



Palestine Economic Policy Research Institute (MAS)

Improving Palestinian Investment Legislation to the Advantage of SMEs

Feras Milhem

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The Palestine Economic Policy Research Institute (MAS)

Founded in Jerusalem in 1994 as an independent, non-profit institution to contribute to the policy-making process by conducting economic and social policy research. MAS is governed by a Board of Trustees consisting of prominent academics, businessmen and distinguished personalities from Palestine and the Arab Countries.

Mission

MAS is dedicated to producing sound and innovative policy research, relevant to economic and social development in Palestine, with the aim of assisting policy-makers and fostering public participation in the formulation of economic and social policies.

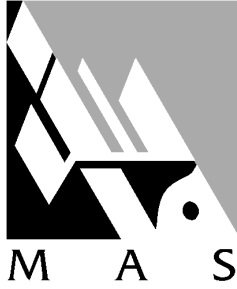
Strategic Objectives

- ♦ Promoting knowledge-based policy formulation by conducting economic and social policy research in accordance with the expressed priorities and needs of decision-makers.
- ♦ Evaluating economic and social policies and their impact at different levels for correction and review of existing policies.
- ♦ Providing a forum for free, open and democratic public debate among all stakeholders on the socio-economic policy-making process.
- ♦ Disseminating up-to-date socio-economic information and research results.
- ♦ Providing technical support and expert advice to PNA bodies, the private sector, and NGOs to enhance their engagement and participation in policy formulation.
- ♦ Strengthening economic and social policy research capabilities and resources in Palestine.

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Foreword

The Investment Promotion Law No. (1) of the year 1998 was one of the very first laws promulgated by the PNA. The law pertains a new legal framework for investment in the oPt for Palestinian, Arab and foreign investors. The law offers investors abundant, generous and competitive incentives ahead of any other country in the region. Nevertheless, the law focused on large and new investments, paying little attention to investments in small and medium enterprises. Furthermore, these suffered severely because of the bad investment environment in the Palestinian economy and the hostile occupation measures, which caused serious losses to investors and affected their competitive capabilities’.

Our experience in this field has shown the need for further amendments that would simplify investment procedures and improve their transparency. This study came as a response to the wide calls demanding amendment to the law, in which all shortcomings were discussed.

This study constitutes one of a series of research studies on fighting poverty through the development of small and medium enterprises. The series aims at identifying the difficulties that hinders their development and at identifying policies that can improve their performance in areas regarding the legal framework, infrastructure, financing, promotion and other policies.

On the occasion of publishing this study, I would like to thank all the people who participated in preparing this study, in particular the team of researchers, and our partners at the International Development Research Centre (IDRC) for their generous fund.

Samir Abdullah
Director General

EXECUTIVE SUMMARY

Small and Medium Enterprises (SMEs) constitute 95% of the existing economic institutions in Palestine, and are the largest employers. The Palestinian National Authority became aware of the importance of such projects in economic development, so they started various studies on how to support and encourage SMEs. It could be argued that those studies are still in their initial stages and have not been translated into substantial actions or practical steps to find ways to promote SMEs as did neighboring countries such as the Republic of Egypt, which developed a series of different policies on how to promote SMEs. Some of those policies have been translated into legislation, such as the law facilitating the registration process of SMEs known as (One-Stop-shop).

In order to contribute to finding the means of strengthening SMEs, the Research Institute of Economic Studies took upon the task of analyzing the Palestinian Investment Act of 1998 by assessing its contribution to promoting domestic and foreign investment in SMEs on one hand, and whether its provisions contribute to bringing foreign investment in Palestine through SMEs, on the other. This study did not stop at this, but evaluated the legal framework for investment in Palestine, and showed the strengths and weaknesses regarding its provisions.

Defining SMEs was not an objective of the study, but some definitions have been reviewed by comparing and looking into those that depend on the amount of capital invested, the number of employees or both. In the absence of a clearly defined and accredited definition of SMEs in Palestine, economic studies reviewed the size of the average capital invested of less than 60% of the minimum required to benefit from the incentives of the Investment Promotion Law.

It should be noted that the legislative policy in place internationally for the promotion of SMEs takes two forms:

First: positively approaching SMEs within the legal framework by having them at the heart of the investment promotion laws through its provisions of tax incentives, customs and public guarantees, as in the Tunisian law.

Second: not specifying a minimum for investment in SMEs, and thus benefiting from the incentives of those projects. With reference to the Investment Promotion Law, it was found that it did not take into

consideration either one of the two approaches above, and thus incentives for SMEs were ignored in the law.

Through the analysis of the Investment promotion Act, it became clear that it didn't identify the investor's nationality, meaning that national and foreign investors alike benefit from its provisions. The Act addressed the incentives and privileges granted to investors, but did not indicate the procedures required to benefit from the incentives granted by law, leaving it to the provisions' regulations which have not been issued yet. The study treated laws related to investment such as company law, intellectual property, the taxation system, and the urban and industrial zones' laws. We concluded that these laws contribute to the promotion of investment, but some are in need of standardization and being kept up to date.

It also highlighted an important issue related to investment guarantees in the Palestinian legal system. The study divided the guarantees into general ones and guarantees related to the settlement of investment disputes. In which concerns the general guarantees, issues of expropriation, transfer of profits, capital investment projects abroad, and safeguards against the abolition of the investment projects were discussed. It was noted that concerning expropriation regulations and transfer of capital investment projects abroad, the Palestinian legal system has been satisfactory. However, the safeguards in the Investment Promotion Law against the cancellation of an investment project were not satisfactory at all. It has been noted that supremacy was granted to the Investment Promotion General Authority in the decision to cancel investment projects, without any indication as to the criteria that restrict the work of the Investment Promotion General Authority or providing the possibility of appealing its decisions.

The study also indicated that the investment law needed to be modified in some of its provisions, including:

- ✧ Redefining the "investor's capital" to remove any existing ambiguity so it includes cash, in-kind investments and moral rights. The definition indicated by the law of investment has been broad enough to include all types of investment, which in our view was the intention of the legislator. It can also be a narrow definition so as not to include investment in intellectual property, shares, and securities.
- ✧ Review of Article IV of the law concerning the nature of the projects benefiting from the incentives so as to encourage certain sectors while not closing the door to others. The technology sector in general and the

Internet and computer specifically are sectors that should be of interest. We point out that most of the projects in this sector, especially the Internet and computers, are SMEs.

- ✧ Reviewing the article 43 of the law, with regard to the exemption of commercial projects, or at least defining the exempted commercial projects in the provisions of the law. It would have been better to use the term business here.
- ✧ Revisiting the articles related to the investment promotion body, especially with regard to determining the functions of the Governing Council and Investment Directorate, and also to increase the representation of the private sector. Some of the tasks entrusted to the board of directors are: supervising the investment projects, as well as maintaining control over them. And here, we see that these tasks rest with the Directorate of Investment, which provides supervision and monitoring reports to the Governing Council for discussion and decision-making and appropriate recommendations.
- ✧ There is a need to clarify or establish clear criteria for some of the terminology used such as "special quality projects."
- ✧ Reviewing the legislative and economic philosophy behind granting tax exemptions. It is well known that the tax and custom exemptions are not considered decisive factors in the investor's decision since the imposition of high taxes on income may lead to the reluctance of investors to invest their money. However, permanent tax-exemption or low taxation may lead to capital flee to the country of the investor. Such a situation occurs when the country of the investor imposes taxes on the income of the company. Moreover, we focus on the following points:
 1. The laws about regulating incentives did not take into account encouraging investment in SMEs.
 2. We can highlight some of the incentives contained in the law which may not comply with international standards, including:
 - Article 24 (d) of the Act which allows the National Authority to give the preferential treatment to national investors.
 - Granting privileges and extra incentives for the use of a certain percentage of local raw material and sources may be contrary to international standards, particularly those contained in the TRIMS Convention. Article 24 (c).
 - The law also does not comply with international standards set by the TRIMS agreement in the text in Article 31 which reads:

"The Commission may grant exemptions for exceptional exporting projects ...".

3. The ratio and duration of tax and custom exemptions are considered high.
4. That the law did not grant tax and custom exemptions based on institutionalized developmental regulation that takes into account the development of certain geographical areas or the development of a particular economic sector.
5. Some experts recommended that tax exemption should enter into force once the project starts making profit and not once the project starts operating, while emphasizing the necessity of activating the supervision over projects in order to reduce the manipulation of financial statements for the purpose of obtaining exemptions provided by the law¹.

We note from the provisions of the law the wide discretion granted to the Investment Promotion Board and the Council of Ministers to grant custom and tax exemptions.

¹ Basem Makhoul, previous source, 66-67.