

# **THE PROSPECTS OF SMALL SCALE INDUSTRY AND COMMERCE IN THE WEST BANK AND GAZA STRIP**

**Dr. Mohamed M. Nasr**

College of Commerce and Economics  
Birzeit University, Palestine

## **I. INTRODUCTION**

I shall start with a word on methodology. The term "small-scale" has to be defined. How small is "small"? And how to measure scale? These two questions have no straightforward answers. As far as scale is concerned, there have been different criteria to measure that. Value added, sales revenue, paid-in capital, value of assets, and number of employees have been often used, with no unique, optimal measure agreed upon by researchers. Fortunately, many studies have shown a statistically high correlation among these variables. Thus, the availability of data has been the primary determinant of using one measure or another. For this same simple reason, we shall use the number of employees in this paper to measure the size of business enterprise.

On the other hand, there is an agreed-upon disagreement on the term "small". The size of the market, the level of industrialization and development, and the existence of economies of scale are main determinants of the "smallness" of firms. While firms employing less than 500 persons are considered small in the U.S.A., Germany, France and Italy, firms of this size are considered very large in small economies like Jordan and the West Bank and Gaza.

## II. THE PRESENT SITUATION OF SMALL-SCALE INDUSTRY AND COMMERCE

A quick glance at table (1) shows that almost two-thirds of the industrial establishments in West Bank and Gaza employ 3 or fewer workers, 93 percent of these establishments employ 10 or less workers, and only 3 percent employ more than 20 workers. This table does not include the owner-operated establishments that do not employ workers, which exceed one thousand establishments, representing about 45 percent of total industrial establishments in the West Bank and Gaza.

**Table (1)**  
**Industrial Establishments by Number of Employees. 1991**

Number of Employees	WEST BANK		GAZA STRIP		Total	
	Number	Percent	Number	Percent	Number	Percent
1	559	28	387	23	946	26
2 -3	669	34	719	42	1388	38
4- 7	485	24	417	24	902	25
8 -10	80	5	95	6	175	4
11- 20	103	5	71	4	174	4
21 +	82	4	21	1	103	3
Grand Total	1978	100	1710	100	3668	100

Source: *Statistical Abstract of Israel, 1992.*

Two other studies by Haifa and Abu-Shokor et al show similar results. Haifa shows that 20 establishments in the West Bank employ 50 or more workers and only 3 establishments employ 200 or more workers<sup>1</sup>. Abu-Shokor et al found that in 1988-89 there were 425 establishments employing more than 7 workers, 97 establishments employing more than 20 workers, 21 establishments employing more than 50 workers, and only 8 establishments employing more than 100 workers<sup>2</sup>. Their study included establishments in East Jerusalem, and was based on a survey of all large firms (defined as employing more than 7 workers) and a stratified random sample of small establishments (employing 7 or less workers) in the West Bank. The study shows that about 35 percent of the establishments employing less than 8 workers are located in Hebron, 22

<sup>1</sup> Haifa (1989), pp. 40-41.

<sup>2</sup> Abu-Shokor et al (1992), p. 53.

percent in Ramallah, and 15 percent in Nablus. Most of those establishments (88 percent) are sole proprietorship and the remainder (12 percent) is joint ventures (private stock companies). These establishments are generally financed by owners, family members and friends. A survey mission of the World Bank found that private sector investment in productive sectors was almost entirely financed by owner's equity rather than by banking system<sup>3</sup>. This fact was confirmed by Abu-Shokor et al who found that about 63 percent of the small- scale establishments in the West Bank have self-financing and the remaining 37 percent obtained loans for their investment, which explains the small average capital investment of less than JD 11 thousand for those establishments<sup>4</sup>.

The importance of the role of small industrial establishments in the subsectors of the economy can be seen in tables (2) and (3). Two alternative size measures are used: the first one consists of establishments employing 1-3 persons, while the second one is a little broader and consists of establishments employing 1-10 persons<sup>5</sup>. Although percentage numbers are different in the two tables, the direction is, however, the same.

**Table (2)**  
**Industrial Establishment Employing (1 -3) Persons in the West Bank and Gaza by Subsector (1991)**

Subsector	West Bank	Gaza	West Bank & Gaza	Total Subsector	Share of Small Establishments
Food, Beverage & tobacco	18	75	93	360	26%
Textile, Clothing & Leather Products	215	245	460	976	47%
Wood & Wood Products	303	259	562	681	83%
Metallic Industries	401	314	715	885	81 %
Other Industries	291	215	506	789	64 %
Total	1228	1106	2334	3688	63%

Source: *Statistical Abstract of Israel, 1992.*

<sup>3</sup> World Bank (1993), vol. 3, p. 86.

<sup>4</sup> Abu-Shokor et al (1992), pp. 70.

<sup>5</sup> The numbers do not include establishments that do not employ workers.

**Table (3)**  
**Industrial Establishment Employing (1 -10) Persons in the West Bank and Gaza**  
**by Subsector (1991)**

Subsector	West Bank	Gaza	West Bank & Gaza	Total Subsector	Share of Small Establishments
Food, Beverage & tobacco	189	108	297	360	83%
Textile, Clothing & Leather Products	334	518	852	976	87%
Wood & Wood Products	355	314	669	681	98%
Metallic Industries	491	374	865	885	98 %
Other Industries	425	308	733	789	93%
Total	1794	1609	3403	3688	92%

Source: *Statistical Abstract of Israel, 1992.*

Most of those small establishments are concentrated on wood and wood products, metallic industries, textiles and leather, and food and beverage. 98 percent of the establishments in the metallic industries employ 10 or less workers. These establishments are mainly small blacksmith shops producing metal furniture, hand tools such as axes, hoes and other simple agriculture and garden tools. In the food, beverage and tobacco subsector, the small scale establishments represent 83 per cent of the total number of establishments. These include mainly bakeries, olive oil refineries, dairy product shops and the like. The other two subsectors of which small scale establishments have large share are textile, clothing and leather products (with 87 percent of the establishments employing 10 or less persons) and wood products (with 98 percent of the establishments employing 10 or less persons).

As table (4) indicates, these two sub sectors constitute about 45 percent of the total number of small scale industrial establishment (regardless of the size criteria used). However, most of the establishments in these sub sectors are subcontractors to Israeli enterprises, who benefit from the cheap labor in the West Bank and Gaza. A World Bank mission concluded that the principal reasons for the Palestinian enterprises to enter into subcontracting is the lack of access to Israeli and foreign markets, which is provided by Israeli enterprise, and the lack of working capital.

Unlike the research and data on the Palestinian industrial sector, there is no sufficient data on commerce. The number of commercial units in the West Bank and Gaza and their size distribution are not available. However, there are indications that the commercial sector also constitutes of a large number of very small comer stores and retailers, and a limited number of medium-size wholesalers. A study by Ramallah Chamber of Commerce and Industry found that most of those retailers deal with foodstuff, furniture, construction materials, electrical appliances, bookstores, meat distribution, ready-made clothes and textiles, and fruits and vegetables. As for the wholesalers, they generally depend on Israeli merchants and agents to supply them with needed merchandise for resale to retailers. A study by EI-Jafari estimates the number of wholesalers to be around 1500 in the West Bank and around 1000 in Gaza<sup>6</sup>.

**Table (4)**  
**The Share of Small Scale Establishment in Industrial Subsectors (1991)**

Subsector	1 -3 Persons		1 -10 Persons	
	Number of Establishments	Percent	Number of Establishments	Percent
Food, Beverage & tobacco	93	4%	297	9%
Textile, Clothing & Leather Products	460	20%	852	25%
Wood & Wood Products	562	24%	669	20%
Metallic Industries	719	31%	865	25%
Other Industries	506	21%	733	21%
Total	2334	100%	3403	100%

Source: *Calculated based on Statistical Abstract of Israel, 1992.*

Most of those wholesalers are small scale enterprises accounting for approximately one percent of the labor force in both regions<sup>7</sup>. The study does not give data on the number of retailers in the West Bank and Gaza, but it quotes preliminary data from the Chamber of Commerce in East Jerusalem indicating that the retail outlets of commerce in the West Bank averaged only one employee per outlet<sup>8</sup>. This means that the retail

<sup>6</sup> EI-Jafari, p. 105.

<sup>7</sup> *ibid.*

<sup>8</sup> *ibid.*

business is very small-scale enterprise in general. Medium size supermarkets exist in the main cities of the West Bank and Gaza, but they do not represent a noticeable proportion of the commercial enterprises. The large supermarkets also exist, but they are limited in number. On the other hand, many of the industrial establishments in the West Bank and Gaza sell their products directly to customers (95 percent) rather than through agents, wholesalers or other marketing methods<sup>9</sup>.

These studies and statistics confirm the simple fact that the Palestinian industry and commerce is, in general, a small-scale enterprise sectors. This situation did not develop purely as a result of market forces and efficiency considerations but, rather, as a result of 27 years history of accumulated distortions caused by the Israeli occupation of the West Bank and Gaza.

This is not to say that market forces (economies of scale, market size, etc.) have not been important, but to claim that the policies and procedures practiced by Israel have led to market distortions and misallocation of resources that have resulted in the present outcome of inefficient size distribution of industry and commerce. Therefore, a brief analysis of Israeli's policies and practices in the West Bank and Gaza would enable us to understand the problems that face the Palestinian industry and commerce at present, and to build a new strategy that would enable the small-scale enterprises to contribute significantly to the development of the new-born state.

### **III. THE IMPACT OF ISRAELI OCCUPATION ON SMALL-SCALE INDUSTRY AND COMMERCE**

During the last 27 years of occupation of the West Bank and Gaza, Israel has introduced and applied various policies and procedure that prevented or retarded the expansion of existing establishments and/or the entry of new ones into the Palestinian markets, with the result that the number of

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<sup>9</sup> Abu-Shokor et al (1992), p. 106.

business firms and the size of these firms are much less than expected had the Israeli occupation did not apply these policies and procedures.

First, A major policy implemented by Israel and seriously constrained the expansion and/or entry of business firms are the many restrictions imposed on granting permits for industrial projects, especially if those projects would be potential competitors to Israeli producers. It is clear that the expansion of small-scale establishments and entry of large one would mean better utilization of machines and human skills and would result in reduction of unit cost that would enable those establishments to compete with Israeli producers. The easiest way for the Israeli authorities to eliminate this potential competition is to deny permits to such large Palestinian projects and to constraint the expansion of the existing ones. This has clearly shaped the size distribution of establishments in favor of small ones.

Second, Israel has imposed a tax regime that adversely affected the industry and commerce in general, and small-scale enterprises in particular. This includes tax rates, tax assessment, and tax enforcement. For example, the current personal income tax rates in the occupied territories are higher than those in Israel and Jordan<sup>10</sup>. On the other hand, the tax law requires all tax payers to keep books of accounts in accordance with detailed regulation. For small-scale enterprise, this is a costly requirement. Failure to do so, however, means that the "best judgment" method of tax assessment will be applied. This method typically includes interest, fines, penalties, etc. Once tax assessment is made, the collection of these taxes starts. This includes night-time raids, confiscation of IDs, seizure and sales of machinery, equipments, and inventory<sup>11</sup>. This tax regime results in arbitrary and sometimes extraordinary high taxes that may end up with the closure of business enterprise.

Third, during the last 27 years, Israel has neglected any repairs or upgrading of the physical infrastructure in the West Bank and Gaza Strip.

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<sup>10</sup> World Bank (1993), vol. 3, P. 20

<sup>11</sup> *ibid.*

The conditions of roads has deteriorated, the electricity supply is very costly, the water supply is inadequate, the educational facilities, transportation and communications are in poor conditions, with the result that cost of production is increased, competition is decreased, and sales and distributions are constrained with a small geographical area. This, in turn, constrains the expansion of existing establishments and keeps small-scale ones.

Fourth, after 1967 war, Israel closed all Arab and foreign-owned banks and transferred their accounts to the Bank of Israel, leaving the occupied territories with no formal financial system. This means that investors would have to rely mainly on their own savings or on borrowing from friends or family members. This absence of organized, strong financial system has inhibited the expansion of existing business enterprises or the emergence of large new ones.

Fifth, Israel has frozen the permits to build houses on land beyond the municipal boundaries, which resulted in extremely high cost of land. This is reflected in the high cost of industrial space, which acted as a barrier to entry by many new establishments, especially small-scale ones. The high cost of land would also mean higher production costs for the industrial and commercial enterprises, and would adversely affect their competitiveness and retard their growth.

Sixth, the employment of Palestinian workers in Israel resulted in a reduction in the supply of labor which, in turn, resulted in a large increase in the wage level in the West Bank and Gaza Strip. However, although large enterprises can absorb these rising wages, the small-scale establishments would find it difficult to absorb.

Finally, there are many other policies that have been applied from time to time which adversely affected the expansion of existing small enterprises or retarded the entry of new (small and large) ones. These policies include the restrictions on the imports of raw materials needed for the industry and commerce in the West Bank and Gaza, restrictions on the exports other than to Israel, uncertainty, ever-changing legal conditions, mass

curfews, restrictions on movements, etc. All these policies have reduced the local market size, increase the cost of production, increase uncertainty, reduce efficiency, impose significant barriers to entry, etc. As a result of all that, small-scale establishments are discouraged to make any additional investment.

Lastly, it should be mentioned here that there are other factors, in addition to those caused by Israel, which helped the emergence of this large number of small establishments in industry and commerce. These factors include the poor endowment of natural resources available to producers, the small size of the market, the lack & marketing and distribution system, etc.

#### **IV. THE PROSPECTS OF SMALL-SCALE INDUSTRY AND COMMERCE**

The peace agreement between Israel and the Arab countries is expected to lead to a new era in the region. The next few years will represent a transition period, during which the structure of the economies of the Middle East will change. In the West Bank and Gaza, the change will be substantial and will affect all aspects of the economy. The final result will depend on the negotiations between the concerned parties. However, the reduction in the political uncertainty following the peace agreement, the removal of constraints imposed on the industry and commerce (partially or totally), and the trade arrangements that may be agreed upon by the parties will result in a substantial change in the economy as a whole, and in the size distribution of industrial and commercial establishments in particular.

Existing small establishments are expected to expand, new establishments (small and large) are expected to emerge, and new types of industries, commercial activities and technologies are expected to be introduced. These changes in the market structure are based on the assumption that the political and economic negotiations between the Palestinians and Israelis will succeed (to a large degree) in removing the distortions that

have prevailed in the Palestinian economy for the last 27 long years, and that a sound strategy to develop the industrial and commercial sectors is adopted by the Palestinian National Authority.

Like any small, less-developed economy, the small-scale enterprise will play an important role in the economic development of the West Bank and Gaza even after a peace agreement is signed. This is not to underestimate the role played by large-scale industries, which will become more and more important in later stages of the industrialization process. In fact, Anderson identifies three stages of industrialization: in the first stage, household manufacturing is predominant; in the second stage, small workshops and factories emerge at comparatively rapid rate; and in the last stage, large-scale production becomes predominant<sup>12</sup>. Clearly, the economy of the West Bank and Gaza did not reach the last stage yet, and we expect the small-scale enterprise to coexist with large-scale ones at all various stages, but their contribution to GDP and employment varies with the country's level of development. The emergence of large-scale enterprise at the expense of small-scale one can be explained in terms of large economies of scale.

However, the industries where economies of scale are not significant and not far reached would be more appropriate for small scale enterprises. The case of small corner stores all over the world is an example of this situation in commerce, while the case of light industries (bakeries, dairy product shops, blacksmiths, etc.) is an example of this situation in the manufacturing sector. The argument that large firms can always derive small ones out of business has not proven to be always true, either in theory or in practice. The more logical argument in this direction is that the efficient enterprise will derive the inefficient ones out of the market. The relationship between efficiency and size remains an empirical issue.

On the other hand, the market size is very important determinant of the number and size of firms in that market. With limited geographical area, like those of the West Bank and Gaza, the number and size of business

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<sup>12</sup> Anderson (1982), p.914; and Kirkpatrick, Lee and Nixon (1984).

enterprises tend to be small. Market size, however, can be expanded by capturing export markets, and can be contracted by opening local market to foreign competition. In this regard, the issue of efficiency is of greater importance if the Palestinian markets are opened to Israeli and non-Israeli producers.

Given the above argument, the small-scale enterprises in the West Bank and Gaza are expected to play a major role if they are given the opportunity to operate efficiently. Therefore, a strategy for the industry and commerce in the West Bank and Gaza should recognize the importance of small-scale enterprise and its role in the economic development of the country, and should set the rules and environment that would attract investors, including small investors, and encourage them to operate efficiently.

The Palestinians are considered among the brightest entrepreneurs and the best skilled professionals in the region. Their records in different parts of the world have proven that. On the other hand, although exact figures are not available, the financial resources that belong to the Palestinians outside the West Bank and Gaza is substantial. An appropriate strategy is to include policies that would attract those human and financial resources through developing a favorable investment environment and removing the obstacles that may discourage investors in general, and small one in particular. The goal of this suggested strategy is to develop a strong small-scale industry and commerce without neglecting the large-scale ones.

The basic elements of such a strategy should include the following:

- Relaxation of the regulatory and administrative constraints, especially those imposed by Israel, on the approval of investment.
- A tax reform that includes a review of current tax rates, assessment, and enforcement, with special attention to tax incentives to both small and large enterprises. However, due to the nature of small business, it

is suggested that the tax forms and procedures for this group be simplified.

- Upgrading physical, social and educational infrastructure, which includes repairing roads and transportation services, expanding electricity network and telecommunications, providing new water resources, etc. This would reduce the cost of production and increase efficiency.
- Establishing a sound financial system to help the industry and commerce in the West Bank and Gaza in general, and small enterprise in particular. To this end, an Industrial Development Bank may be established to help small projects and provide them with medium and long term loans. Furthermore, the commercial banks can be induced to provide finance for small projects through a "Credit Guarantee Fund".
- Development of business support services. This may include the establishment of an advisory unit, or a Small Business Administration (SBA), to help Palestinian small-scale enterprises in the areas of marketing, preparing feasibility studies, exploring export opportunities, preparing strategic plans, identifying appropriate technology and equipment, information services, etc.
- Establishment of fully-serviced industrial estates and expansion of existing one, with reliable utilities at reasonable prices. This would reduce the cost of land and, therefore, the cost of production.
- Improving the human resource base through training the work force and administrators, restructuring the educational and vocational system to meet the needs of small-scale industry and commerce through providing relevant courses and programs, etc.

Most of these principals are still under negotiation between the Palestinians and the Israelis. The ability of the National Palestinian Authority to develop a sound strategy for small-scale industry and commerce is subject to the product of these negotiations. However, a recognition of the role of small-scale industry and commerce is a

necessary condition for such sound strategy. The first draft of the Law of Encouragement of Investment in Palestine does not reflect this recognition. In fact, the proposal reflects a bias against small-scale industry and commerce as it grants tax exemption of 5 years for projects with \$500 thousands or more paid-in capital and 25 employees or more, 3 years exemption for projects with \$150 thousands or more paid-in capital and 25 or more employees, and 2 years exemption for projects with \$100 thousand or more paid-in capital and 10 or more employees. Clearly, this proposed law is intended to encourage the establishments of large business, and puts the small-scale establishments at a competitive disadvantage vis-a-vis large ones.

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