19.3	85.8	54.9	280.0	9.2	–

Source UN ESCWA Statistical Abstract (2002) & World Bank World Development Indicators (2002)

3.2 GDP per Capita

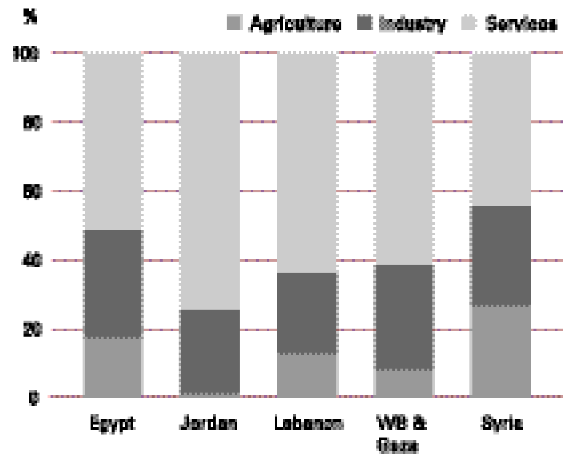
Figure 3.1 GDPper Capita (US$)



Source UN ESCWA Statistical Abstract (2002) & World Bank World Development Indicators (2002).

3.3 GDP Composition

Figure 3.2 GDPComposition (US$)



Source UN ESCWA Statistical Abstract (2002)

Appendix 4

Key Palestinian Indicators

4.1 Population of the West Bank and Gaza - 1997

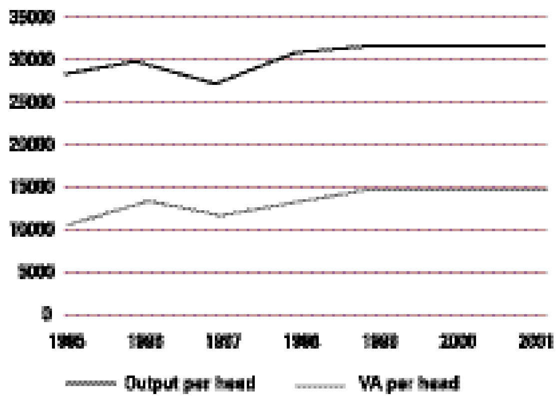
Table 4.1 Population of the West Bank and Gaza - 1997

	Population	% of Total
West Bank	**1,873,476**	**64.7**
Hebron	405,664	14.0
Jerusalem	328,601	11.3
Nablus	261,340	9.0
Ramallah & Al-Bireh	213,340	7.4
Jenin	203,026	7.0
Bethlehem	137,286	4.7
Tulkarm	134,110	4.6
Qalqilya	72,007	2.5
Salfit	48,538	1.7
Tubas	36,609	1.3
Jericho	32,713	1.1
Gaza Strip	**1,022,207**	**35.3**
Gaza City	367,388	12.7
Khan Youris	200,704	6.9
North Gaza	183,373	6.3
Deir Al-Balah	147,877	5.1
Rafah	122,865	4.2
Total	**2,895,683**	**100.0**

Source PCBS Publication of Population, Housing and Establishment Census, (1997 - most recent figures)

4.1 Palestinian Productivity Source

Figure 4.1 Palestinian Productivity Source (US$)



Source UN ESCWA Statistical Abstract (2002) & Portland Trust (2004)

4.2 GDP by Economic Activity - The West Bank & Gaza

Table 4.2 GDPby Economic Activity - The West Bank & Gaza (US$ Mil)

	1998	1999	2000	2001
Agriculture & fishing	487.5	477.3	394.4	337.1
Share of GDP (%)	10.9	9.8	8.5	8.0
Mining, manufacturing, electricity & water	676.9	714.9	723.9	678.1
Share of GDP (%)	15.1	14.6	15.7	16.0
Construction	405.0	652.7	300.3	156.7
Share of GDP (%)	9.0	19.4	6.5	3.7
Wholesale & retail trade	480.6	548.9	512.8	395.8
Share of GDP (%)	10.7	11.2	11.1	9.3
Transport	246.0	301.5	375.7	407.4
Share of GDP (%)	5.5	6.2	8.1	9.6
Financial intermediation	134.7	169.5	191.3	158.2
Share of GDP (%)	3.0	3.5	4.1	3.7
Services	968.7	1,017.6	1,078.2	1,034.6
Share of GDP (%)	21.6	20.8	23.3	24.4
Public administration & defence	460.4	502.0	557.7	698.9
Share of GDP (%)	10.3	10.3	12.1	16.5
Publicly-owned enterprise	117.6	156.5	168.9	166.6
Share of GDP (%)	2.6	3.2	3.7	3.9
Total GDP incl. other items	**4,485.8**	**4,883.4**	**4,619.2**	**4,236.3**
Share of GDP (%)	100.0	100.0	100.0	100.0

(Constant 1997 prices: US$ Mil unless otherwise indicated)
Source EIU Country Profile (2004)

Appendix 5

Report Methodology and Analysis

5.1 The Sample

We have responses to questions regarding current employment, and output and expected peacetime employment and output from 78 firms in the West Bank and Gaza.

The sample varies widely in terms of sectors of business representing firms in the manufacturing sector, the tourism sector and other services, such as trade and retail. The firm size (as of June 2004) ranged from 1-109 employees. Compared to the Palestinian economy as a whole our sample over-represents large firms. In the Palestinian industrial census in 1999 the average firm size was 4.9, whereas in our sample the average firm size for 1999 is 41.4 (and 15.3 for 2004).

The analysis is based on the following questions:

1 How many people do you employ now?

2 How many people did you employ in 1999?

3 If there were a peaceful resolution to the conflict, would you plan to increase your employment?

4 By how much?

5 Has your production increased or decreased since 1999?

6 By what percentage?

7 If there were a peaceful resolution to the conflict, would you plan to increase your production?

8 By what percentage?

5.2 Methodology

For each firm we have figures for the change in employment from 1999 to the present. We also have responses on the expected change in employment in the case of peace. We have obtained the corresponding output figures for a smaller sample of firms. While we do not have any direct information about investment, we can make some inferences about likely future investment behaviour on the basis of existing data on investment - output ratios.

We distinguish between three sectors: "industry", i.e. manufacturing, including firms involved in manufacture and retail; "tourism", i.e. hotel, catering and allied services; and “services”, i.e. all other services, including retail and distribution.

5.2.1 Contraction of Output and Employment, 1999-2004

For each firm we calculate the actual percentage contraction in employment and output between 1999 and 2004 and the predicted percentage change in employment and output in the case of a lasting peace settlement. We then calculate the average expected change in employment and output for all firms in our sample.

We firstly compute the mean change in employment and output in our sample since 1999 and compare this to the data provided by the PCBS. We find that in our sample, employment contracts much more strongly than in the industry census as a whole (by an average of 79.7% in the sample compared to 9.8% in the industry census). One explanation is that large firms have shed proportionally more labour than small firms. This is confirmed by looking at the correlation between firm size and past contraction within our sample of over 70 firms. There is a strong relationship between size and the magnitude of contraction. More technical information is provided in Appendix 6, which shows that the correlation is statistically significant. Employment in the tourism sector has contracted most dramatically. Tourism fell 78% faster than in industry or other services, after controlling for firm size.

Although there is a difference in the average rate of contraction of employment in the manufacturing and services sector in our sample - the contraction being smaller in services - this difference disappears when one controls for firm size (firms in the industry sector are larger on average).

When we look at the output data for 1999-2004, the total fall in industry output as reported by the PCBS is 39.5%, which is lower than the mean figure of 52.4% in our sample. However, the difference between these two numbers is not statistically significant. Neither is there a statistically significant relationship between the percentage fall in output since 1999 and firm size in our sample. Output contraction is more or less independent of firm size.

As for the sectoral pattern of output contraction, in our sample the output contraction in the tourism sector is again the largest at around 80%. The over-representation of tourism firms in the sample could explain why the output contraction in our sample exceeds that of the PCBS industry census. However, the differences in the sectoral averages are not statistically significant in the sample of firms analysed here.

5.2.2 Prospective Expansion of Output and Employment with a Peace Settlement

Both the PCBS figures and the questionnaire results clearly show a large contraction in economic activity since the start of the Intifada in 1999. Respondents are also clearly looking forward to expanding output and employment in peacetime.

The response to the expected peacetime change in employment varies between the different sizes of firms. Small firms (with 1-4 employees in 2004) predict a 400% increase in employment, while medium-sized firms (5-19 employees) and larger enterprises (more than 19 employees) predict an increase in employment of around 240%. This difference is statistically significant. However, there is no significant variation across sectors.

What do these figures tell us about the potential increase in total employment in the case of a peace settlement?

Total private sector employment in the West Bank and Gaza in 2002, according to the employment census was 366,000. The total number of firms in the 2002 census was 78,572, of which there were 71,340 with fewer than 5 employees ("small firms") and 188,232 with at least 5 employees ("large firms").

We assume that the average employment level across all small firms is 2.5 employees. This implies that employment in small firms is about 178,000, and so in large firms the implied employment figure is 188,000 (366,000 - 178,000). If all the small firms increase employment by 400%, and all the large firms by 240%, the total estimated peacetime employment dividend is 1,163,000 (extra) jobs.

This figure is an estimate of the increase in labour demand. What about labour supply? The PCBS employment census gives the total adult population for 2002 as 1,856,000, of whom 486,000 are employed (in the public and private sector together), 221,000 are officially unemployed and seeking work, and 1,149,000 are outside the labour force. This last figure includes 505,000 15-24 year-olds outside the labour force. Reported Palestinian employment in Israel in 2002 is 50,000.

Not all of those people outside the labour force are "disguised" unemployed, but a substantial number of them are likely to be. So the estimated increase in labour demand is likely to be roughly equal to the number currently (officially and unofficially) unemployed. But it is possible that if the increase in labour demand were realised then there would be some excess demand for labour.

The average expected change in output due to a peace settlement in the sample of 51 firms for which data is available is 89.1%, but there are significant sectoral differences. Tourism is the most optimistic sector, followed by industry, which presumably expects an easing of import and export restrictions, which have hampered production and sales in the last years.

The services sector is the least bullish about expanding output.

The 2002 PCBS industry census provides the following figures for gross output and value added for the three sectors:

Table 5.1 Output in different sectors (US$ Mil), 2002

Sector	Gross output	Value added*
Industry	976.9	367.1
Tourism	32.1	13.0
Services	1025.0	716.4

* Gross output less intermediate input costs

If the three sectors grow at the same rate as the firms in the sample predict (93%, 127% and 69% respectively), the extra output and value added will be:

Table 5.2 Extra output and value added (US$ Mil)

Sector	Gross output	Value added*
Industry	908.5	341.4
Tourism	40.8	16.5
Services†	707.3	494.3
Total	**1656.6**	**852.2**

* Gross output less intermediate input costs
† Trade, retail, not financial services

5.2.3 Investment

The investment to output ratio in Palestine in 2002 was a mere 1%. This is very low by international standards and it is likely that firms are running down their capital stock, i.e., their investment spending is less than that required to replace depreciated capital. The 1999 ratio is similarly low (2.1%) showing that Palestinian businesses were already holding back in their investment before the Intifada. However, in 1994 (the earliest year for which data is available) the equivalent investment figure is 6% (corresponding to about 15% of value added).

This figure of 6% is in the normal range of investment ratios in international comparisons and we use it to forecast total investment in Palestine should the conflict be resolved. Thus the expected additional investment in the business sector would be 6% of US$ 1656 million = US$ 99.4 million of additional investment per annum by the existing business community if a lasting peace settlement is achieved.

Appendix 6

Statistical Analyses of Report Methodology

6.1 Sample statistics for the reported percentage contraction in employment, 1999-2004.

Table 6.1 Descriptive statistics

	Mean	Standard deviation
Whole sample	79.665	11.191
Industry only	82.413	14.244
Tourism	170.83	23.912
Services	34.330	16.189

Table 6.2 Regression equation for the % change in employment

Explanatory variable	Coefficient	Standard error	t ratio
Intercept	-1.6066	24.252	-0.066
Tourism sector dummy*	-77.783	28.198	-2.758
Log employment in '99	-22.944	8.384	-2.737

* dummy variable equal to unity if the i^{th} firm is in the tourism sector, and equal to zero otherwise.

$R^2 = 0.2888$
Equation standard error = 0.7788
Residual Normality test: $\chi^2(2) = 1.7433$ [p = 0.4183]
LM test for heteroskedasticity: F(3,59) = 0.8708 [p = 0.4614]

The t ratio on the log of employment in 1999 is significant at the 1% level; in other words the proportional decline in employment is significantly lower in smaller firms. The t ratio on the tourism sector dummy is similarly significant, indicating that the decline of employment in this sector is significantly higher for a given firm size.

When a dummy variable distinguishing between services and industry is added to the regression equation it is not statistically significant. (The F-test for adding the dummy is F(1,62) = 1.3624 [p = 0.2476]). In other words, once one has controlled for firm size, the decline in services employment is not significantly different from that in industry employment.

6.2 Sample statistics for the reported percentage contraction in output, 1999-2004.

Table 6.3 Descriptive statistics

	Mean	Standard deviation
Whole sample	52.426	9.016
Industry only	54.241	13.025
Tourism	79.500	22.181
Services	37.727	14.954

A regression of output contraction on initial firm size does not produce a statistically significant relationship. The F-test for the significance of log employment in '99 in such a regression equation is F(1,59) = 1.8638 [0.1774].

6.3 Sample statistics for the prospective percentage expansion in employment with a peace settlement.

Table 6.4 Descriptive statistics (1)

	Mean	Standard deviation
Whole sample	305.89	61.233
Industry only	301.85	89.407
Tourism	484.49	137.46
Services	208.03	104.59

Tourism firms are most optimistic, services firms least, but the sample is too small to say that this is true of Palestinian firms in general. None of these differences is statistically significant.

In order to test whether there is a significant correlation between current firm size and the degree of employment optimism, it is necessary to transform the data for prospective employment growth. This is because the distribution of percentage changes across firms is left-skewed.

A logarithmic transformation of the data produces an (approximately) symmetrically distributed variable. The transformed variable, x, is constructed as follows:

x = log of (% change in employment) if the reported change is > 0 = log of 0.5 times the minimum observed positive change in the sample if the reported change is equal to 0.

Table 6.5 Regression equation for x

Explanatory variable	Coefficient	Standard error	t ratio
Intercept	5.6459	0.3377	16.717
Log employment in '04	-0.3324	0.1413	-2.352

$R^2 = 0.0929$
Equation standard error = 0.7788
Residual Normality test: $\chi^2(2) = 0.2983$ [p = 0.8615]
LM test for heteroskedasticity: F(2,51) = 3.1302 [p = 0.0522]

Small firms are significantly more optimistic, even though they have shed less labour.

There are no significant sectoral differences here. The test for adding two sector dummies in the regression is: F(2, 52) = 1.629 [p = 0.2060].

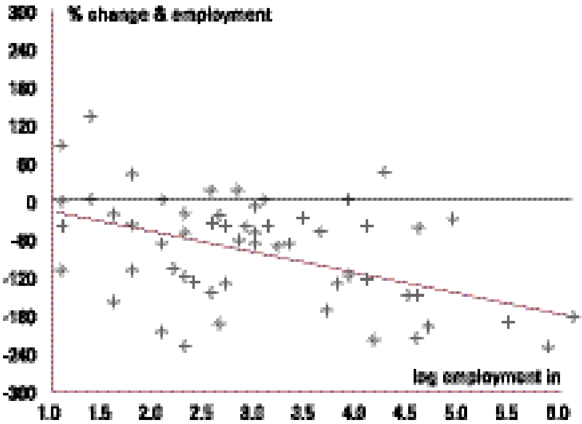
Table 6.6 Descriptive statistics (2)

	Mean	Standard deviation
Firms of fewer than 5 employees	404.91	571.68
Firms of between 5 & 19 employees	244.18	385.75
Firms of more than 19 employees	237.50	330.98

So small firms (1-4 workers) predict a 400% increase in employment, and larger ones (5+ workers) predict a 240% increase in employment. The standard deviations are quite big here, but the difference is significant when the data is transformed as above.

6.4 Sample statistics for the prospective percentage expansion in output with a peace settlement.

Figure 6.1 Scatter plot of employment change & initial firm size, with regression line



† What is being measured is 100 times the change in the logarithm of employment

Table 6.7 Descriptive statistics

	Mean	Standard deviation
Whole sample	89.059	58.107
Industry only	93.174	1.621
Tourism	126.88	19.705
Services	69.200	12.463

The low sectoral standard deviations indicate the sectoral differences to be statistically significant. The F-test for the significance of sectoral differences is $F(2,48) = 3.1738$ [$p = 0.0508$]. Tourism is definitely the most optimistic sector, and services the least.

A regression of prospective output increases on firm size in 2004 does not yield a significant coefficient. The F-statistic for the significance of the firm size variable is $F(1,47) = 0.0659$ [0.7985].

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