



Palestine Economic Policy Research Institute

Palestinian Services Sector and Its Role in Economic Development

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3. The internal scientific committee supervises the work of the researcher or team of researchers through periodic progress reports.
4. The initial draft of the study is reviewed by the scientific committee for objective content-related amendments to be added to the second draft.
5. The second draft is then submitted for evaluation in accordance with the terms of reference to two or three external academic experts specializing in the subject. Provided that there is a positive evaluation by at least two experts, the researcher is asked to review the study taking into consideration the objective recommendations of these experts.
6. The study is presented for discussion at a public workshop attended by academics, researchers, and representatives from public and private sector institutions related to the subject of the research.
7. Comments and feedback from the workshop are incorporated into the study and the final draft is reviewed by the scientific committee to ensure that the necessary amendments have been made. The study is then edited.
8. Research papers written in English are translated into Arabic and published in both languages. An executive summary in English is attached to research papers written in Arabic.

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Summary

Introduction

This study analyzes the role of the services sector in the development of the Palestinian economy in terms of contribution to Gross Domestic Product (GDP), employment, investment, and the balance of trade. In addition, the study investigates the constraints impeding the development of Palestinian services and potential for improvements.

The study is based on a two-dimensional analysis, both theoretical and applied, of the services sector, classified according to function: distribution services, production services, social services, individual and private services, tourism, financial intermediation firms, maintenance and repair-related services, and public sector services. This classification is used to differentiate advanced economies from those of developing countries. While production services dominate in developed economies, wholesale and retail trade services, along with maintenance and repair services, are the most important in developing economies.

The study relies on data published by the Palestinian Central Bureau of Statistics (PCBS) for the years 1995-2000. The first chapter analyzes the role of the services sector in the Palestinian economy. Chapter two traces the development of services provided by the public and private sectors. Chapter three evaluates the performance of the services sector in the Palestinian Territories while chapter four presents and discusses the major obstacles hampering its development. Chapter five assesses the damages and losses incurred by the Palestinian services sector since the outbreak of the Al-Aqsa Intifada due to Israeli measures. Chapter six concludes with recommendations to improve the services sector.

Performance of services sector

The contribution of the services sector to GDP rose from 46.7% in the mid-1970s to 52.2% between 1995-2000 and more than 61% of the Palestinian labor force were employed in the services sector. There was marked expansion in wholesale and retail trade services and domestic transportation services in the West Bank and Gaza Strip. Around 75.7% of service activities were concentrated in internal trade while the transportation sector contributed 11.9%, real estate 7.1% and financial

intermediation firms 16.3%. Internal trade employed around 62.5% of all service sector employees. The health and social work, education, and transportation sectors (formal and informal) absorbed 9.2%, 8.1%, and 9.7% respectively. Internal trade contributed 49.2% to the total production of service activities, followed by the transportation sector and financial intermediation firms, each with 14.2%.

The significant increase in relevant indicators of health, education, and social services, such as the rise in the number of teachers, students, and physicians, was not coupled with an increase in current expenditure. The Ministry of Education's share of current expenditures dropped from 20.3% in 1995 to 17.5% in 2002. Current spending on health did not exceed 11.1% between 1995-2002 and current expenditure by the Ministry of Social Affairs was only 5.4% during the same period. The Palestinian public sector is therefore facing tremendous problems, which have led to a drop in the quality of services provided.

The financial intermediation and insurance sector represents a small percentage of the number of institutions and employees operating in the services sector. There were 45 firms (excluding money changing businesses) employing 4,000 people. The value of their production topped \$220 million in 2000. The banking sector is the largest financial sector and includes all banks operating in the Palestinian Territories, in addition to credit institutions, moneychangers, and the Palestinian Monetary Authority. In 2002, there were 23 banks; three investment banks, four Islamic banks, 15 commercial banks, plus Palestinian banking institutions. Bank capital formation was \$250 million in 2000 but dropped to \$225 million by the end of June 2002. Deposits rose by 98% between 1996 and June 2002. Commercial banks in the WBGS invested a significant percentage of their deposits abroad. In 1996, deposits invested abroad made up 68% of total deposits but this dropped to 59% by the end of June 2002.

Credit facilities rose from \$423.9 million in 1996 to \$1,2120 million in 2001, or by 188% between 1996-2001, averaging annual growth of 28%. However, figures fell by 9% in 2001 compared with 2000. In 1996, the credit-deposit ratio was 24% and increased to 30% in 2002. The highest average was 38% in 2000 but these percentages are low in comparison with neighboring countries and demonstrate the modest role of banks in financing economic enterprises in the Palestinian Territories. This conclusion is reinforced by the figures for development lending, which includes the agricultural, industrial, and construction sectors. By the end of

June 2002, development lending represented only 27% of all credit facilities provided. In the same period, the share of non-developmental lending totaled 77%.

Service sector problems

1. Banking sector

All banks in the Palestinian Territories are suffering from a number of obstacles which have forced them to adopt very strict credit policies. Banking services concentrate on short-to-medium term credit directed primarily towards serving the commercial sector. Constraints facing this sector include the lack of political and economic stability in the Palestinian Territories due to Israeli occupation, thereby increasing investment risks. In addition, the absence of a national currency leads to bank surpluses being transferred abroad. Banking institutions also suffer from a shortage of expertise and efficiency.

2. Insurance companies

Like the banking sector, insurance companies have several problems which have negatively affected the level of their services. Some of these problems result from practices implemented by the insurance companies themselves, including price "wars" which led to prices being reduced much below the market value at the expense of the quality of service provided. Also, insurance companies have failed to abide by the regulations of the insurance controller. Companies have either failed or been late in supplying accurate reports, data, and financial statements necessary for supervision by the controller, particularly concerning their accounts. This has prevented companies from having their performance monitored or measures taken against them to halt mistakes or violations.

The inadequate performance of government bodies created further problems for insurance companies. These bodies include the insurance controller, the police, judiciary, and the Ministries of Health and Labor. There has been no legislation to control and regulate the insurance industry and specify company commitments and responsibilities. Insurance companies, particularly foreign ones, can obtain a license easily. Foreign companies are treated differently from Palestinian ones, particularly regarding minimum capital. Control over the activities of insurance companies is poor, given the shortage of human, technical, and capital resources available to the insurance controller. In addition, insurance tenders for projects granted by the

Palestinian National Authority (PNA) have lacked clarity and transparency. The police have been lenient in policing uninsured vehicles and there is also 'free play' in the reporting of accidents. Some physicians have "sympathized" with victims of accidents covered by insurance companies when it came to the assessment of disabilities resulting from injuries.

The lack of an insurance culture among individuals and institutions has resulted in low purchasing of insurance services, particularly car insurance, work accident insurance, and life insurance. As a result, insurance companies are deprived of the large financial returns that would result if there was a higher level of awareness about insurance among individuals and institutions. Also, lawyers tend to exaggerate compensation claims, particularly when their fee is calculated as a percentage of the compensation received by the claimant.

3. Palestine Securities Exchange (PSE)

Up to now, there is no legislation to regulate the activities of the PSE, nor any independent supervisory authority. Financial disclosure procedures are weak, as is the role of brokerage firms, and there is little public awareness about securities. All these factors have weakened the volume of trading and limited the role of the PSE to mobilizing financial resources and directing them towards productive investment.

4. Other services activities

The services industry faces a number of impediments. The main ones are weak infrastructural services and restrictions on investments in the private sector and in legislative and institutional frameworks. Infrastructure services, namely electricity, transportation, and telecommunications, have been consistently neglected for decades since they were controlled by the Israeli military authorities and there was little public investment in them. The Israelis actually restricted any development in these services in order to increase dependence on Israel.

There have also been severe restrictions on investment. The lack of stability and difficulties in financing were the most challenging obstacles facing investors between 1994-2000. Related problems were high interest rates and the lack of necessary guarantees to obtain finance. All these constraints significantly affected the involvement of investors in the production of major and ancillary services and has

contributed to a drop of investment in a number of industries. This has led to a drop in demand for ancillary services that support major services. Political instability caused a downturn in tourism which was reflected in a number of service activities such as transportation, restaurants, and hotels.

Surveys of the private sector to evaluate the services provided by government ministries and other institutions found that the performance of both the Ministry of Economy and Ministry of Agriculture was very poor, particularly in terms of the organization and regulation of internal trade (retail and wholesale trade) and trade agents. These findings were similar to those monitoring the performance of the Ministry of Industry in terms of developing technical and administrative skills, entry into new market outlets, and the promotion of national products in foreign markets. The Palestinian Legislative Council failed to approve economic-related legislation. Overall, PNA institutions performed poorly, particularly in economic fields.

Impact of Israeli measures on services sector

Since October 2000, the Israeli policy of siege and closure imposed on Palestinian areas has had a destructive effect on the Palestinian economy. The services sector suffered heavy losses in all activities, as summarized below:

- The tourism sector slowed down in all areas. PCBS data showed a significant drop in the number of hotels from 108 in the first quarter of 2001 to 70 in the first quarter of 2002. Around 80% of hotel and restaurant workers were unemployed, with the number of employees in this sector falling from 8,401 in 2000 to 2,500 by September 2002. Financial losses in this sector were around US \$628 million. Investment also slumped by around US \$50 million between 2000-2002 according to Palestinian Ministry of Tourism reports.
- The transportation sector also incurred heavy losses of around US \$1,494 million. The number of employees fell by 40%, particularly among bus and truck drivers. The telecommunications and postal sector lost US \$92 million.
- Losses in the retail and wholesale sector totaled US \$250 million and the number of employees fell by 50%. This sector is considered to be one of the most important service activities as it absorbs 60% of employees in the services sector.

- Education was subjected to heavy losses, both direct and indirect. The persistent blockade and siege imposed on the Palestinian Territories prevented students and teachers from reaching schools and universities and disrupted the educational process for long periods of time. Furthermore, around 185 schools were bombed during the recent Intifada, 60 more were stormed, seven closed down, and 11 others transformed into military posts. Studies in 850 schools were disrupted as a result of Israeli measures.
- Like other sectors, the health sector sustained heavy damage while the events of war exposed its inherent weaknesses. It was found that the health sector has a significant shortage of qualified personnel and medical supplies. Israeli soldiers attacked ambulances 240 times, destroying 34 of them. Hospitals and health centers were also attacked, including medical teams, and 18 medical staff and civil defense employees were killed during the Al-Aqsa Intifada.

Banking activities reduced significantly and by the end of August 2002, deposits had fallen by 9.8% compared with September 2000. Private sector deposits also declined by 8% during the same period. Credit facilities experienced a significant fall of 34.4%, primarily in overdrafts which declined by 42.5% or US \$382 million. Loans were also down by 17%. Credit facilities offered to the public and private sectors fell by 29% and 45.4% respectively. The losses of financial intermediation firms, including those of banks, were estimated at US \$9.1 million during the fourth quarter of 2000.

In the Palestine Securities Exchange, the daily average trading volume plummeted by 81.7% during the first five months of 2002 in comparison with 2000. The market capital of the listed companies dropped from one billion dollars to US \$600 million by the end of 2000. The companies listed on the PSE lost around 40% of their market value. The benchmark Al-Quds Index dropped and closed at 144 points by the end of December 2002. Its maximum value was recorded in April 2000 when it closed at 293 points.

In the insurance sector, turnover reduced significantly as institutions and individuals were reluctant to buy insurance. The number of uninsured vehicles rose from 45% prior to the outbreak of Al-Aqsa Intifada to around 70% at present, a phenomenon aggravated by the lack of attempts by police to control it. The Ministry of Labor made little attempt to ensure private institutions had insured employees against work accidents and the insurance controller also failed to follow up illegal practices by insurance companies.

Suggestions to improve service sector performance

Any improvement in the role of the services sector in the Palestinian economy depends largely on the public and private sectors implementing supportive measures to enhance labor force absorption in this sector and increase its contribution to GDP. These recommendations can be summarized as follows:

- ✧ The public and private sectors must focus primarily on creating high wage and productivity job opportunities. They should strengthen partnership and cooperation between the services sector and other economic sectors rather than continuing with the present status where the performance of the Palestinian services sector is only a response and reflection of external elements exemplified in offering marketing and import services from Israel through retail and wholesale trade and local transportation services, which expand their activities to provide transport for workers between the Palestinian Territories and Israel.
- ✧ To significantly increase the role of Palestinian services in local and export markets, the relevant authorities need to formulate effective and appropriate policies based on data covering all services activities: consumption, investment, production, imports and exports. There are numerous other activities that have not been identified and documented although they are considered within the unorganized informal economic sector.
- ✧ Establish a legal environment pertinent to licensing, taxes, quality, standards, foreign investment, rules, and regulations associated with the flow of services to foreign economies.
- ✧ Specify the role of public and private sector institutions in services production. Rules and conditions, particularly related to quality and standards, must be adhered to.
- ✧ Enhancement of the role of distribution services, such as retail and wholesale trade and transportation, will depend on the contribution of agriculture, industry, and construction to GDP and will be directly reflected in the role of these services in replacing imports with local products. The relevant authorities must formulate industrial and agricultural policies to strengthen the role of these sectors in producing competitive goods for local and export markets.
- ✧ Encouraging the industrial, agricultural and construction sectors in the long term will depend largely on the extent to which high quality production services such as banking, financial insurance, real estate, construction, design, engineering, professional, and legal services are available.

There are numerous services that do not meet international standards or quality control in packaging, promotion and advertising, trucking and transportation, and computer services.

However, development of all branches of the services sector including social, personal, production, basic, and distribution services hinges upon the availability of trained and qualified human resources proficient in dealing with technology. Policies therefore need to be taken to restructure university programs to ensure their output is consistent with the needs of both the public and private sectors. Graduates should have the potential and ability to keep abreast of international developments in technology, particularly information technology, as this is a basic requirement for the development of all branches of the services sector.

The following are some specific suggestions to improve the performance of the financial sectors:

1. Banking sector

- ✧ Encourage the merger of small banks to strengthen them financially and improve their services and ability to offer medium and long-term loans.
- ✧ Develop mechanisms for long-term borrowing and for small and medium-enterprise finance.
- ✧ Develop judicial independence from the executive. In addition, establish effective trade courts to settle business disputes that cannot wait under the present judicial system.
- ✧ Apply measures when loan payments are not made.
- ✧ Implement legislation relating to the monetary authority to guarantee its independence and develop its role in creating a sound and competitive banking environment.
- ✧ Grant greater powers to the Palestinian Lands Administration Authority, speeding up land surveys and facilitating land registration to make it easier for real estate to be used as a guarantee for banks.
- ✧ Develop the legal framework for the introduction of municipality and company bonds and leasing finance as mechanisms for long and medium term finance.
- ✧ Enact a transferable mortgage law as a guarantee for bank loans and mechanisms for the appropriate registration of these mortgages.
- ✧ Develop the credit market between banks and encourage the exchange of information. In addition, develop data sources, statistical information, and sectoral studies and make them available to banks.

2. PSE
 - ✧ Speed up the enactment of a securities law to regulate the work of the PSE and establish a financial controlling authority.
 - ✧ Develop the financial disclosure system, thereby contributing to improved transparency and efficiency in the PSE.
 - ✧ Increase the margin available for change in share prices to more than 5% (effective at present).
 - ✧ Activate the role of financial intermediation firms by introducing consultancy services for share traders.

3. Insurance companies
 - ✧ Speed up the enactment of the Palestinian Insurance Law and other legislation relevant to the organization and regulation of the insurance market in the Palestinian Territories.
 - ✧ Encourage greater control of activities by the insurance companies' controller, including legal measures against companies and agents in violation of rules and regulations.
 - ✧ Urge the police to exert stricter control over uninsured vehicles and ensure accident reports are accurate. The Ministry of Labor needs to check businesses to guarantee that employees are legally insured.
 - ✧ Adopt a licensing policy for insurance companies and agents on the basis of their economic feasibility and Palestinian market needs.
 - ✧ Display transparency when inviting tenders for the insurance of public property and projects.
 - ✧ Adopt a policy of reciprocity when licensing foreign companies.

