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Dynamics of Small and Medium-Sized Enterprises:
Evidence from the Occupied Palestinian Territory

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Abstract

The development of small and medium-sized enterprises has long been regarded as a seedbed for industrialization and the achievement of broader economic objectives of developing countries. In the case of the future State of Palestine, the importance of these enterprises as an engine of growth is even more crucial, especially in view of the economic legacy of occupation, the economy's deep-seated structural weaknesses, and limited size of local markets.

Based on the findings of UNCTAD's survey-based study on the prospects of developing the Palestinian SMEs,¹ this paper examines the reasons behind the SMEs' limited presence. This is done through shedding light on these enterprises' life cycle and the factors influencing their birth, survival, growth and closure along with the determinants of these change components before and after the on-going crisis. The paper focuses on SMEs in the industrial, construction and tourism sectors. The choice of these sectors stems from their large contribution to the growth and employment of the Palestinian economy.

The paper shows that the development prospects of Palestinian SMEs are limited by political instability, and the arrangements governing the Palestinian economy's relations with Israel. Although the period 2000-2002 saw the growth of some SME branches, these positive developments are undermined by the proliferation of the protracted conflict and the lack of concerted efforts targeting the SMEs growth dynamics. These can only be addressed within the context of a cohesive sector-focused development strategy that creates synergy between trade and industrial policy, while targeting existing growth bottlenecks at the micro, meso and macro levels.

Keywords

Palestinian SMEs; SME dynamics; development aid.

¹ United Nations Conference on Trade and Development (UNCTAD), *Palestinian Small and Medium-Sized Enterprises: Dynamics and Contribution to Development*. UNCTAD: Geneva, 2004.

I. Introduction

The contribution and significance of small and medium-sized enterprises (SMEs) as an important engine of growth is receiving increased attention in both developed and developing countries. These enterprises are often considered as the backbone of the economy, providing major sources of technological development and new jobs, and a seedbed for entrepreneurship. Such a prominent role is mainly attributed to their flexibility in responding to emerging opportunities, and resilience in the face of adverse conditions. If anything, SMEs are the most competitive sector in a Darwinian sense. They are in a constant state of evolution, with successful enterprises graduating into large firms and new firms emerging to replace the ones that have been forced out of the market. During periods of recession, they can constitute a safety net for troubled economies to survive the crisis.

In the case of the occupied Palestinian territory, SMEs form a minority, accounting for only 9 percent of total registered establishments in 1999 (PCBS, 1999). Moreover, there is evidence of a missing middle, with small enterprises constituting 91 percent of total SMEs in the same year. The development of these enterprises ranks high on the Palestinian Authority's (PA) policy agenda. However, relatively little is known about the dynamics determining their birth, expansion and closure. A solid understanding of these dynamics gains much importance at this critical stage of the development process, whereby policy makers are struggling to enhance the economy's resilience in the face of a widespread economic crisis and set the stage for its sustained recovery. This difficult task is further complicated by a legacy of prolonged occupation, forced attrition and distortion of the economic structure, and the fierce competition in regional and global markets, shaped by innovation, liberalization and organizational restructuring. Enterprises are facing increasing pressures as the criteria that defines best practice in production are continually evolving to reflect the constant pace of upgrading in both product and process technologies. They are also continually seeking to adhere to international standards on quality assurance, environmental standards, labour norms and even social ethics, all of which are becoming critical determinants of global competitiveness.

This paper examines the factors influencing Palestinian private SMEs growth, with the aim of providing new illumination concerning the patterns of these enterprises birth, survival, growth and closure along with the determinants of these change components before and after the crisis since 2000. In so doing, it focuses on SMEs involved in the industrial, construction and tourism sectors, given their important role in generating growth as measured by their contribution to employment and gross domestic product (GDP). Within the industrial sector, the study focuses mainly on those activities that demonstrate a heavy concentration of SMEs, including mining and quarrying, the manufacturing non-metallic products, food and beverages, wearing and apparel and furniture.

The paper draws on the findings of UNCTAD's survey-based study on Palestinian SMEs. The survey was implemented by the Palestinian Central Bureau of Statistics (PCBS) in cooperation with UNCTAD, covering the period June 2000-June 2002 (PCBS, 2003). The survey involves a structured sample of 15 percent of the population frame (3735 enterprises), whereby enterprises are classified according to the size of their workforce. Enterprises employing 5-19 persons are considered as small, while those employing 20-50 persons as medium.² The survey covers a number of issues related to SMEs' growth and performance, including their productivity, contribution to innovation and technological progress, backward and forward linkages, their responsiveness to economic policies, adaptability to shocks and crisis, as well as their needs.

2 This is consistent with the PCBS approach, whereby enterprises are classified in accordance to the size of their workforce. The PCBS establishment consensus divides enterprises into the following five categories: (i) enterprises employing less than 4 persons; (ii) enterprises employing 5-9 persons; (iii) enterprises employing 10-19 persons; and, (iv) enterprises employing 50-99 persons; and (v) those employing more than 100 persons. See PCBS, 1998.

The findings of the survey were supplemented by structured and open-ended interviews that were conducted in 2001 and 2002 on the present problems and future challenges facing Palestinian SMEs with local and international business support institutions, entrepreneurs, bankers and PA officials. The analysis has also benefited from sectoral and other statistics made available by the PCBS on the targeted SMEs main performance indicators, including their contribution to GDP and employment in 1999, 2001 and 2002.

The paper starts by providing an overview of the SMEs contribution to the industrial, construction and tourism sectors, before presenting their static picture that emerges from the survey. A discussion of the major forces influencing their growth comes next, including an examination of the new evidence on the turbulent process of these enterprises creation and closure as well as their expansion. This is followed by an analysis of the enterprises' response to the crisis, and its impact on their salient features and main performance indicators, and a proposed policy framework for guiding future development efforts, leading to specific proposals at the policy, programme and project levels that are also informed by the experiences of other developed, developing and war torn countries in the area of SME development.

II. Profile of Palestinian Industrial, Tourism and Construction SMEs

Research to date on Palestinian SMEs has treated these enterprises as a homogenous group sharing common structures and salient features. The results of the PCBS/UNCTAD field survey reveals several areas where the two groups (small and medium-sized enterprises) demonstrate contrasting features. This sub-section highlights these differences using 1999 data, with a view providing a context for examining the growth determinants of these enterprises before and after the crisis. The next section singles out the major forces that influenced SMEs growth before the crisis, while section IV examines the impact of the crisis on the SMEs growth path.

A. Contribution to Growth

As shown in Table II.1, despite their limited share of total establishments, SMEs enterprises have a strong presence in the surveyed sectors and stand as a major source of employment and production growth.

Table II.1- SMEs Contribution to Industrial, Construction and Tourism Growth. RWBGS, 1999

Performance indicator	Contribution to Industrial growth	Contribution to Construction growth	Contribution to tourism growth
Share of total employment	58	71	44
Share of total VA	56	73	62
Share of total output	62	69	57
Share of GFCF	40	24	17
Share of total compensation	67	75	69

B. Size and Ownership

SMEs are dominated by small enterprises, accounting for 92 percent of the surveyed enterprises on average. Small enterprises drive the SMEs sector, accounting for 76 percent of its work force, 71 percent of total value added, 69 percent of total output, 67 percent of gross fixed capital formation (GFCF) and 68 percent of total employment compensation. The surveyed enterprises are also dominated by family-owned businesses, accounting for around 65 percent of the surveyed enterprises. However, this is mainly a feature of small enterprises, showing a high sole-proprietorship ratio of 67 percent on average. Medium enterprises feature a stronger presence of partnership structures, with enterprises registered as sole proprietorship accounting for 37 percent of total medium enterprises only.

C. Location

Palestinian industrial, construction and tourism SMEs are mainly concentrated in the remaining West Bank areas (RWB, excluding Jerusalem), which accommodate 71 percent of these enterprises.³ These enterprises also show tendencies towards industrial agglomeration in major towns. For example, manufacturing enterprises are mainly located in Nablus, Hebron and Gaza (PCBS, 1998). However, only 24 percent of the surveyed SMEs are located in industrial zones. The majority (around 50 percent) operate from residential areas located on heavily trafficked roads, particularly those involved in the manufacturing of wearing and apparel products and construction activities. The remaining enterprises are located in commercial areas, particularly tourism SMEs and small-sized food and beverages manufacturing enterprises.

D. Entrepreneurial Profile

Around 47 percent of the surveyed SMEs in the RWB areas and Gaza Strip (RWBGS) are owned by middle-aged entrepreneurs between 36 and 45 years old. Entrepreneurs between 46 and 55 years old own 30 percent of these enterprises, while the rest are mainly owned by older entrepreneurs. This is particularly the case of medium-sized enterprises, of which 24 percent belong to entrepreneurs who are more than 56 years old. The majority of the entrepreneurs (more than 70 percent) have prior business experience in areas related to their present activities. However, they lack formal training. This is mainly the case of small enterprises, with 44 percent of the owners lacking formal training beyond elementary education.

E. Composition of Activities

The majority of the surveyed enterprises are engaged in the production of final goods. This is mainly the case of Gaza based SMEs, where 91 percent of the enterprises produce final products, reflecting a limited industrial base that lacks enterprises specialized in the production of intermediary goods. In contrast, 78 percent of West Bank-based small enterprises and 72 percent of medium enterprises are involved in the production of final goods.

Furthermore, industrial SMEs are heavily concentrated in three sectors, namely the textile sector, non-metallic products and food and beverages. These accommodate 60 percent of the SMEs, with 30 percent of the enterprises involved in the manufacturing of wearing and apparel products, 21 percent in non-metallic products and 11 percent in the manufacturing of food and beverages.

F. Labour Force Characteristics and Management Structures

The surveyed SMEs labour force is made up primarily of paid workers, accounting for 80 percent of their total work force in 1999. However, 87 percent of the paid labour force is engaged in operative tasks related to production, with only 9 percent involved in managerial activities and 4 percent in marketing, accounting and other managerial activities. This reflects informal management structures, whereby owners undertake most of the managerial and administrative activities.

G. Backward and Forward Linkages

1. Linkages to markets: The market linkages between SME enterprises are limited, with approximately 40 percent selling directly to final consumers rather than to other firms. SMEs engaged in foreign trade demonstrate a greater tendency to operate through market intermediaries, with only 25 percent of medium enterprises and 28 percent of small enterprises selling directly to buyers. However, those selling through intermediary channels are more dependent on Israeli agents. The survey shows that only 15

3 This is only to be expected given the small size of the Gaza Strip. The West Bank is 5,800 square kilometres in area, while the Gaza Strip covers 365 square kilometres.

percent of the medium enterprises and 3 percent of the small enterprises sell through Palestinian agents. In contrast, 22 percent of the medium enterprises and 15 percent of the small enterprises sell through Israeli agents. This is especially the case of SMEs engaged in the wearing and apparel industry.

2. Sources of raw materials and equipment: Palestinian SMEs import a large share of their raw materials and all of their equipment needs. Israel stands as the main source of raw materials, especially for SMEs involved in the manufacturing of wearing and apparel products, food and beverages and furniture. Apart from Israel, Europe stands as the second main source of SMEs' raw materials, especially for those operating in the West Bank. Europe also stands as the major source of equipment, followed by Israel, except for the West Bank based small enterprises that are heavily reliant on Israel.

3. Sources of finance: More than 80 percent of the surveyed enterprises rely on their personal savings for covering their start-up and operating costs. Bank loans do not figure as an important source of finance for SMEs, except for West Bank based medium enterprises. Banks are the second source of finance for 49 percent of these enterprises. In contrast, only 18 percent of small enterprises benefit from bank loans, and the percentage of Gaza based medium enterprises accessing bank loans does not exceed 4 percent. As such, SMEs rely on other sources; particularly moneylenders, leasing and suppliers credit loans. Some enterprises also make use of market finance (equity issues and bonds) through informal channels, since they are not listed in the Palestinian stock market.

4. Involvement in e-commerce: The majority of the surveyed SMEs do not make use of the Internet in fostering their backward and forward linkages. Less than 10 percent of the enterprises have a website, which they mainly use for promotional purposes. Medium-sized tourism enterprises stand as an exception with 83 percent of the enterprises having websites.

5. Industrial subcontracting: Only 22 percent of the SMEs are involved in industrial subcontracting arrangements. Israel is the main subcontractor of 55 percent of these enterprises, continuing a trend that was established during the occupation period. These enterprises are mainly medium-sized engaged in construction activities and the manufacturing of food and beverages and wearing apparel products. Indeed, Israel accounts for 94 percent of the wearing and apparel medium enterprises subcontracting arrangements.

In contrast, small enterprises are mainly involved with local partners that account for 52 percent of these enterprises contracting arrangements. Subcontracting with regional and multinational companies have begun to surface in certain activities, including all (100 percent) food and beverages manufacturing medium enterprises and 76 percent of wearing and apparel small enterprises. By and large, the SMEs' subcontracting arrangements involve labour-intensive tasks and offer the enterprises with limited benefits, including advanced payments, on the job training, supply inputs in addition to machines and equipment.

H. Production Process

Palestinian industrial, construction and tourism SMEs are mainly engaged in labour intensive activities, with the amount of fixed capital per worker (capital to labor ratio-K/L) standing at \$8,331 on average in 1999. Needless to say, small-size enterprises are more labour intensive than medium enterprises, showing an average amount of fixed capital per worker of \$7,261 as compared to \$11,667 for the medium enterprises.

These aggregate figures mask variations in the relative importance of the labour factor in the SMEs production process. To be more specific, the surveyed SMEs can be grouped into low capital intensive, medium capital intensive and high labour intensive. Those belonging to the first group include the enterprises involved in the manufacturing of wearing and apparel and furniture products, with the average amount of fixed capital per worker, at \$1,603 and \$4,100 respectively. SMEs involved in the manufacturing of non-metallic products and construction activities represent medium labour intensive industries, with the average amount of fixed capital per worker standing at \$8,161 and \$9,627, respectively. Enterprises belonging to the third group are involved in mining and quarrying activities (\$18,839 per worker) food and beverages manufacturing (\$16,096 per worker) and the remaining manufacturing activities (\$13,130 per worker).

It is worth noting that, except for those involved in tourism activities, the SMEs are not more productive than the sectors in which they operate, as measured by labour productivity.⁴ Moreover, contrary to observed trends, capital-intensive enterprises do not score the highest labour productivity levels. In 1999, construction SMEs produced the highest value added per labour unit and were more than twice as productive as all surveyed enterprises on average. These yielded \$24,746 of value added per labour, thereby exceeding the average level of labour productivity for all surveyed enterprises that stood at \$10,482. Mining and quarrying, and food and beverages SMEs also showed above average labour productivity levels. However, they lagged behind construction enterprises, producing \$15,241 and \$13,931 of value added per labour, respectively. Tourism SMEs showed below average labour productivity (\$6,972), while textile and furniture produced the lowest value added per worker (\$3,974 and \$3407, respectively).

The surveyed enterprises are also operating well below their production capacity, signifying a low demand for their products. This is reflected in their high capital to output (K/O) ratio that reached of 35 percent on average in 1999. This partly explains their low productivity levels. Indeed, there appears to be a negative association between K/O ratios and productivity levels, with enterprises showing high K/O ratio scoring low on labour productivity. Textile and furniture manufacturing SMEs show a positive association between the two indicators, signifying that their low productivity is mainly the result of the labour-intensive nature of their production processes.

I. Main Markets

The surveyed SMEs focus mainly on local markets. To be more specific, the West Bank based enterprises sales are confined to the West Bank areas, while those of Gaza are confined to the Gaza Strip. Only 42 percent of enterprises were participating in foreign trade before the crisis, with Israel standing as their main export market.

J. Profitability

Given the absence of accurate data on SME's sales, the study adopts productive surplus for measuring their ability to generate income.⁵ This indicator is significant since it measures the excess surplus as a percentage of the amount of total value added after deducting expenditures on compensation, depreciation, taxes and fees and the purchase of assets. The SMEs productive surplus constituted 46 percent of their total value added on average in 1999. However, this does not necessarily mean that they reap high profits, especially in view of the low demand for their products. Moreover, more than 40 percent of the enterprises allocate significant amounts of their financial resources in building up precautionary inventories. Indeed, stockpiling constitutes a prominent feature of the enterprises' business strategies, as a safeguard against distribution problems generated by Israeli movement restrictions and border closure.

III. Dynamics of Palestinian Industrial, Construction and Tourism SMEs

SMEs are constantly evolving, with new enterprises being created, existing firms expanding or contracting in size and poor performers exiting the market. However, the significance of most of these changes is overlooked by a limited focus on the aggregate changes in the SMEs performance indicators over time, which only explains the forces influencing existing enterprises' growth. These factors can be summarized in two concepts, namely, net firm creation, which is new starts (births) minus closures (deaths), and 'mobility' or net firm expansion, which refers to enterprises' expansion

4 In 1999, the industrial SMEs average labor productivity stood at \$9,740, while those of construction and tourism SMEs were \$24,746 and \$6,972, respectively. Comparable figures for the entire economy were \$10,086, \$24,028 and \$ 4,967, respectively. See, PCBS, different economic surveys, available on: <http://www.pcbs.org> (Accessed, 20 January 2004).

5 Productive surplus is a proxy for return on capital, since it measures the value added left for the owners after deducting expenditures on compensation, fees and taxes and depreciation.

less firm contraction. This section examines these indicators during the period leading up to the crisis.⁶ The next chapter will look into the factors influencing these indicators during the crisis.

A. Net Firm Creation and Mobility

Most of the SMEs created over the period 1994-1997 are concentrated in the construction sector, the wearing and apparel manufacturing branch and mining and quarrying with their number increasing by 43 percent, 37 percent and 24 percent, respectively. The majority of the new entrants into the wearing and apparel manufacturing branch were medium enterprises, while small enterprises constituted the majority of the new entrants into the other two sectors. Although basic metallic manufacturing SMEs and those involved in the production of electrical machinery showed significant growth, the absolute number of new entrants was insignificant. Tourism SMEs fared badly over this period, with their number decreasing by 2 percent.

The period 1994-1997 witnessed the closure of a significant number of SMEs that were mainly involved in capital-intensive activities, with over half of those involved in the production of medical equipment, vehicles and transport equipment forced to exit the market. Most of the existing enterprises were small. These show high death rates during their initial years, with as many as 95 percent failing to maintain their operations beyond the first two years (AEA, 1997).

Available statistics for the period 1997-1999 do not allow for an examination of SMEs' growth at the branch level. Nonetheless, they show that this period witnessed a surge in number of tourism SMEs that registering the highest growth rates. The number of construction SMEs grew by 8 percent, while the number of those involved in manufacturing and mining and quarrying activities increased by 4 percent and 2 percent, respectively. It is worth noting that growth rates vary significantly according to enterprise size, with medium enterprises expanding at higher rates than small enterprises.

Nonetheless in 1999, nearly 41 percent of the SMEs involved in the surveyed sectors were poised to expand their activities at the eve of the crisis. This was particularly the case of SMEs involved in the tourism and construction sectors, with more than 50 percent of these enterprises forced to postpone or cancel their expansion plans following the outbreak of the protracted conflict. Non-metallic producing enterprises ranked second, with 41 percent of the enterprises postponing or abandoning their expansion plans. These were followed by mining and quarrying, wearing and apparel and food and beverages SMEs, where more than 30 percent of the enterprises postponed or cancelled their plans.

An examination of the expansion plans by sector shows that most of these were concentrated in the wearing and apparel and non-metallic manufacturing sectors. Moreover, small sized enterprises accounted for 90 percent of these expansion plans. The construction sector stands as the only exception, with 38 percent of the expansion plans generated by medium-sized enterprises.

B. Major Internal Factors Influencing SMEs' Growth

The lack of natural resources and the limited size of their markets aside, the major factors influencing the SMEs' performance stem mainly from these enterprises' salient features. Other (macro) factors, which have a bearing on all enterprises, SMEs included, are discussed below:

1. Location: For the majority of Palestinian SMEs, proximity to local markets in addition to the availability of infrastructure services seem to be the most important factor influencing this decision. As shown earlier, enterprises prefer locating their operations in urban business centres on heavily trafficked roads. Moreover, proximity to Israel, which stands as the Palestinian enterprises' main trade partner and source of supply inputs, does not seem to be a very important advantage for all SMEs. This is indicated

⁶ This approach to examining the dynamics of SMEs was advanced by Liedholm and Mead (2001 and 1999) in the course of their work on SMEs in developing countries.

by the location of the regional manufacturing agglomerates, especially those operating in the West Bank. These are heavily concentrated in Nablus, which does not lie close to the borders.

This can be mainly explained by the nature of the SMEs activities, entailing direct interaction with customers, with production and retail often conducted at the same location. This also indicates that scale effects from proximity to local markets outweigh gains reaped from proximity to Israel. However, such a situation does not reflect the work of free, unfettered market forces. Rather it reflects the prohibitive transaction costs facing Palestinian traders in view of the Israeli restrictive security measures and cumbersome customs and overland transport procedures at the main borders.

This has rendered inward looking enterprises that are less interested in extending their outreach beyond local markets. Indeed, 70 percent of the survey respondents explained their non-participation in foreign trade before the crisis by 'lack of interest'. Moreover, 46 percent of medium enterprises and 34 percent of small enterprises singled out the prohibitive trade-related transaction costs as a major impediment to their increased participation in foreign trade.

2. Sector: At the aggregate level, SMEs in the construction, mining and quarrying, manufacturing of food and beverages and non-metallic products sectors experience higher levels of labour productivity than the rest of the SMEs. However, these sectors do not fair better than SMEs in terms of their salient features and structural weakness. This suggests that, unlike the case of other developing countries, the sectors do not contribute to the SMEs development; rather these enterprises appear as driven by external stimuli (Liedholm, C., 2001).

3. Size: The results of the survey reveal that the size of enterprises is an important determinant of their productivity. Table III.2 shows a positive relationship between the value-added per worker and the number of workers per establishment. However, the small enterprises' disappointing performance cannot be attributed to their size *per se*. Rather, the problem lies in these enterprises' meagre financial resources and under-developed production processes that have been hampering their growth and setting limits for their size.

Table III.2 - Labour Productivity by Enterprise Size and Economic Activity RWBGS, 1999 in \$*

Economic activity	Small enterprises	Medium enterprises
Manufacture of food & beverages	13,614	15,408
Manufacture of wearing apparel	3,785	4,369
Non-metallic products	10,986	22,484
Manufacture of furniture	3,210	4,396
Construction	26,920	22,621
Hotels & restaurants	6,081	12,079
Mining & quarrying	13,057	35,196
Remaining manufacturing activities	15,522	15,235
Grand average	9,918	12,405

*Labour productivity = total value added /total no. of workers

4. Ownership: Perhaps the most fundamental source of strength of Palestinian SMEs lies in the fact that they are dominated by family-owned enterprises. This prominence is not dictated by traditions in as much as by the adverse conditions that rendered the family a vital support mechanism, providing its members with a sense of security, solidarity and social status. Palestinian families' ability to provide critical capital and human resources remain an important determinant to the development of the industrial base. Meanwhile, owners' commitment and devotion to their businesses drives these enterprises, enabling them to persist and succeed despite adversity.

5. Sub-contracting arrangements: Sub-contracting arrangements, that are often relied upon to facilitate the transfer for technology to enterprises in developing countries, have generally been

detrimental to the growth of the Palestinian SMEs. As shown earlier, the majority of Palestinian medium-sized enterprises are engaged in subcontracting arrangements with Israeli enterprises, resulting in the diversion of their backward and forward linkages towards Israel. This is particularly the case of the wearing and apparel sector, whereby Israeli enterprises stand as their main source of input supplies, machines and equipment, trade credit and outlet for their products.

If anything, Israeli firms have been setting the limits for the development of these enterprises' production capacity and experience in industrial management, limiting their production processes to labour-intensive activities. This has contributed to the impoverishment of the SME sector's industrial base, especially as the medium enterprises, that are supposed to spur technological progress, are under-developed.

6. Production processes: The survey reveals that SMEs' under-developed production processes stand as the major impediment to improving their performance. The majority (over 50 percent) of firms expressed an urgent need of technical assistance in the area of product development. Furthermore, over half of SMEs attributed their inability to increase their participation in foreign trade to the poor quality of their products and the lack of skilled labour.

More than 60 percent of the industrial and construction SMEs operate with old equipment and machinery. They are also unable to cover the depreciation costs of their machines and equipment, exhibiting an investment gap that ranged from \$746,7000 (in the case of furniture manufacturing enterprises) to \$13 million on average (in the case of non-metallic manufacturing enterprises).⁷ This comes despite the fact that the majority of the enterprises allocate significant amounts of their financial resources to acquiring new equipment. Indeed, 55 percent of the surveyed enterprises indicated that a major chunk of their resources goes into the purchase of new equipment.

7. Finance: The SMEs' investment gap partly explains their inability to yield high profits. Yet, they do not consider the lack of finance as a major impediment to improving their performance. Enterprises reporting an urgent need for financial support services did not exceed 34 percent in 1999. However, the enterprises have complained from the paucity of trade finance, with 43 percent of small enterprises and 27 percent of medium enterprises pointing out that this works against their increased participation in foreign trade.

8. Entrepreneurial skills and management structure: The profile of the surveyed entrepreneurs suggests that previous working experience is a significant determinant of the enterprises' decision to start new businesses, and not their formal training. These entrepreneurs have proven their willingness to assume the risks associated with establishing new ventures, despite the adverse market conditions. In so doing, they demonstrated a remarkable capacity to harness their personal qualities (talents, education and previous experiences) and available resources to exploit emerging business opportunities. However, there seems to be an overall scarcity of entrepreneurs in the Schumpeterian sense. The enterprises' under-developed production processes and the limited economy's industrial base suggest that entrepreneurs are unwilling to invest in long-term projects. Moreover, their ability to improve their performance is undermined by poor managerial skills.

C. Major External Factors Influencing SMEs' Growth

1. Market support institutions: Nearly all of the surveyed SMEs are members of semi-governmental business support institutions, including chambers of commerce, agriculture and industries and industrial federations. However, only 34 percent of these enterprises are members of specialized institutions. The entrepreneurs are not highly satisfied with these institutions' services, with only 2 percent of the respondents rating these services as 'excellent'. Palestinian enterprises also stressed the need for specialized research institutions and modern laboratories for testing local and imported products.

7 The term investment gap refers to the size of investments required for covering maintenance costs.

2. The legal framework: The SMEs' limited investments can also be explained by the absence of a comprehensive legal framework for regulating economic transactions. Despite the considerable progress in developing the Palestinian legal framework, it remains weak, lacking the key laws for ensuring a conducive business environment. The Palestinian Legislative Council (PLC) is yet to issue such key laws as: Capital Markets Authority Law, Income Tax Law amendments, Chambers of Commerce Law, Insurance and Securities Law, Competition Law, Foreign Trade Act, Intellectual Property Law and Customs Law.

3. Economic policies: Thus far, the Palestinian Development Plan (PDP) for 1999 to 2003 constitutes the only initial framework for the development of the Palestinian economy. It seeks to foster a broad based growth, better targeting of resources, increased participation in foreign trade, human resource development and institutional capacity and infrastructure building. The PDP attaches great importance to private sector development as a requisite for achieving the motioned objectives, and gives priority to export-oriented industries.

In this context, the Palestine Liberation Organization (PLO) has signed several trade agreements with the rest of the world for the benefit of the PA, in order to facilitate the economy's integration with regional and international markets. These agreements provided Palestinian exports with duty free access to a number of countries, including the United States of America (USA), the European Union (EU), the European Free Trade Association (EFTA), the Arab Free Trade Area (AFTA), Jordan, Egypt and Saudi Arabia.

However, as indicated by the proliferation of the economy's structural weaknesses and the expanding trade deficit, Palestinian enterprises are not responding to the PA's development efforts, nor are they exploiting the aforementioned trade agreements. This is mainly because the existing trade regime, as defined under the terms of the Israeli-Palestinian protocol, (the Paris Protocol), is geared to serve the commercial and economic interests of the much stronger Israeli economy.⁸ At the same time, the PA is yet to design a national development strategy that goes beyond a generic commitment to private sector-led development and export promotion.

4. Donor-funded private sector development projects: Over the period 1994-June 2000, the occupied Palestinian territory received foreign aid amounting to \$3 billion, equivalent to around 14 per cent of GNI per annum. However, private sector development projects accounted for around 10 percent of total disbursements only.⁹ At the same time, the impact of private sector support projects was undermined by the lack of adequate coordination among donors, and the absence of coordination at the government level as well as among Palestinian market support institutions that often competed to tap the same resources. Moreover, most of the institutions lack qualified staff capable of formulating long-term strategies for assisting the private sector, thus rendering them more vulnerable to donors' agendas and priorities.¹⁰

D. Explaining Palestinian SME Performance Record up to 2000

The analysis shows that Palestinian SMEs are faced with a harsh environment, shaped by the developments in the peace process and the arrangements governing the Palestinian economy's relations with Israel that are implemented within the absence of a cohesive national development strategy.

The combined effects of political instability, the small size of the Palestinian economy, the lack of natural resources and the weak legal framework have set limits upon the size of the new enterprises entering the market, causing business opportunities to be highly unpredictable. Prohibitive transaction costs associated with foreign trade activities is another factor, discouraging the creation of export-

8 For a discussion on the economic impact of the Oslo accord, see for example, Naqib, 2002.

9 Data was obtained from the Palestinian Authority Ministry of Planning and International Cooperation (MOPIC).

10 Per conversations with representatives of Palestinian market support institutions, August 2002, Ramallah.

oriented enterprises that could have otherwise expanded the medium-sized enterprises' category.¹¹ The proliferation of subcontracting arrangements introduced by the Israeli enterprises to govern their commercial relations with Palestinian enterprises have also been a significant determinant of the size of new entrants. As shown earlier, these arrangements assign limited, labour-intensive tasks to the Palestinian enterprises, thereby obstructing the creation of larger enterprises. Add to this the existing trade regime that has fostered Israel's position as the Palestinians' main and dominant trade partner, thereby limiting business opportunities to developments emanating from the Israeli economy.

Indeed, the surge in the number of the wearing and apparel manufacturing SMEs and those involved in mining and quarrying activities over the period 1994-1997 can be mainly explained by the increased Israeli demand for their products. However, the situation shifted for mining and quarrying enterprises during the mid 1990s, in view of the heavy influx of cheaper Jordanian, Turkish and other products into the Israeli market. This is indicated by the limited number of new entrants into the market over the period 1997-1999. The developments in Israeli markets have also impacted negatively on the existing enterprises' performance, forcing them to reduce their marginal profits well below production costs. As a result these enterprises are no longer able to invest in upgrading the quality of their products, and shifted to price based competition. This in turn, has been discouraging the entry of new firms, especially given the prohibitive initial capital requirements, in particular the high land prices in view of the limited territorial areas made available to the Palestinians under the Oslo accords.¹²

In contrast, the growth of tourism and construction SMEs over the period 1994-1997 was mainly stimulated by increased optimism in the future of the Palestinian economy following the establishment of the PA. The findings also suggest that for high return activities, initial capital requirements and the experience of entrepreneurs already in the industry, and level of regulation—all of which are barriers to entry—are all inversely related to new start rates.

As for existing SMEs, the analysis shows that it is variables such as location and size of establishments that significantly influence their performance, and not the evolution of the sector in which they operate. This should not be surprising since the economy is dominated by micro-enterprises that are mainly involved in subsistence activities.

At the micro level, managements tend to be small and multi-functional, with entrepreneurs running the businesses single-handedly and taking all key decisions. Moreover, SMEs' outdated machines and lack of skilled labour have been undermining their ability to improve the quality of their products. This can be mainly attributed to their shaky economics and subcontracting arrangements with Israeli enterprises. The arrangements have also created a distorting environment. If anything, the analysis shows that the Palestinian SMEs' expansion became dependent mainly on their ability to forge commercial relations with their Israeli counterparts, rather than on their production and innovative capacity. This has discouraged the Palestinian enterprises from upgrading their production processes.

No doubt that the political instability and high degree of uncertainty with regards to future economic arrangements with Israel and the rest of the world are also very much responsible for such a disappointing performance record. However, a closer examination of the survey's results reveals a multitude of other forces that need to be taken into consideration. Most notable is the existing policy and legal environment that have resulted in flooding the local markets with cheaper low quality products, thus leaving the Palestinian enterprises with no incentive to upgrade their production processes. At the same time, the SMEs lack of information on markets and technologies reflects a genuine deficiency in their immediate environment.

If anything, the above mentioned factors have shoved the Palestinian SMEs into a 'low productivity trap', whereby their disappointing productivity is working against the improvement of

11 For a detailed discussion on this issue, see UNCTAD , 2004 a.

12 Per conversation with Palestinian businessmen. September 2001, Ramallah.

their products' quality, which in turn, has been putting downward pressures on sales and capacity utilisation (Prokopenko, 1992,7). This has reduced productivity levels further through insufficient retained earnings, thereby obstructing capital formation. Capital formation is hampered further by the enterprises' obstructed access to bank credit, and the high degree of uncertainty generated by their adverse environment. This has limited the enterprises' focus on adapting to survive, with managers occupied mainly with short-term problems and needs rather than long-term improvement opportunities. This is indicated by the fact that the majority of the surveyed enterprises do not consider the lack of finance as a major impediment to growth. This suggests that Palestinian entrepreneurs are only willing to assume risks associated with short-term investments, and are risk averse when it comes to long-term investments that do not yield revenues at the start of operations. This is not surprising given the high degree of uncertainty surrounding investment decisions.

Creating a larger, professional management is certainly desirable for improving the SMEs' performance. However, it is difficult to create much division of labour until a certain economies of scale is reached. It is also difficult to stress capital accumulation as a way for boosting the industries' productivity, since available statistics do not show a positive relationship between average capital to labour ratio and labour productivity. This means that additional capital resources will not produce proportional increases in labour productivity as expected. Rather, breaking the productivity trap requires expanding the size of the SMEs market, especially through increased participation in international trade, in addition to developing their production processes. Only then will additional capital help raise these enterprises' productivity levels.

IV. Impact of the Economic Crisis on Industrial, Construction and Tourism SMEs

The Israeli restrictions on the mobility of people and goods since the outburst of the second Palestinian uprising, *Intifada*, in September 2000, and the tight internal and external closure policy imposed on the West Bank and the Gaza Strip have taken a dramatic toll on the Palestinian economy. At the demand side, the surveyed SMEs are isolated from their main export markets, and are faced with impoverished local markets. By the end of 2002, around 41 percent of the labour force was unemployed,¹³ thereby reducing gross national income (GNI) per capita to 55 percent of its 1999 level to an estimated \$896 and shoving around 50 percent of the population below the poverty line of \$2 per person per day.

At the supply side, the enterprises' production capacity has been significantly weakened by the destruction of physical infrastructures and private and public property, which cost the economy an estimated \$1.1 billion in indirect losses by end of 2003. These harsh conditions have forced some enterprises to shut down completely, or halt their operations until political stability is achieved. The remaining enterprises were left with no choice but to scale down production. As demonstrated below, this has involved a significant shift in these enterprises' activities towards products with low value added (UNCTAD, 2004 *b*).

A. SMEs' Main Performance Indicators and Contribution to Growth

By 2001, the surveyed enterprises' total value added and output was cut by 39 percent and 24 percent, respectively in relation to 1999. This means that the value added component in their output has declined by 15 percent during that period. The enterprises have also witnessed the erosion of their capital base, with the value of their GFCF declining by 23 percent. This came despite the 14 percent increase in the book value of their average assets, reflecting their chronic inability to cover the depreciation costs of their machines and equipment. Moreover, these enterprises have lost 63 percent of their productive surplus, despite laying off 6 percent of their paid workforce and reducing compensation levels by 39 percent in average. Nonetheless, their contribution to growth did not witness a dramatic change as compared to 1999.

¹³ Based on the relaxed definition of unemployment, this includes discouraged workers.

A closer examination of these aggregate figures reveals significant differences in the enterprises' response to the crisis at the sectoral level. As shown in Table IV.1, SMEs involved in tourism activities have been harder hit, and the majority of the enterprises are facing the threat of being wiped out. Construction enterprises registered a less steeper decline in 2002 in relation to 2001, but remain in a critical condition.

Table IV.1 - Impact of the Crisis on SMEs' Economic Indicators by Activity, RWBGS, 2001

Percentage change between 1999 and 2001

Economic activity	Employment	Output	Value added	GFCF	Compensation	Compensation per paid employee
Mining & quarrying	64	-12	9	-91	62	-6
Food & beverages	95	87	42	376	61	-12
Wearing apparel	-14	-21	-25	-97	-32	-19
Non-metallic products	-22	-36	-56	60	-43	-29
Manufacture of furniture	12	-25	86	-8	22	-5
Other manufacture activities	10	-41	-52	-84	0	-5
Hotels & restaurants	-53	-58	-76	-89	-66	-16
Construction	-21	-55	-60	-82	-54	-39
Total	-4	-24	-39	-23	-23	-18

The SMEs' response have also varied by region, with the West Bank based enterprises showing less resilience in the face of the crisis compared to their Gaza based counterparts. These enterprises laid off 27 percent of their paid workforce in June 2002 in relation to June 2001, and reduced their compensation levels by 31 percent. In contrast, the size of the Gaza based SMEs paid work force contracted by 13 percent only, and compensation by 21 percent. This regional disparity is strongly pronounced in the case of West Bank wearing and apparel and construction SMEs that were forced to lay off 38 percent and 27 percent of their paid labour force, respectively. In contrast, Gaza based wearing and apparel enterprises laid off 12 percent of their paid workforce and reduced compensation by 25 percent, while construction enterprises maintained the pre-crisis level of paid employment and reduced compensation levels by 9 percent only.

Thus far, the industrial SMEs have proven to be the most resilient, acting as a shock absorber for the troubled economy. This can be attributed to the marked expansion in the manufacturing enterprises' activities. Namely, those engaged in the production of food and beverages, mining and quarrying activities and the manufacturing of furniture, whose paid labour force grew by 84 percent, 71 percent and 29 percent, respectively in 2001 in relation to 1999. This growth was accompanied by a surge in total value added and compensation levels, which increased by 42 percent and 61 percent, respectively in the case of food and beverages manufacturing enterprises; 86 percent and 22 percent in the case of furniture manufacturing enterprises; and 9 and 62 percent in the case of mining and quarrying activities (see Table IV.1).

Available statistics from the PCBS also shows that by 2002, the food and beverages, wearing and apparel, furniture and construction SMEs had lost more than 30 percent of their 1999 value added and output levels. These have also seen the erosion of more than 25 percent of the book value of their average assets in relation to 1999. The furniture manufacturing SMEs stood as an exception, registering an 18 percent increase in total value added in 2002 compared to 1999 and increasing the book value of their average assets by 35 percent. However, these enterprises lost 41 percent of their 1999 output level.

The remaining manufacturing activities laid off 22 percent of their paid employees over the period June 2001-2002 in relation to the previous period, and reduced compensation by 26 percent. Compared to the twelve months period of 1999, these enterprises lost 45 percent of their paid employees and 51 percent of their compensation level. The mining and quarrying SMEs did not fair

better, registering 18 percent and 28 percent decline in the number of paid employees and compensation over the period June 2001-2002. By June 2002, these enterprises had lost 13 percent of their paid employees and 33 percent of their compensation level as compared to 1999.

B. Production Processes

As mentioned earlier, the crisis has generated increased demand for the products of certain enterprises, thereby encouraging them to hire more workers and/or purchase new assets. Table 3 shows that except for the construction SMEs, this has rendered these enterprises more capital intensive as reflected in their increased K/L ratios. However, in the case of wearing and apparel and non-metallic products, the increased investments in fixed assets was accompanied by a marked contraction in the size of their labour force. Moreover, these enterprises have witnessed a significant increase in their excess capacity. The K/O ratio of wearing apparel SMEs grew from 25 percent in 1999 to 45 percent in 2001, while that of non-metallic producing SMEs increased from 28 percent to 83 percent (see Table IV.2). This means that these industries may not be as capital intensive as they appear to be.

Table IV.2 - Relative Importance of Capital in SMEs' Production Processes, Labour Productivity and Capacity Utilization - RWBGS, 2001

<i>Economic activity</i>	Capital intensity (K/L) (\$)*	Productivity (\$)	K / O (%)**
Mining & quarrying	21,289	10,133	126
Manufacture of food & beverages	18,460	10,184	47
Hotels & restaurants	18,401	3,488	150
Remaining manufacturing activities	10,103	6,716	51
Construction	6,675	12,460	25
Non-metallic products	19,827	7,081	83
Manufacture of furniture	4,203	5,647	33
Manufacture of wearing apparel	2,522	3,463	44
Grand average	11,731	6,644	62

* K/L=average value of assets of SMEs by activity /no. of workers by activity

**K/O= average value of assets of SMEs by activity/ total output by activity

This perpetuating increase in the SMEs' unutilized capacity is creating downward pressures on their already low productivity levels, with the value added per labour decreasing by 37 percent in average in 2001 in relation to 1999 (see Table IV.2). Moreover, productivity declined at a steeper rate than compensation levels, thereby aggravating the SMEs financial burden. This was particularly the case of construction and tourism SMEs demonstrated the steepest declines (50 percent) in their labour productivity. Consequently, by the end of 2001 the share of compensation in the enterprises' dwindling value added had increased from 35 percent to 44 percent, reflecting declined returns on capital. The tourism SMEs showed the highest increase in their compensation to value added ratio, from 45 percent in 1999 to 65 percent in 2001.

Other enterprises appear to have become more capital intensive when in fact they are not. This is particularly the case of tourism enterprises that reduced the size of their labour force by 53 percent and lost 45 percent of the book value of their average assets, and saw the soaring of their K/O ratio from 116 percent to 150 percent. In contrast, food and beverages and furniture SMEs were able to increase the book value of their average assets at a faster rate than their workforce was. Moreover, their K/O ratio grew at a less steeper rate than the rest of the enterprises, reflecting an improvement in their capital intensity.

C. SMEs' Coping Strategies

Apart from scaling down their production activities, SMEs resorted to several measures to cope with the crisis. These include postponing the payment of taxes and fees by 42 percent on average, and reducing maintenance activities by 7 percent. Moreover, the enterprises show an increased reliance on internal financing and informal markets for covering their expenses. West Bank based small enterprises showed a particular preference to issues of bonds as their main sources of funds suppliers' credit, while medium enterprises showed increased reliance on informal profit sharing loans. In contrast, Gaza based SMEs showed increased reliance on retained earnings, and small enterprises showed increased preference for informal profit sharing loans. Especially in view of the commercial banks' tightened lending policies, with total loans registering a 33 percent decrease by December 2002 in relation to September 2000.¹⁴

The SMEs have also resorted to a range of erosive coping strategies, with devastating consequences on their supply capacity. According to the United Nations Special Coordinator Office in the occupied Palestinian Territory (UNSCO), the closure has forced enterprises to replace skilled workers with less skilled workers, build-up their precautionary inventories and use Israeli companies to transport their imported inputs from Israeli ports. Some enterprises have also rented apartments for their workers and additional storage facilities to avoid disruptions in their production and distribution activities. Moreover, enterprises are losing connections with their non-Israeli suppliers, as they are becoming more reliant on Israeli suppliers to avoid delays at ports.

D. The Separation Barrier

Another detrimental factor to the development of Palestinian SMEs is the separation barrier, the construction of which commenced by the Israeli Authorities in June 2002 after the implementation of the survey. The barrier will encircle the West Bank areas, creating an effective economic border between the occupied Palestinian territory (oPt) and Israel. It comprises a system of fences, ditches, razor wire, groomed trace sands, electronic monitoring systems, and patrol roads through which people and goods will be authorized to pass only at certain gates that are opened during limited hours. In some areas, the barrier intrudes into the West Bank areas, and involves 8 to 9 metre high concrete slab segments, which are connected to from a wall.

According to the most recent maps published by the Israeli Authorities, when completed, the barrier will stretch for 622 kilometres in length. Around 15 percent of the West Bank areas will lie between the United Nations armistice line, the Green Line, and the Barrier, including 93,000 Palestinians. These will be living in 'closed areas', and must obtain special 'long-term resident' permits to maintain their residency rights. These permits are valid to pass through one gate only, and Palestinians who are dependent on the closed areas to earn their living should apply for special permits to reach their jobs and farms (OCHA, 2004).

Ascertaining the impact of the separation barrier on the SMEs' performance requires an in-depth survey based study. Nonetheless, and taking into account that the impact will vary by locality, it is possible to discern its immediate effects, including: increased transaction costs; the loss of agricultural lands and water resources; further isolation of Palestinian enterprises from main (export and local) markets; and higher risks associated with new investments.

Add to this the further depletion of the enterprises' supply capacity by the Israeli destruction of production facilities and the dwindling demand as a result of falling incomes and mobility restrictions. By the end of 2003, the construction works have seen the destruction of around 573 economic establishments and 85 residential buildings. Moreover, around 2,173 families became internally displaced, thus putting upward pressures on the Palestinians' already exhausted coping strategies (PCBS, 2004). Over half of the population were found to be living below the poverty line of \$2 per

14 Palestinian Monetary Authority (PMA), Statistical Bulletin, different issues.

person per day by the end of 2003. In terms of deterioration of household income, it is estimated that 72 per cent of Palestinian households (66 per cent in the West Bank and 83 per cent in Gaza), were living below the poverty line of \$3.6 per day per household of four people (UNCTAD, 2004 *b*).

Available statistics on the Palestinian economy's performance indicators for 2003 shows the tourism and construction sectors as registering the highest contraction as measured by their contribution to GDP and total employment. The industrial sector's contribution to economic growth has also exhibited a declining trend, though at less steeper rates, leaving the agricultural sector as the major engine of growth. This sector registered a 3 percent increase in its share of total employment from around 13 percent in 1999 to 16 percent in 2003 (UNCTAD 2004). However, its role in enhancing the economy's resilience is threatened by the construction of the barrier. By the end of February 2004, the construction works has resulted in the confiscation of around 270,558 dunums of the West Bank, mainly agricultural, lands and 49 wells (UNSCO, 2003).

Meanwhile, the PA is becoming increasingly dependent on foreign aid to maintain its basic services, with the budget deficit to GDP estimated at 39 percent in 2002. Although around 75 per cent of external debt is to multilateral creditors, debt service will become an additional budget burden. Indeed, although most of the loans are within the grace period, interest/service payments grew from \$1.4 million in 1998 to \$3.8 million in 2002, with accumulated arrears of \$2.4 million (UNCTAD, 2003 *a*).

Nonetheless, economic indicators for 2003 show the domestic economy as absorbing 538,000 workers as compared to 461,000 in 1999, with 52,000 jobs created by the private sector and the rest by PA institutions. This helped reduce unemployment rates to 33 percent in 2003 (UNCTAD, 2004 *b*). If anything, this signifies a resilient economy that continues to generate new business opportunities despite adverse conditions.

V. A Policy and Assistance Framework for Developing Palestinian SMEs

The widespread economic crisis has generated renewed development efforts on the part of the PA that is reconsidering the existing trade regime. The period September 2000-2002 has also witnessed a surge in donors' commitments that increased by 57 percent (UNCTAD, 2003 *b*). Meanwhile, the private sector is actively seeking to influence these efforts within the context of the National Economic Dialogue, which brings together PA senior officials and private sector representatives.

The results of the survey suggest that the starting point for developing Palestinian SMEs is to enable them to raise their productivity. This requires an integrated policy framework that addresses the multitude of factors influencing their performance at the macro, meso (institutional environment) and micro levels. The results also indicate that this framework should be conceived within the context of a bottom-up approach to development, whereby efforts at different levels are aligned to address immediate needs generated by the crisis and target the economy's structural weaknesses, rather than macro-economic disequilibria.

However, present efforts to formulate a development strategy tend to pay little attention to the economy's growth bottlenecks, or the profound changes that have taken place in its structure and functioning. Much importance is being attached to achieving economic liberalization, complying with the multilateral trading systems' rules and regulations, and accelerating regional integration. As important as these objectives may be, alone they are insufficient for kick-starting economic growth, nor can they substitute economic policy. If anything, the analysis clearly shows that such efforts have been consistently defeated by the enterprises' limited capacity to respond to external stimuli.

As regards donor funded projects, with a few exceptions (see section V.D), these are mainly allocated for emergency assistance projects, with commitments to long-term infrastructure and capacity-building work assuming a declining trend. Technical assistance programmes targeting the private sector are also limited to responding to the enterprises' emergency needs, particularly through financial support in the form of credit. While the proliferation of the protracted conflict and the enterprises' impoverished resources necessitates a comprehensive package of emergency assistance

programmes, such a limited focus risks further aggravating the economy's structural weaknesses, in addition to breeding long-term dependencies on foreign aid.

There is little by way of theory and empirical evidence that brings together all the factors influencing SMEs' productivity in a cohesive framework. Moreover, the extent to which the PA can draw on the experiences of other war-torn and developing countries is undermined by the emerging Palestinian State's unique conditions. It is an occupied territory that is governed by an autonomous authority with limited tools to manage its troubled economy. The legacy of occupation aside, the Palestinian economy is crippled by internal and external closures, curfews and the systemic destruction of the industrial base. Meanwhile, the separation barrier threatens to set further limits to the economy's development prospects, turning the emerging state into isolated islands. Nonetheless, it is possible to discern a number of frameworks for guiding Palestinian SMEs development in such a way that allows for creating synergy between industrial and trade policy, and aligning efforts around the productivity-enhancing objective.

A. A Policy Framework for Guiding Development Efforts at the Micro Level¹⁵

Efforts to improve productivity at the enterprise level should go beyond the promotion of business management and technology transfers. Training in the areas of marketing and production does not necessarily enable the entrepreneurs to make the right decisions on their production processes. Moreover, mere access to foreign technology, whether in the form of machinery or blueprints does not imply mastering it. Indeed, tacitness associated with new knowledge, and the fact that foreign technologies are not necessarily geared to address specific local needs and conditions, could work as barriers to effective implementation of imported technologies.

The experiences of other developing countries show that successful incorporation of new technologies is only possible in countries with sufficient local skills capable of adapting imported technologies to local needs and assimilating more complex technologies through product development. Simply put, gaining mastery of a new technology requires technological skills, efforts and investment by the receiving firm, and the extent of mastery achieved varies by firm according to these inputs. Therefore, efforts should seek to develop these 'technological capabilities'. This involves identifying the enterprises' ability and scope for efficient specialization in technological activities, extending and deepening these activities/technologies, and drawing selectively on other technologies to complement the already existing capabilities.

Fostering an enterprise's technological capability entails a lengthy process, whereby the enterprise graduates to higher levels through mastering core skills and functions at each stage of its development. These range from simple functions, whereby an enterprise is mainly engaged in adapting new technologies to local needs to more sophisticated ones. These involve continuous upgrading of product quality and design, diffusing new technologies within the economy, and exporting them through licensing agreements and turnkey projects.

The survey shows that Palestinian SMEs are still at the very early stages of technological development, with enterprises engaged in simple routine activities that are based on rules of thumb as opposed to research and scientific knowledge. As such industrial policy should seek to assist enterprises graduate to upper levels of technological capabilities.

B. A Policy Framework for Guiding Development Efforts at the Macro-Level

The economy's supply capacity is not simply the sum of thousands of individual firm-level capabilities developed in isolation. The extent of mastery achieved by a firm depends not only on its skills, effort and investment but also on the incentives generated by the economy. These affect the

¹⁵ This section is based on the evolutionary theories developed by Nelson and Winter, 1982; Lall, S. , 1992; Caniels, M. and Henry, R. , 2002.

pace of accumulation of capital and skills, the types of capital purchased and the kinds of skills learnt and the extent to which existing endowments are exploited in production.¹⁶

The implication for Palestinian policy-making efforts is the necessity of reconsidering the scope and pace of economic liberalization. Technological learning is a lengthy process, requiring some protection until local producers reach a reasonable level of mastery. The rationale behind such an interventionist approach also stems from the economy's depleted supply capacity by decades of occupation and over four years of protracted conflict.

At the same time, the PA should develop a well articulated sector-specific strategy that goes beyond generic statements of objectives, in order to ensure targeting the SMEs deep seated structural weaknesses. However, the choice of the specific sectors that would form the target of development efforts is rather complex. While the pressing unemployment problem requires the promotion of labour-intensive activities, the deteriorating terms of trade of labour-intensive products begs the need for restructuring the industrial base to allow for greater emphasis on technology-intensive products with higher value added. An imperative which is also generated by the need to create a nexus for developing local technological capabilities. Otherwise, Palestinian enterprises will continue to rely on outside sources, with adverse consequences for industrial development and economic growth. This is because the nature of the technology supply and the direction of technological change will not be geared to service the development interests of the SMEs. Moreover, the much needed technological progress will be obstructed by the lack of local capability to repair, maintain, reproduce and adapt imported technologies to local requirements.

Hence, the need for a balanced approach that seeks to expand priority capital intensive sectors as well as targeted labour-intensive industries. However, implementing such a strategy under the current conditions is rather difficult. As shown earlier, emergency humanitarian needs have been diverting attention away from long-term development objectives. At the same time, the separation barrier and the Israeli repeated incursions into the Palestinian-controlled areas are discouraging donors from investing in institution-building.

The literature on war-torn economies points out the possibility of striking a balance between immediate and long-term development objectives through linking relief to development efforts. This can be achieved through 'allocating emergency and relief assistance in a manner that leads to persistent development accumulation, no matter how slow or intermittent, through distinct and sequential efforts'. This means that emergency assistance should be based on a development strategy, and designed in such a way so as to permit movement along a continuum from relief through rehabilitation to development (UNCTAD, 2004 *b*, 10). This also means that for short-term, efforts should focus on the project and programme levels, with a special emphasis on the meso level, so as to lay the ground for forging ahead with the long-term development efforts upon the achievement of political stability.

At the same time, special attention should be made to build on the enterprises' coping strategies. As previously shown, the crisis has seen the birth of small enterprises that have played an important role in absorbing the unemployed labour force. However, these are mainly involved in labour-intensive, low-productivity activities, and are focused on adapting to survive. Efforts should, therefore, seek to improve these enterprises' productivity and product quality, enhancing their backward and forward linkages, in addition to enabling them to compete in global markets through linking them with regional and international supply chains, and exposing them to best practices in international trade.

C. Spatial Arrangements

As previously mentioned, while forming spontaneous industrial agglomerates, Palestinian SMEs exhibit weak inter-firm collaboration in the form of backward and forward linkages. At the same time, existing industrial zones, which are supposed to foster such linkages, have attracted a limited percentage of the enterprises.

¹⁶ For a detailed discussion on this issue, see Schmitz, H. and K. Nadvi, , 1999; and Lall, S., 2000.

The experiences of other countries show that agglomerates of firms emerge spontaneously, and that policy interventions would only be successful to the extent that they foster inter-firm collaboration and the particular growth dynamics of these agglomerates (Brusco,1990). This means that should governments choose to create agglomerates from scratch, support measures should be designed in such a way to generate inter-firm collaboration, before investing in infrastructure development.

The implication for Palestinian policy makers is to focus on developing existing agglomerates, and foster collaboration between SMEs. However, the industrial estates and free zones project and the municipal complexes seek to create industrial agglomerates from scratch. While the need for new industrial zones can be justified by the lack of proper infrastructures, it would be more appropriate to consider rationalizing the number of industrial estates, free zones and internal estates, as it is more effective to establish a few specialized industrial estates rather than spreading too thin.

In so doing, the focus should be on establishing sector specific zones to support the development of priority activities. The oPt has little to start with: there are significant frictions in physical and transaction costs that may hamper the relocation of enterprises into the planned estates, and there is a dearth of supporting industries, factors of production and capable market support institutions. Moreover, the separation barrier has effectively set the limits to resorting to spatial arrangements, and may also requires reconsidering the location of the planned industrial zones and municipal complexes.

At the same time, there is a need to substantiate the industrial estates and free zones project and the municipal complexes with additional measures to foster inter-firm collaboration and create spill-over effects into the economy. This can be done through drawing on the clustering approach, which focuses on creating two sets of growth dynamics. The first relates to inter-firm coordination, and entails the promotion of 'flexible specialization', whereby the production process is decentralized through subcontracting arrangements to allow member enterprises to specialize in specific phases of the production chain. This allows enterprises to take advantage of different economies of scale afforded at different stages of production, focus on product characteristics (instead of price), achieve economies of scope through adaptive machinery and broader participation by multi-skilled employees so that the relationships between firms become organic and promote innovation (Piore, M. and C. Sabel, 1984)

The second set of dynamics relates to inter-firm collaboration, and involves creating the required institutions for facilitating the enterprises' joint action. The focus of policy measures should be on supporting purposive joint actions, which result in 'collective efficiency', as opposed to passive externalities that accrue to firms by virtue of being part of a cluster. The derived benefits depend on the number of participants and the direction of joint action, which can be either horizontal and/or vertical. Horizontal cooperation entails partnerships between companies operating at the same (or similar) stage in the production chain, while vertical cooperation comprises any type of contractual or informal arrangement between final producers and their input suppliers (backward cooperation) in addition to the exchange of market information between buyers and producers (forward cooperation) (Schmitz, H., 1995; and 1997).

D. Policy Implications

1. Macro-economic policy: As aforementioned, a keystone to linking relief to development efforts is a well articulated sector-focused strategy, which addresses the pressing problem of unemployment, seeks to improve productivity at the enterprise level and promotes greater specialization in technology-intensive activities.

In designing such a strategy, the PA could consider adopting two sets of policies, with the first focusing on industries that entail significant capital investment, as well as research and technology intensive activities. Priority branches may include: machinery, transport equipment, information and communications technology, and high-tech industries. The second set of policies could focus on labour-intensive industries that can achieve a simultaneous increase in employment and output without sacrificing productivity, such as food and beverages, in addition to those branches that registered significant expansion including mining and quarrying, furniture and wearing apparel SMEs.

It is within this policy framework that present development efforts at the programme and project level, including donor funded ones, should proceed. These should target priority sectors, be geared towards achieving the above-mentioned broad policy objectives, and complemented by incentive packages. Such packages could comprise export targets at the industry, product and firm levels that are set by the PA in close consultations with export firms and industry associations. Targets can be enforced by such measures as denying import licenses to poor performers, and encouraging successful enterprises through publicity and prizes.¹⁷ Other policy measures may include: simplifying and streamlining licensing requirements, earmarking a fixed proportion of government procurement for SMEs, reconsidering existing investment laws so as to enable SMEs to benefit from tax holidays; and research and development (R&D) tax breaks. These efforts need to be supported by tailor-made programmes, in addition to efficient and well functioning factor markets and support institutions that are capable of servicing the targeted sectors (see below).

In the long-term, the PA could opt for a dynamic industrial strategy that creates synergy with trade policy. This entails introducing temporary protection measures for promoting selected industries at each point in time, while reducing or eliminating support to others. These measures should be limited to those instances where there is a market failure, and phased out gradually based on clear performance indicators, such as enforcing early entry into export markets.

This should not be understood as an attempt to suggest that the PA should create a protected environment for promoting SMEs, or establish state-owned enterprises. Rather, the point to be stressed here is that the PA should actively prepare for liberalization within the context of a time-bound sector-focused strategy, which seeks to improve the economy's technological capability. The PA has a significant room to manoeuvre, given its status as a least developed country (LDC) and the fact that it is not a member of the World Trade Organization (WTO). As such, it could use protectionist measures, particularly for promoting infant industries, using the exemptions and special and differentiated treatment accorded to LDCs. In designing such measures, the PA should avoid creating upwards pressure on its already cash strapped budget, or inflate red tape.

To this end, the PA can draw on the experiences of other countries, particularly Korea and Taiwan, which show great technological depth and export technology-intensive products. Korea, adopted a gradual approach to liberalization, based on a rigorous strategy for upgrading and restructuring the industrial base. This strategy involved, among other measures, quantitative and tariff restrictions on imports, export promotion programmes, and guided credit (Westphal, 1990). Taiwan provides useful examples on policy measures for controlling the influx of foreign direct investment (FDI), which the PA can resort to at different stages of the development process. During the early stages of its industrialization process. During the early stages, Taiwan sought to attract FDI with no discrimination by origin, destination (excluding services) or degree of ownership. During the 1960s the government started targeting FDI, directing it first to labour-intensive activities and then to technology-intensive sectors. As the industrial sector developed, the government exercised closer monitoring to ensure that the technology is in line with changing national priorities (Wade 1990).

2. Programme and project level: The focus of policy interventions at this level should be on developing the SMEs technological capabilities at the firm level. Ongoing projects address the manufacturing enterprises' weak technological capability, but not in a comprehensive manner. These include employment skill upgrading programmes, which although still in the pilot phase, have been met with success.¹⁸ Other projects include the United Nations Industrial Development Organization (UNIDO) Integrated Programme for Upgrading Palestinian Industries, and UNCTAD's integrated capacity-building programme for promoting SME development (EMPRETEC)- Palestine (see Box 1

17 This approach to promoting exports was implemented in Korea with marked success (Rhee *et al.*, 1984).

18 For further information, visit the Palestine Trade Center (Paltrade) and the Palestinian Information Technology Association (PITA) at: <http://www.paltrade.org>, and <http://www.pita-palestine.org>.

below). All these projects are hosted by local market support institutions, and are implemented in close consultations with relevant PA Ministries. However, there remains much room for improving coordination, both between local market support institutions as well as between donors and international development organizations.

Box 1: Examples of Donor-Funded Programmes for Developing Palestinian SMEs' Technological Capability

UNIDO Integrated Programme for Upgrading Palestinian Industries

The Programme aims at upgrading the performance of Palestinian industries and integrating them with global markets through capacity-building in both government and the private sector institutions. In addition to enhancing the PA capacity in the area of industrial policy making, the programme involves supporting the Palestine Standards Institution; total quality improvement for selected industrial enterprises, the establishment of an Entrepreneurial Incubator Network, the establishment of a Fashion Design and Technology Development Centre for the garment industry, and the establishment of a Palestinian Building Resource Centre.¹⁹

UNCTAD EMPRETEC-Palestine

The programme focuses on promoting entrepreneurship, entrepreneurial culture, innovation, and business linkages through providing training, technical assistance, and an institutional framework for fostering entrepreneurial capabilities and the growth of internationally competitive SMEs. It involves training entrepreneurs and assisting enterprises in preparing business plans, accessing the financial market, establishing mutually beneficial links with larger national and foreign companies, and putting in place long-term support systems to facilitate the growth and internationalisation of their ventures.²⁰ Progress to date has involved the establishment of a core national training and capacity support team for servicing West Bank based SMEs. Moreover, 9 of the entrepreneurs who participated at the training workshops started their own businesses, 7 participants expanded their existing operations, and another 2 participants reopened their closed businesses. Future plans include establishing a similar institutional arrangement in Gaza, and introducing special training components for agro-businesses and women entrepreneurs.

The next step would be to complement these programmes, with tailor made projects that focus on fostering the entrepreneurs' skills in three specific areas. The first relates to investment decisions, and involves developing the entrepreneurs' ability to identify, and obtain the required technology, including construction, equipment and human resources. These determine the capital costs of the project, the appropriateness of the scale, product mix, technology and equipment, and the technology understanding gained by the operating firms. The second area concerns the production processes and range from basic skills such as quality control, operation, and maintenance, to more advanced ones such as adaptation, improvement or equipment 'stretching', and further to the most demanding ones of research, design, and innovation. The third area involves the enterprises' ability to transmit skills and technology to, and receive them from, component or raw material suppliers, subcontractors, service firms and technology institutions. The three components may be grouped together under one programme, with sub-programmes targeting SMEs involved in priority sectors. The PA may also

¹⁹ For further information, visit UNIDO at: <http://www.unido.org>.

²⁰ For further information, visit UNCTAD at: <http://r0.unctad.org/palestine/>

consider seeking the donor community's assistance in establishing a special fund for fostering linking SMEs with foreign enterprises, and sector specific technology transfer programmes.

As regards tourism SMEs, efforts should focus on enhancing the vertical linkages within the sector. Hotels and restaurants; travel agencies and tour operators; and tourist guides should be addressed as part of a value chain that interacts vertically and horizontally with other sectors of the economy, through backward and forwards linkages, to produce and market the final product, such as 'holiday packages' and other related services. In this context, there is a need to focus on networking Palestinian SMEs with their regional and international counterparts. This could be done within the context of linkages programmes, which also includes training activities for familiarizing SMEs with international standards and best practices.

3. The meso level: The need to foster Palestinian market support institution capacity cannot be over-emphasized. However, this should be done within the context of a case by case needs assessment, and with a view to enabling these institutions to assume an active role in supporting the PA's development efforts. More important still is to design donor-funded projects in such a way that allows for developing these institutions' capacity to manage and maintain the projects beyond the life cycle of the international funding.

There is also a need to create institutions that directly affect industrial capabilities, including testing laboratories and technology institutions for promoting learning and innovation in targeted industries.

4. Sector specific incubators: Perhaps the most effective approach to developing technology-intensive SMEs would be to establish sector specific business incubations. This is particularly in view of the lack of capital and market support institutions for nourishing such activities. Incubators allow policy makers to catalyze the process of starting and growing companies, providing entrepreneurs with the expertise, networks and tools they need to make their ventures successful. The incubators should be equipped with the professional staff, and linked with the local and international market support institutions and universities in order to capitalize on and contribute to the development of existing resources and services targeting SMEs. They can be hosted by the industrial estates or by universities, depending on the nature of their services.²¹

5. SMEs access to long-term finance: The analysis shows that the Palestinian banking sector's poor contribution to economic growth is a symptom of economy's structural weaknesses. The problem lies in the forced and systematic occupation related economic distortion and the financially risky environment it creates in the face of many Palestinian SMEs. This financing constraint can only be solved through promoting semi-formal financial institutions that are willing to provide risky loans to these industries, as well as government loan guarantees to qualified SMEs in priority sectors. This could also be complemented employment upgrading/generation schemes.

Such institutions could tap the banking system's deposit base for financing their credit lines. This could be done through establishing a special guarantee/insurance fund that allows these institutions to act as intermediaries between potential borrowers and the banks. The institutions would screen borrowers, monitor their performance and assume responsibility to the banks in case of default. The PA can also consider the establishment of separate guarantee fund for financing SMEs trade activities.

6. Spatial arrangements for industrial SMEs: As previously mentioned, it would be more useful to focus, at least at this stage, on fostering networking among SMEs. Networking opportunities generally arise wherever firms draw on similar sources of labour and materials, capital equipment or IT, or are confronted with similar problems of distribution and marketing. For example, national market support

21 In 1994, two pilot incubators were designed for supporting Palestinian enterprises, in An-Najah University of Nablus and in Gaza. The first incubator was meant to stimulate technological entrepreneurship and commercialise the results of scientific research, while the Gaza-based facility focused on fostering innovative products and services, particularly in agribusiness, computer software, garments and artisan products, in addition to construction. However, the two projects have not been implemented for various reasons, particularly the lack of competent staff (AEA, 1997).

institutions can promote networking through creating sector specific forums to discuss and resolve common problems posed by external competition. Drawing on the Chilean Government's experience, this could be done within the context of programme that also involves companies providing support and infrastructure services to the primary producers, as well as main suppliers and contractors, trade unions and universities (see Box 2 below). This will encourage SMEs to share experiences and enter into joint ventures. Indeed, one of the major positive externalities of EMPRETEC-Palestine project was the promotion of inter-firm collaboration (MSI, 2002).

Box 2: Promoting Direct Cooperation and Networking among SMEs: The Chilean Experience

The PROFO programme was introduced by the Chilean Government's SMEs promotion agency, SERCOTEC, in 1990. The programme aimed at promoting direct cooperation between firms, increasing take-up of other services provided by SERCOTEC and creating focal points in local economies that can act as stimulants for development.

PROFO involved the following three inter-linked phases:

(a) Preparation. SERCOTEC identifies a particular locality, diagnose their problems and establish the credibility of SERCOTEC itself as an agency that can offer useful support. Any group of firms can apply for joining to a PROFO, but SERCOTEC must be convinced that a basis for collaboration exists and that there are clear short-term and medium-term goals which might be met. The number of firms is small—usually between 10 and 30.

(b) Consolidation. This is the main part of the process, entailing the appointment of a manager to act as an interface between the PROFO's members and their institutional and market environment. One of the first tasks of the manager is to improve the delivery and take-up of support services, requiring coordination not only with SERCOTEC but also with other local agencies, both private and public. A second task is to develop better relations between participating firms through such activities as visits to each other's factories, group workshops and group travel. The manager also works towards building the self-esteem of the group and promoting its activities. Once this is achieved, the participants and the manager start to develop competitive advantage based on cooperation.

(c) Independence. The aim of the PROFO initiative is to create groups of enterprises which can develop and sustain their competitiveness, and at the same time encourage other firms in the locality to emulate the experience and inject dynamism into the local economy. For this reason, the managers are appointed for a period of three years, after which the participating firms must take over all support for their salary. The aim is that each group of firms will be self-sustaining.

An evaluation of the PROFO initiative, carried out in 1993, shows that seven out of ten PROFOs which had been in existence for between 20 and 30 months met at least four of the twelve criteria chosen for the evaluation and four of the PROFOs met at least six of the criteria. This indicates a capacity for collective action, and the ability to upgrade. Firms are not only working together, but also taking initiatives on product and process development, human resource development, sales and finance (Humphrey, J. and H. Schmitz, 1995).

There is also a need for promoting programmes that seek to integrate the enterprises with regional and international companies through subcontracting arrangements and strategic partnerships. Indeed, agglomerates that are isolated from these chains are more likely to follow the low-road growth path, whereby enterprises focus mainly on squeezing production costs to maintain their market shares. In contrast, SME clusters well connected to global markets are more likely to follow the high-road path, and experience evolutionary growth based on the continuous upgrading of products and processes.

In the case of industrial SMEs, such programmes should encourage foreign companies to source some parts, components, indirect materials and services from Palestinian enterprise suppliers, as well as outsourcing the distribution of brand name products to Palestinian enterprises. This can be done through creating regional and global networks that bring together local firms and international enterprises, which together form a complete production chain. Such networks may entail: (i) horizontal collaboration, such as sharing the costs of expensive equipment or R&D; (ii) vertical collaboration through facilitating the decentralization of the production process; and/or (iii) both, allowing member enterprises to form information networks' to exchange technology or pool in their resources to solve a common problem.

For capital and technology intensive activities, efforts should seek to assist companies to form strategic partnerships with their international counterparts. These differ from traditional partnerships in that they provide the basis for forging a two-way relationships, which focused on joint knowledge production and sharing as opposed to a one-way transfer of technology. These usually involve formal contractual arrangements and equity participation, and are based on a long-term vision rather than short-term considerations, such as quick profit.

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