



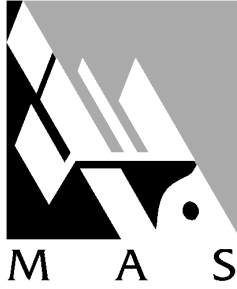
Palestine Economic Policy Research Institute

**Palestinian Industrialization Policies  
and Strategy: Options Available at  
Short-and Long Terms**

Policy Paper Series (1)

**Basim Makhool  
Odeh Zaghmouri  
Nasr Atyani**

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The Palestine Economic Policy Research Institute (MAS) was founded in 1994 as an independent, non-profit institution to address the socio-economic policy making process through appropriate and relevant applied economic and social policy research.

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P.O. Box 19111, Jerusalem and P.O. Box 2426, Ramallah  
Tel: ++972-2-2987053/4, Fax: ++972-2-2987055, e-mail: [MAS@planet.edu](mailto:MAS@planet.edu)  
Web Site : <http://www.palecon.org>



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**Prepared by:**

Basim Makhool, Research Fellow at MAS, and Associate Professor at Al-Najah  
National University, Nablus.

Odeh Zaghmouri: Secretary General – Palestinian Federation of Industries.

Nasr Atyani: Research Assistant at MAS

**Editorial Assistants:** Abed Alruhman Y. Abu Shammaleh (Arabic)

Karen Mann (English)

**Translated to English:** Samir Mahmoud

**Layout:** Lina Abdallah

**Funding:** This Study was mainly funded by Friedrich Ebert Stiftung

Complementary Funding: MAS core budget funded by Ford Foundation and  
revenues of the endowment granted by Arab Fund for Economic and Social  
Development.

Palestine Economic Policy Research Institute (MAS)

Jerusalem and Ramallah

July, 2001

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3. The internal scientific committee supervises the work of the researcher or team of researchers through periodic progress reports.
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# Summary

## Introduction

The Palestinian National Authority (PNA) gives the industrial sector a high priority as a means to drive sustainable Palestinian economic development. The possibility of transforming the West Bank and Gaza Strip from a developing to a developed economy, making them the “Singapore of the Middle East”, is even considered as a possibility by some. Yet, in spite of success achieved in some branches of Palestinian industry, the total performance of the industrial sector and its role in the Palestinian economy is still modest. Furthermore, the industrial sector suffers from structural problems that limit its competitiveness and impede its transformation into a leading sector. Some of these weaknesses result from the Israeli occupation but others are due to the absence of a well-defined Palestinian economic policy. There is also the problem of individual and family owned businesses with firms characterized by their small size and narrow marketing outlets. Some branches of industry depend heavily on subcontracting relationships with Israeli companies. In addition, industrial clusters have not been completed and there is an absence of forward and backward linkages. Another problem is the weak role played by supporting institutions and the generally poor investment environment in the Palestinian areas.

The PNA has made a number of attempts to improve the performance of industrial enterprises by introducing industrial and economic policies aimed at creating an environment conducive to investment. The PNA has adopted an industrialization strategy aimed at achieving a balance between import substitution and export promotion. It has also established more than one ministry, several institutions and government bodies necessary to support the private sector as well as issuing important economic legislation and initiating improvements in infrastructure services. A number of industrial zones have been established. At international level, several preferential trade agreements have been signed. The PNA has also set up a development program to update Palestinian industry and has supported the establishment of numerous bodies to serve the industrial sector.

Yet, in spite of all these efforts, the PNA has been unable to motivate the private sector to create and improve the competitive advantage of the industrial sector. The lack of success can be attributed to objective circumstances: Israel’s continued control of economic resources and border crossings, dramatic regional and international changes and the economic challenges they pose, the limited role played by newly-established government bodies, and the weak performance of the private sector.



## **Industrialization Strategies**

Theoretically, the goals of any industrialization strategy can be summarized as increasing the efficiency and growth of the industrial sector and improving its competitiveness. This applies to strategies of both import substitution and export promotion. To achieve the goals of industrialization strategy, government cooperation is essential, especially to introduce policies and measures known as industrial policies. These industrial policies, or policies influencing them, fall into five groups each with its own identified tools: price control, trade policy, fiscal and monetary policies, labor policies, and labor relations. The government therefore has a role in determining both industrial strategy, industrial policy and in implementing and controlling them.

There are several forms of government intervention in the implementation of industrial policies, sometimes in the form of laying down guidelines. That is, the government sets in place macroeconomic policies that are not well defined and depends on the market mechanism for their implementation. It's role might be supportive in identifying general trends or a more specific policy to drive an industrial activity in a particular direction. At other times, the government can be active and takes direct intervention in special areas of industrial activity. This includes targeting companies in certain sectors to assist in their restructuring. Finally, the government might assume a central role in which it takes nearly full control.

There are schools of economic thought that justify government intervention in the economy in general, and particularly in the industrial sector in cases where the market mechanism has failed to achieve optimal distribution of economic resources. However, it is necessary to estimate the expected returns and costs of government intervention before adopting any policy. There are actually a number of tools available to industrial policies and the same goals can be achieved by using more than one tool. The tools available to the decision-maker could be guidelines such as economic plans, or direct tools including laws and regulations as well as material and procedural incentives.

## **Successful Experiences in Other Countries**

From the experiences of countries that have achieved substantial progress in the industrial field, we may summarize the following important lessons:

- ◇ Countries that adopted export promotion strategies achieved faster growth than those adopting import substitution strategies.
- ◇ The market mechanism produces the best results. However, if government intervention is necessary, then an industrial policy based on incentives is better than one based on laws and regulations.

- ✧ Government investment in fields that the private sector can handle effectively is fraught with a high degree of risk and low economic efficiency.
- ✧ There has been a decline in the role of national legislation as an industrial policy tool, particularly in the wake of the establishment of the World Trade Organization (WTO).
- ✧ Specialized government bodies are needed, with sufficient expertise, to set up and implement effective industrial policies based on an accurate evaluation of available options, to supervise implementation, and with the flexibility to modify industrial policies. These bodies should work professionally and in isolation from political pressure.
- ✧ The lack of efficient government bodies relating to the implementation of industrial policies is one of the most important factors that lead to the failure of these policies.
- ✧ Clear and well-defined goals are required as well as sound management capable of keeping abreast of developments. This is in itself one of the important factors of success.
- ✧ Small-size local market countries were more successful using industrial policies that reduce production costs rather than policies aimed at increasing revenues.
- ✧ The concept of government intervention to support and develop high-tech strategic sectors is currently more acceptable than the concept of protecting new industries.
- ✧ Policies of direct financial support have proved to be ineffective because the majority of targeted companies have not benefited appropriately.
- ✧ Trade protection, when needed, must be temporary and gradually eliminated. Long-term protection may set companies into a vicious cycle.

### **Determinants of Industrialization in Palestine**

The West Bank and the Gaza Strip have few natural resources, save those of the Dead Sea salts. Stone and marble remain the most important resources available and exploited in Palestine. The Palestinian areas also have low levels of rainfall. Yet, Palestine has potential of other kinds, such as tourism at historical and religious sites. However, only very limited areas of the West Bank and Gaza Strip have been transferred to direct PNA control in the wake of the peace process. The West Bank and Gaza Strip areas have been temporarily divided into areas A, B and C. This has resulted in a number of crucial restrictions: the limited ability of the PNA to make active use of available economic resources or to implement economic policies in terms of issuing industrial and construction licenses, and severe restrictions on travel by people from one area to another.

Moreover, the Palestinian areas also suffer from weak infrastructure services in general in comparison with neighboring countries. Data indicate a weakness in the base of capital resources available for investment. Indeed, fixed investment was even not enough to cover the depreciation of production assets in most years. The

volume of banking credit was only 35% of total deposits and most of this was in the form of overdraft facilities.

Furthermore, the Palestinian areas are characterized by small markets and low crude participation rate in the labor force of 23% in the West Bank and 16% in the Gaza Strip. The female participation rate in the workforce was only 13.5% in the West Bank and 8.6% in the Gaza Strip. There is a high level of education in the labor force, with 24% of the workforce having completed 12 years of schooling.

### **Industrialization Policies and Strategy**

The structural problems of the industrial sector, and the limited resources available for industrialization in the West Bank and the Gaza Strip underline the difficulty of expanding and developing the industrial sector to become a driving force in the development and growth of the Palestinian economy. However, modern economic thought that tries to interpret the economic progress of some countries and the under-development of others emphasizes that wealth is created and not necessarily inherited. That is, poor countries might become rich and vice versa. Natural resources, geographical location or military power are no longer essential elements in determining the wealth of a country or the welfare of its population. It is the decisions and behavior of individuals and their governments, the efficiency of the institutions they have developed and how they invest their savings that determine their economic progress and welfare.

The competitive advantage of a country depends on four basic factors: market conditions for goods and services; the market conditions for inputs; supportive institutions and strategies; and the industrial structure and rivalry among existing firms. The secondary elements influencing competitiveness include government policy towards the four basic factors, in addition to the chance or luck factor. Industrial success may stand on the basis of the availability of natural resources, on skilled labor with high productivity, on the ability to develop and innovate, or on the basis of information.

### **Short-term Industrialization Policies and Strategy**

The existing political reality, that is the continued Israeli military occupation of the bulk of Palestinian land, the Israeli complete control over border crossings and most Palestinian economic resources, imposes serious restrictions on the PNA's ability to implement Palestinian economic development policies. Nevertheless, it is possible to suggest a number of vital policies to develop the Palestinian industrial sector even under the assumption that the current situation persists. Existing constraints do limit real progress for the Palestinian economy in regional and global integration. A short-term industrialization strategy should focus on tackling structural obstacles facing the industrial sector and developing production and management skills. Production should concentrate on non-durable goods that

meet local market needs (import substitution) and substituting goods imported from Israel with those from other countries. To achieve these goals the following steps need to be taken:

- ✧ Identification of a clear Palestinian economic policy. The open market policy or free economy adopted by the PNA needs specific implementation not connected to public monopolies and direct government investment in areas where the private sector is active and can handle effectively.
- ✧ Critical reviews of economic and trade agreements signed with other countries.
- ✧ Drawing up a plan for economic development that takes into consideration the needs of all economic sectors in conjunction with the active involvement of representatives of the authorities and institutions concerned.
- ✧ Completing the building of institutions and bodies to empower economic sectors.
- ✧ Restructuring PNA institutions, particularly relevant ministries, to eliminate the duplication of powers and responsibilities.
- ✧ Ensuring a consistent legislative framework of laws and regulations pertinent to economic and development activity.

### **Long-term Industrialization Policies and Strategy**

Long-term industrialization policy and strategy has been analyzed on the basis of full sovereignty in a Palestinian state and a certain degree of Palestinian independence. Palestinian control of economic resources, border crossings and the potential to draw up, implement and modify economic policies, including trade policies, in line with Palestinian national interests has also been assumed. Initially, the short-term industrialization strategy should achieve its goals, particularly in relation to the structural obstacles facing the industrial sector and the development of Palestinian productive and management potential. The short-term strategy of import substitution then needs to be transformed to one that promotes exports based on the production of non-durable consumer goods derived from distinctive natural resources and other goods relating to information technology. The small size of the Palestinian market justifies this as it is unable to benefit from a large-size economy. In addition, Palestinian authorities have limited ability to provide protection for Palestinian industrial products from competition in light of modern global trends towards free trade, as reflected in the GATT agreements. Therefore, the most suitable option in the long-term is to depend on exports as an industrialization strategy, provided that the goal is to increase competitiveness by raising factor productivity.

This raises the question of what goods and services can be developed competitively in Palestine for export? That is, which are the leading sectors?

The leading sectors can be determined on the basis of their ability to create and develop a dynamic competitive advantage. This might be based on the availability of natural economic resources, skilled labor or transfer of information.

Leading sectors based on natural resources include:

- \* The quarrying industry using stones for marble and building.
- \* The tourism industry based on the exploitation of historical and religious sites in the Palestinian areas.
- \* Complementary industry based on agricultural produce.

Leading sectors based on a skilled labor force include those connected to subcontracting, including assembly industries for textiles and footwear for multinationals, provided that Palestinian companies carry out production while international companies do the marketing.

Industries based on informatics are experiencing dramatic growth in world demand for their products or services but are subject to large investment. These industries do not require costly machinery or other fixed assets. Their requirements are limited to modern computers and networks and the most important element of success is the presence of an innovative work force, a highly developed telecommunications network at reasonable cost, a legal environment that protects intellectual property rights, and trade relations with multinationals. These elements are within the reach of Palestinians.

## **The Role of Government in Promoting Industrial Sector Development**

To achieve the goals of a long-term industrialization strategy, the government needs to reinforce the private sector and promote its growth. Policies need to achieve economic stability and create an environment conducive to investment. This, in turn, requires the existence of an economic vision of development with clear-cut goals. The following are some general suggestions for industrial policies which may contribute to the development of the industrial sector and its competitiveness. These policies will be presented in the general framework of Porter's Model which divides government industrial policy into four groups:

### **Industrial Policies Influencing Elements of Production**

#### ***Education and Training***

In addition to addressing primary education, the government needs to develop education, training curricula and systems that produce highly skilled labor. This can be achieved through improving standards and systems of academic and vocational education, updating courses and educational material, and linking them with the needs of industry. The government may also provide tax incentives to

enterprises that offer training to their employees or offer scholarships in specific fields compatible with industrial strategy.

### ***Science and Technology***

The government has a central role in supporting scientific applied research activity and innovative development for introducing and transferring technology. In particular, the government can draw up a national plan for science and technology creating a link between research and development and the needs of the leading economic sectors. It can also help companies to transfer and absorb knowledge and foreign technology in fields determined by the country itself. This is in addition to support given to private and public scientific research centers and the strengthening of ties between research centers and industrial firms. The government may also support research and development departments inside industrial firms.

### **Infrastructure**

Competitive advantage is influenced by the quality of infrastructure services provided, particularly water, electricity, telecommunications, road networks and transportation. Infrastructure is particularly significant in industries based on a competitive strategy influenced by time (delivery of goods to markets on time), and export industries. Although the PNA has experience in the privatization of some services, a mechanism needs to be created to effectively prevent monopoly behavior by companies with concessions to provide infrastructure services.

### ***Capital***

Industrial investment and continuous high-tech modernization require sufficient low cost capital. The PNA can influence capital markets by encouraging individual saving and avoiding budget deficits in current expenditure, thereby strengthening the ability to attract foreign investment and improve the investment environment. However, experience has proved that government intervention to lower interest rates or the prices of production materials is ineffective.

## **Industrial Policies Influencing the Market for Services and Goods**

### ***Government Tenders***

Government tenders can be a major outlet for the marketing of domestic products. Several countries give preference to national goods but preferential treatment should be temporary and conditional on a gradual improvement in the quality of production. To create a long-term competitive advantage, government tenders should be open to local and foreign competition. The basic standards required should also be raised to encourage companies to improve the quality of their products.

### ***Standards and Specifications***

Raising the level of standards and required specifications in goods, services and means of production is equally important to drive companies to improve their quality and efficiency. High standards are particularly vital for goods intended for export. A number of countries demand certain standards and specifications from imported goods while other countries require previous registration of products before they can be imported. Pharmaceuticals are a case in point. Moreover, rigorous standards and specifications are used as a mechanism to limit the entrance of imported goods and strengthen the competitiveness of national goods.

### ***International Political and Trade Links***

A country may contribute to the creation of export outlets through the establishment of trade relations with other countries. Preferential treatment can also be achieved through the signing of detailed trade agreements, although the current global trend as witnessed in the GATT agreement is to stop discrimination between countries in trade deals. Nevertheless, some countries resort to bilateral agreements and the establishment of economic blocs that give greater advantages than those given to other countries.

## **Industrial Policies Influencing Supportive Institutions**

The success of any given industry requires the presence of effective institutions to complement and support it. Government policy can promote and encourage the establishment of specialized industrial associations within an appropriate legal framework that grants them powers and provide sources of information on marketing opportunities and production techniques. The government can also support the establishment of an industrial data bank and economic research institutions to conduct market research on local and international markets, sources of raw materials, and high-tech development. This will assist in keeping abreast of developments and improving competitiveness. The government can encourage the establishment of marketing companies to market products internationally, including holding international exhibitions for local products, and searching for marketing partners. The government may also contribute to the establishment of financial institutions that provide financial credit to exporters.

## **Policies Influencing Industrial Structure and Company Strategies**

It is necessary to provide or create a suitable legal environment that explicitly defines the rights and duties of those involved in the production process and forces companies to improve their competitiveness locally and internationally. In this field, the government should do the following:

- \* Increase competitive pressure between companies by using the license mechanism to encourage competition. However, the licensing policy should

have a proper economic basis. The government should also prevent monopoly behavior, or at least restrict it to that justified by an economy of scale (natural monopoly). The competition mechanism may improve efficiency through the creation of permanent pressure that forces manufacturers to search for other methods that reduce cost or/and improve the quality of products.

- \* Since competitive success is measured at global levels, local companies need to be exposed to a significant degree of competition with multinationals by freeing foreign trade, encouraging local companies to establish trade relations with foreign companies, whether in the field of investment or production, and setting up a mechanism that guarantees that protected firms improve their competitive performance.



