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Palestine Economic Policy Research Institute (MAS)

## قطاع الخدمات الفلسطيني: بنيته وأثره الاقتصادي

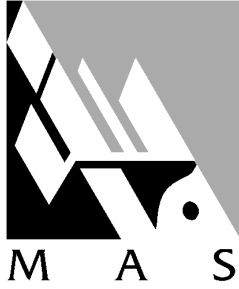
## Structure of the Palestinian Services Sector and Its Economic Impact

بلال الفلاح

Belal Al-Falah

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**Structure of the Palestinian Services Sector and Its Economic Impact**

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## **Foreword**

This study aims at discussing the reasons for the expansion in the services sector and its growing role in terms of employment and contribution to the formation of the Gross Domestic Product. The study clarifies that the expansion in the Palestinian services sector differs fundamentally in its causes and trends from the expansion of the services sector in developed economies and the global economy in general. This expansion has formed one of the manifestations of the transition from an industrial economy to a knowledge economy. The expansion of the role of the services sector in the Palestinian economy accompanied the embedded role and importance of the traditional service branches, such as trade, transportation and distribution services, while the modern service branches, which are linked to the information and communication sector, still has limited contribution, despite its remarkable growth in recent years.

This study is one of the few studies that dealt with the services sector in Palestine, and it provides an important addition to the characteristics of the development of this sector. The study also highlighted a lot of information that grabbed the attention of policy makers and those interested in the future of the Palestinian economy. It emphasizes the need to stimulate the growth of some advanced service branches that are necessary to move the Palestinian economy towards new prospects. The study also raised many questions that require follow-up research.

With the completion of this study, I would like to thank the research team, reviewers and discussants who provided important notes that contributed to the improvement of the study. I also extend my sincere thanks to the Arab Bank for Development in Africa, and the Islamic Development Bank - Al-Aqsa Fund for funding this study, which constitutes one of the priority studies of the Palestinian National Authority Research Program.

**Dr. Samir Abdullah**  
**Director General**



## Executive Summary

Since the mid of the last century, the global economy has witnessed an accelerating growth in the service activities. Notably, the global GDP contribution of services has increased from 55% to 70% during the 1977-2007 period, leading to structural change for many countries toward service based economy. Amounting literature has discussed the economic impact of expanding the service sector. Several researches have shown that the effect actually depends on the structure (type) of service activities. Particularly, economic development is linked to the expansion of modern services, mainly business and financial services. In this regard, several researchers find that economies that rely on modern (traditional) services have experienced rapid (slow) overall productivity growth.

The Palestinian economy heavily relies on service activities. In 2012, the service sector made up 57% of the real GDP and 62% of total employment. At the regional level, Gaza's economy seems to be more dependent on services. Specifically, the service sector makes up 62% of its GDP relative to 56% for West Bank. Also, the service sector in Gaza employs 77% of the total employment compared to 55% in West Bank. The dominance of the Palestinian service sector raises important question on its ability to enhance economic growth, mainly in the light of the decreasing contribution of other sectors, mainly manufacturing.

The first objective of this research aims at exploring the extent to which the Palestinian service sector is driven by modern services (business services, financial services, and real estate services) versus traditional services (distributive services, personal services, and social (governmental) services). The importance of this quest hinges on the relationship between the structure of the service activities and economic development. The second objective is to explore the mechanism through which the Palestinian service sector has expanded by emphasizing the linkages to economic distortions imposed by the Israeli occupation. Finally, the third objective is to examine the economic performance of the Palestinian service sector, exclusively highlighting its impact on the overall productivity growth.

Utilizing PCBS's labor force and national account data, I show that the service sector in the Palestinian territories is largely driven by traditional services. Specifically in 2012 traditional services account for about 85% of

service's GDP contribution and 98% of total service employment. However, the composition of the traditional services differs regionally. In Gaza, social services are more dominating with 60% of service's GDP contribution while distributive services accounts for 21%. In West Bank, distributive services comes first with 46% followed by social services with 32%. Nonetheless, the contribution of personal services in West Bank is similar to Gaza's, amounting to 5% of the service's GDP contribution. The same conclusion also holds when considering employment contribution. In Gaza, social services employ around 59% of the total service workers relative to 31% for the distributive services. Yet, distributive and social services in West Bank have similar employment contribution (41% and 39%, respectively). As for the personal services, it slightly differs between West Banks (15%) and Gaza (18%).

This research also provide evidence that the dominance of service activities can be traced back to the beginning of the Israeli occupation in 1967. Data from Israeli Central Bureau of statistics shows that throughout the 1967-1993, services constituted more than 45% of the WBG's total employment and 50% of the GDP and that traditional service is the main contributor of the service sector. The dominance of the service sector and the expanding (shrinking) trend of traditional (modern) services during this period can be attributed to the economic distortions imposed by the Israeli occupation. These include, extensive trade deficit, which is basically financed by remittances from Palestinian workers in Israel, low competitive industrial sector, and Israeli restriction measures.

The establishment of Palestinian authority in 1994 has not really changed the over- dependence of the Palestinian economy on the service sector. In fact, the share of services has expanded at the expense of the tradable sector (manufacturing and agriculture). Up until 2012 in West Bank, the service sector's share of GDP has grown annually at 0.28%, while the share of tradable sector (manufacturing and agriculture) has witnessed a declining trend. Also, service employment has also increased at an annual rate of 0.75%. Similarly, Gaza's service share of GDP and employment has increased at annual rate of 0.9% and 1.4%, respectively. Similar to West Bank, Gaza's tradable sector witnessed a declining trend.

This study also considers the difference in the evolution of the service structure between West Bank and Gaza after 1994. The results show that service's GDP growth in Gaza is almost entirely accounted for by the social services. On the other hand, GDP growth contribution of the other services, including production sector, has witnessed a negative growth.

However, in West Bank, distributive services scored first, reaping 48% of the service's GDP growth, followed by social services (37%), and personal services (4.5%). Production services accounted only for 11%.

Also, during the 1995-2012 period, the service sector generated about 89% of the employment growth. Social services, however, has dominated (63% of the service employment growth) in which public administration and defense services are the main contributors. The distributive and personal services accounts for the remaining employment growth, 28% and 9%, respectively. Still, production services experienced a negative growth. The service sector in West Bank has generated 63% of the employment growth in which social services accounts for 42%, followed by distributive services (38%) and personal services (19%). Production service, however, accounts for less than 1%.

This study also estimates the indirect (multiplier) effect of the expansion of the service employment. Specifically, it shows the effect of increases in service employment on generating non-service (manufacturing, construction, and agriculture) employment. Utilizing pooled regression analysis, this research finds that the service indirect employment elasticity is 0.33, which indicates that increasing service employment by 1% increases non-service employment by 0.33%. This research also explore the indirect employment effect for separate non-governmental (non-social) services subsectors. Reflecting the enormity effect of traditional services, the findings show that the magnitude of elasticity, whether in West Bank or in Gaza, for distributive services is the largest, followed with a great margin, by personal and production services.

This research also explore possible mechanisms through which traditional services have been expanding in the aftermath of establishing the Palestinian authority. Specifically, it relates the expansion of the distributive services (mainly domestic trade) to the downsizing of the tradable sector, mainly manufacturing, and consequently the excessive increase in import and trade deficit. This study also relates the expansion of the social (public) sector to the rising unemployment rate, which intensified in the aftermath of the Second Intifada. This is likely indicating that the Palestinian public employment has, to some extent, increased to quell the rising level of unemployment due to restricting the access for the Palestinian workers to the Israeli labor market as well as other negative economic shocks from restricting mobility within and across the oPt.

The dominance of traditional (social and distributive) services in terms of GDP and direct/indirect employment at the expense of modern services raises serious economic concerns. Mainly, relying on social (governmental) services is less likely effective to quell the rising unemployment in the long run as the expansion of the public sector is not basically linked to economic growth. This is in addition to the financial hardship that have frequently gusted the Palestinian authority. Also, the fact that the demand for distributive service, mainly domestic trade, is linked to excessive import casts doubts on the ability of this sector to sustain employment growth. This is specifically evident as trade deficit is, to a great extent, financed by international aid.

This paper further highlights the negative impact of the expansion and dominance of the traditional services. Utilizing non-governmental firm level data, the results show that over-relying on low productive services, mainly distributive services, negatively affect the productivity level and productivity growth of the service sector and overall economy, possibly leading to economic growth stagnation.

The far reaching message of this research is that the dominance and expansion of traditional services is basically driven by economic distortions imposed by Israeli restrictions and reliance on international aid. Therefore, at the policy level, further expanding the traditional services is less likely fruitful to achieve sustainable economic development. Policies that aim at enhancing business and financial services is necessary to enhance productivity growth. Also, policies that aim at enhancing the tradable sector are necessary to increase the demand for the modern services through backward and forward linkages.