Palestine Economic Policy Research Institute (MAS)

Background Paper

Roundtable (7):

Evaluation of the 2014 Amendments to the Investment Promotion Law

2014

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Background and Rationale

Investment is a key driver for the development of economies worldwide. This is particularly true for Palestine, where investment, both public and private, is affected by exceptional circumstances and external determinants that impact the development process, constrain the performance of the economy and determine economic and social development indicators.

The launching of the “Peace Process” and the establishment of the Palestinian Authority (PA) was accompanied with upbeat expectations of stable political and security climate as well as improvement in the performance of the Palestinian economy. It was then incumbent on the PA to create and improve the legal and institutional environment so as to attract private investment. Consequently, an executive order to promote investment in Palestine was decreed by the President of the PA in 1995. Three years later, the Legislative Council passed the first Investment Promotion Law (IPL) which had many incentives for local and foreign investors.

Unfortunately, the counteractive political and security determinants, that adversely affected the development and investment climate after 2000, were enormous and even outweighed the advantages of the package of incentives provided to investors by the Palestinian law. These factors created a discouraging investment climate, which was reflected in a decline of private investment which shrank by 38 percent comulatively in the period following the 2000 as compared to 1994. Meanwhile, the share of private investment to GDP hovered around 13-15 percent in the last 13years as compared to 22 percent in 1999[1].

Within a dynamic process of reviewing and improving the legal environment- as well as dealin realistically with the requirements to attract investment and provide incentives to investors, while catering for the developmental, sectoral and geographical needs- the PA introduced important amendments to the legal environment through the issuance of the amended 2011 law which increased the minimum seed capital from USD 100 thousand to USD 250 thousand. The amended law has also reclassified investment brackets entitled to tax breaks, increasing years for total exemption while reducing the period for partial exemption. The amendment added employing labor, in addition to the capital, as a condition to get the exemptions stated in the law.

Article 15 of the 2011 amended law allowed terminating incentives two years after the law enters into force. This means that since early 2013, the Palestinian decision-maker has been in a position to choose whether to freeze the incentives or to postpone related claims. In March 2013, the Council of Ministers issued an executive order[2] that extended the law until the end of 2013. This came together with an internal decision by the Palestine Investment Promotion Agency (PIPA) not to accept new requests from investors as of November 2013. When the extension period came to an end, the executive authority started work on developing a new investment promotion law. The effort produced the Presidential Decree No. 7 of 2014 on the amendment of the Palestinian Investment Promotion Law. The law and its timing have raised questions regarding the justification for issuance, the ability of the law to achieve its objectives, its compatibility with other laws applicable in Palestine, the clarity of articles and the potential to address the challenges in the investment environment.

Within its role in stimulating national discussion of socioeconomic priority issues for decision-makers, the Palestine Economic Policy Research Institute (MAS) endeavors to host a roundtable

1 Center for Private Sector Development (2013).A Survey of the Determinants of Private Investment in the Palestinian Territory.

2 Council of Ministers' Executive Order No. (م.و/س.ف/14/45/59) of 2013 on extending granting tax incentives provided for in the Investment Promotion Law No. (1) of 1998 and its amendments. The Executive Order was issued on March 5th, 2013.

that gathers different stakeholders for an insightful discussion to find answers to the topical issues. This background paper is intended to steer the discussion to focus on three major themes. The first provides an overview of the status and indicators of investment in Palestine. The second looks into the determinants of the investment climate. The third reviews the 2014 law and compares it with the 1998 law (and its amendments) and sheds light on the role of the new law in reducing the negative impact of the determinants of investment.

2. Investment in Palestine (facts and indicators)

Investment in Palestine is influenced by set of determinants as well as internal and external factors. The variations in the size and momentum of investments in different periods are closely linked to changes in the security and political situation and the performance of the PA's institutions, as well as the legal framework governing business activities. The developments in the political process and the escalation of the Israeli adverse measures are the most detrimental factors to the investment climate in the Palestinian Territory. In general, investment in Palestine has been developed across four basic periods. Below is a review of the investment developments as represented by the total value of the gross fixed capital formation[3] (see Figure 1):

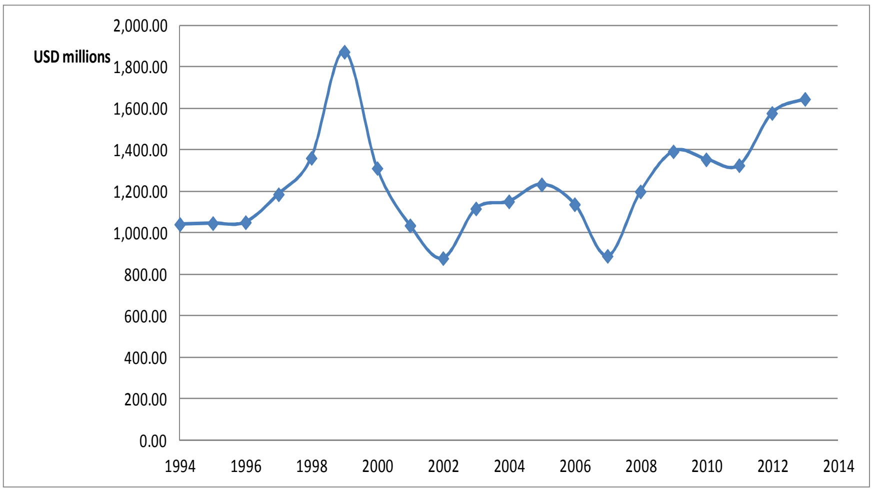
Period I (1994-1999)

This stage, that followed the Oslo Accords and the establishment of the Palestinian Authority, enjoyed a relative calm and optimistic outlook regarding the political process and the stability of the political and security situation. This led to an increase in the size of investment from USD 1.042 billion in 1994 to more than USD 1.874 billion in 1999, a year that saw the biggest increase in the volume of investments (38 percent over 1998), probably an outcome of the issuance of the first investment promotion law by the Legislative Council in 1998.

Period II (2000-2002)

With the outbreak of the second Palestinian Intifada, and the resulting tightened Israeli measures of closure and destruction of infrastructure, the majority of economic and social indicators saw a decline. The investment indicator, the most vulnerable one, declined significantly during that period. Figure 1 reveals massive divestments from the Palestinian Territory as a result of the deteriorating security situation and the lack of investor confidence, resulting in a decline in investment in 2002 to USD 877.5 million.

Figure 1: Gross Fixed Capital Formation in Palestine (1994-2013) at constant prices



Source: PCBS, National Accounts, various years.

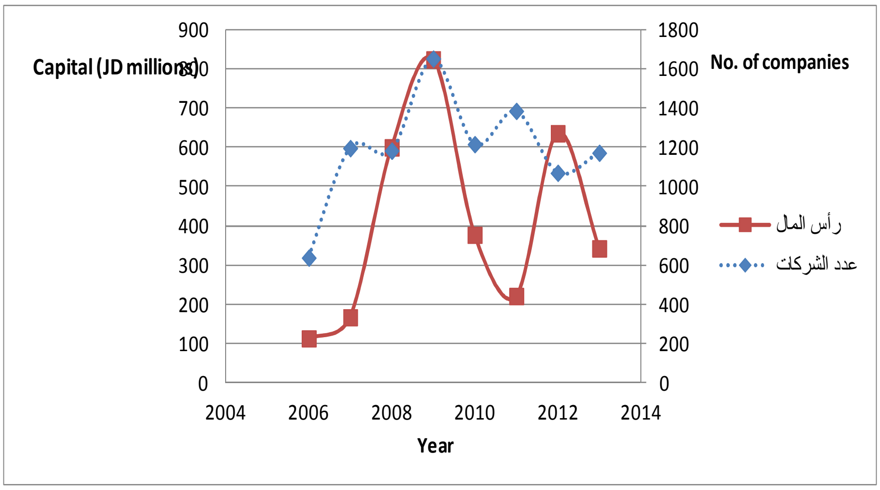
[3] This item involves investment in the construction of buildings and non-buildings, as well as the change in inventory.

Period III (2003-2007)
After the Israeli escalation had peaked in 2002 (with Israel's military invading all Palestinian towns and villages), the territory started to witness a relative calm. This period also marked some corrective actions that came as part of the reform process and the PA's efforts to disseminate the principles of transparency and good governance in public institutions. The relative stability and the advances in financial and administrative reforms helped to restore investor confidence, which was reflected in an increase in investments by more than 27 percent in 2003. This trend continued in the subsequent years, but at a slower pace, bringing the volume of investment in 2005 to about USD 1.234 billion. However, the consequences related to the Hamas' win of the Palestinian parliamentary elections in 2006, the blockade placed on the Palestinian Territory and the internal divide were counteractive to the investment climate. This translated into a decline in investments, which receded to less than USD 888 million in 2007, a level close to that reported in 2002.

Period IV (2008-2013)
With the widened internal divide, and the consequent formation of two governments (one in the West Bank and the other in Gaza), international donors began to pump aid into the coffers of the West Bank's government, which improved economic performance and investment environment in the West Bank, a state that boosted investment significantly, especially in 2008 when investment portfolio reached about USD 1.2 billion, an increase of about USD 312 million over 2007. In the subsequent years and up to 2011, the investment remained relatively settled at about USD 1.3 billion annually. Year 2012 saw a marked increase in investment, which then totaled more than USD 1.578 billion. The upward trend continued to 2013 with a reported volume of USD 1.646 billion. The growth was, however, mainly reported in the construction sector whose share in 2011 and 2012 surged to 88 percent and 87 percent, respectively. The concentration of investment in the construction sector during that period helped offset the negative levels of change in the inventory.

The number and total capital of newly-registered companies are other important indicators of the investment climate. The reported data are consistent with the developments in the volume of investments during the 2006-2012 period. According to the Department of Company Registration and Industrial License in the Ministry of Economy, the number of new companies registered per year has witnessed a steady increase since 2007. While in 2006, the number of new companies registered in the West Bank was 637, the figure jumped to 1,196 in 2007, with a capital of JD 166 million. Year 2008 saw a further significant increase in the capital invested in new companies (about JD 600 million). In the following year, the number of newly-registered companies rose to 1,653 with a capital of JD 824 million, signaling an adequate investment climate in the West Bank. In 2010 and 2011, the figure fell from its level in 2009 but remained stable during the 2-year period both in the number and capital of newly-registered companies. In 2012, the figure fell to 1,070 companies with a capital of JD 636 million (see Figure 2).

Figure 2: Number and Capital of newly-registered Companies in Palestine, 2006-2013



Source: Department of Company Registration and Industrial License, various years.

3- Determinants of investment in Palestine

The unstable political situation remains the key determinant of investment in Palestine. The World Bank report[4] on the ' West bank and Gaza Investment Climate Assessment' cites the political uncertainty and restrictions on movement and access to resources and markets as the main determinant for economic growth in Palestine. According to the report, "decades of military presence, violence, restrictions on the movement of people and goods, restricted access to economic space and resources, governmental crises, internal Palestinian political division, and relative isolation from the global economy have increased the cost of doing business, leading to an uncertain environment in which it is difficult to predict future risks and returns." As a result, the report continued to say, "the level of private investment in the Palestinian Territory is well below the level required for proper economic growth that can create enough jobs and reduce unemployment."

The barriers to market entry, have, to a large extent, limited "competition to those firms capable of maneuvering through the myriad ever-changing regulations and restrictions, as well as to firms that stay small enough to avoid them." As a consequence, "the Palestinian private sector is largely confined to small-sized firms in low productivity sub-sectors."[5] It is not our intention here to provide details of the Israeli policies and their impact on the Palestinian economy, as literature on this topic is abundant. It suffices to say that Israel's control of the crossings; its restrictions on the movement of people and goods; the isolation of Jerusalem; the separation between the West Bank and Gaza; the blockade placed on Gaza; the restrictions on land; and neglecting and even deliberately destroying the infrastructure for decades have thwarted development and undermined productivity. Other determinants of investment are related to or stem from these occupational policies.

The procedural and legal environment

The regulatory framework under which Palestinian businesses operate is fragmented (the Gaza Strip under Hamas de facto government, the territories under the Palestinian Authority jurisdiction, East Jerusalem and area C under Israeli military orders). This complexity in volatile regulations increase the costs and time of doing business. During the years of internal divide, lawmakers in Gaza passed a set of laws, including the Companies Act in force in the Gaza Strip. In parallel, the Palestinian President issued a number of presidential decrees in force in the West Bank. In both cases, the regulations have split the legal system. Now, all businesses are affected by this discord in terms of company registration, licensing, taxation, investment incentives and enforcement of contracts.

Land, resources and infrastructure

Restrictions to land use, especially in Area C, thwart the Palestinian endeavors to develop necessary infrastructure and utilities needed for basic life, not to mention investment. These restrictions affect the price and quality of services, telecommunications, energy, transportation, water, and the treatment of wastewater and solid waste, which raises production costs in the economy. Also, about 70 percent of the land in the West Bank is not officially registered in the Land Registration Department. This land is, thus, not accepted as collateral for loans needed to start a business. According to a World Bank report, Area C, if exploited (and restrictions are removed), can increase Palestinian 2011 GDP by 35 percent. Moreover, Israel's continued control over Palestinian natural resources (such as water, land and the Dead Sea) impedes Palestinian and potential investors' access to natural resources.

Ease of market entry

The ease of entry into and exit from the market is a key requirement for an efficient, competitive economy. It is also one of the most important determinants to investment. The global *Doing*

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4 http://www.worldbank.org/en/news/press-release/2014/09/16/palestinian-economy-in-decline-and-unemployment-rising-to-alarming-levels

5 Ibid. The proportion of formal firms with more than 20 workers is just 11
Percent, compared to 35 percent in comparable lower-middle income countries.

Business annual report uses three indicators to measure the extent of ease of doing business: the number of procedures needed to register a business, the time required to complete these procedures, and the minimum seed capital required. Undoubtedly, facilitating procedures and reducing their cost would stimulate investment and encourage investors to officially register their businesses. Registered organizations can easily access services, financial institutions like banks and administrative institutions like courts and ministries, while workers can benefit from the protection offered by labor and social protection laws. In Palestine, legalizing informal businesses is of particular importance, as the informal sector (in terms of the number of businesses and the number of employees) accounts for a large part of the Palestinian economy[6], which impacts the state treasury in an adverse way, usually in the form of lost tax and non-tax revenues. Moreover, the informal businesses cannot avail themselves of the incentives necessary for growth and expansion and they do not comply with safety requirements, suggesting lack of sensitivity to the consumers' health and safety. In this context, the reader might need to know that companies in the West Bank are registered under a law different from that applicable in Gaza.

In 2014, Palestine ranked 143 out of 189 countries in the 'Ease of Doing Business', as *Starting a Business* requires 9 procedures carried out in 45 days with a cost of 85 percent of the average per capita income, as compared with a regional average of 6 procedures completed in 19 days at a cost of 29 percent of the average per capita income.

Labor

In developing countries, the availability of cheap labor is a main characteristic[7], which attracts foreign investments from international companies that seek low costs of production. However, the structural distortion in the Palestinian labor market, resulting from prolonged occupation and economic dependency on the occupier, deprived the Palestinian economy of this advantage. The destructive policies pursued by Israel against the Palestinian Territory have divested the economy of the ability to create new jobs to absorb the growing numbers of workers, forcing 11 percent of the Palestinian labor to seek employment in Israel and the settlements, especially that the average daily wage for Palestinian workers employed in Israel was NIS 163 in 2012 compared with NIS 88 in the West Bank and NIS 63 in the Gaza Strip[8], suggesting three different wage rates. One of the main reasons for the high wages and distortion of the structure in Palestine is the high prices resulting from the high production and import costs, a consequence of the Israeli obstacles imposed under a unified customs system. Cross-country data show that the rate of wages in Palestine outweighs those in Jordan (JD 16.8 or NIS 85 in 2012) and Egypt (USD 7.4 or NIS 27 in the same year).

4. A review of the 2014 amendments made to the Investment Promotion Law

Given the wide array of determinants influencing the investment climate in Palestine, a greater responsibility rests with the Palestinian law-makers and decision-makers who are supposed to enact a modern law that stimulates investment, reduces costs and mitigates the high level of risk that potential investors might face. Since its establishment, the PA has exerted much effort to create and improve the legal environment for stimulating investment. Yet, one should always keep in mind that the process of conducting reforms is dynamic and responsive to changes occurring in the investment environment. The recent effort regarding the amendments to the Investment Promotion Law is only part of ongoing initiatives of improving the legal framework. Below, this background paper provides a review of the most important amendments to the original law and examines these changes in terms of their ability to address the gaps in the investment climate and the challenges investors might face. The amendments, which came as an executive order, involve 17 articles. Below is a summary of the most important amendments, together with some comments.

[6] Falah, B. (2014). The Informal Sector in the Palestinian Territory, MAS.
[7] Specifically, the lowest income countries within the middle-income group.
[8] The average daily wage for working in the 3 regions (West Bank, Gaza and Israel) was NIS 93 in 2012.

Definitions

- ✧ The amended law defined **Incentives Package Contract** as that under which the Palestine Investment Promotion Agency grants the investor either tax or non-tax incentives (such as waiving transaction fees and providing support services, training and logistics) based on a decision issued by the PIPA's Board of Directors in return for the investor's commitment to the implementation of the project in accordance with the conditions set forth in this contract. The definition of the 'Incentives Package Contract' was first introduced in 2011 Law. Unlike 2011 amended law (which stated that additional incentives may be granted), the 2014 amendments expressly gave the PIPA the powers to grant the incentives contained in the law. This amendment may allow for giving the investors the full package of incentives contained in the law even if they do not meet the certain conditions and criteria. While 2011 amended law granted only tax incentives, the new amendments accounted also for non-tax incentives. Interestingly, unlike the 2011 amended law, the new amendment gave the PIPA's Board of Directors the powers to grant tax and non-tax incentives without referring to the Council of Ministers or the Legislative Council, the body with inherent authority to enact laws. Obviously, this amendment fails to comply with Article 8 of the 1998 General Budget Law (and its amendments) which provides for the inadmissibility of exempting anyone from taxes other than those designated in the law. The amendment also breaches the constitutional principle that taxes and fees are only levied by the law, and that exemption (just like charging) is granted by the law rather than an executive body.

- ✧ In its definition of **developing an existing project**, the new amendment added the following condition: "or introducing a new product or manufacturing a product imported from abroad." This amendment suggests that drafters meant to encourage the diversification of products and replace imported products with local ones. This article should, however, be paired with another article which sets the minimum proportion of production input (70 percent) as a condition to be entitled to the incentives contained in the law.

- ✧ The new amendment abolished the definition of **real estate development projects**[9] contained in the original law, but added a definition of agricultural and tourism projects. The abolishment and addition are probably related to projects covered or excluded from the incentives enshrined in this law, as the subsequent Article 12 states that real estate development projects (which are replaced by real estate projects and real estate development) are not entitled to the incentives contained in the law. Agricultural and tourism projects, on the other hand, were explicitly stated in Article 8 as targets for incentives, and thus they should have been defined.

Target sectors

Article 3 of the new amendments states that the **economic activities** within the **Incentives Package Contract** are entitled to the incentives specified in the law. Unlike the 2011 amendments (which named the economic sectors entitled to incentives), the 2014 amendment allowed other sectors to benefit from these incentives provided they have the approval of the Council of Ministers. It was probably more convenient to name the target sectors, leaving the door open to add other sectors later in accordance with the legal procedures and in line with the priorities of the Palestinian development. Defining such sectors would first ensure compliance with transparency requirements and second identify with the national development plans, with a tendency of supporting specific sectors so as to give the Palestinian economy a particular character in the next phase. The amended Article 8 defined the target sectors, namely: agriculture, industry and tourism.

PIPA Management

The new amendment reduced the number of members of the PIPA's Board of Directors from 17 to 11, thus excluding representatives of five government agencies (namely: Palestine Monetary Authority, the Ministry of Agriculture, the Ministry of Public Works, the Ministry of Foreign

[9] Projects identified by the PIPA through a special system

Affairs and the Ministry of Planning); adding a representative from the Ministry of Communications and Information Technology and a representative of Energy and Natural Resources Authority; excluding representatives of the Palestinian Information Technology Association of Companies, the private tourism sector and the Palestinian Contractors Union; and finally replacing the representative of the Palestinian Center for Development of Trade with a representative from the Palestine Trade Center- PALTRADE.

Apparently, the new board is heterogeneous- with a representative of the Ministry of Communications added (to claim heeding the IT sector), while at the same time the Palestinian Information Technology Association of Companies excluded. It is also unclear why the Ministry of Agriculture has been excluded at a time when agriculture is included within the privileged sectors. Similarly, ignoring the Authority of Energy and Natural Resources suggests overlooking a promising sector with significant future potential investments in light of the talk about setting up power plants and possible intensified investment in quarries and stone manufacturing and processing, especially in so-called Area C.

On the other hand, in the amendment, the Board of Directors serves for a period determined by a regulation by the Council of Ministers based on the Board nominations. This article is fuzzy, as setting a term of service should only apply to representatives of the private sector and not all members. The appointment of private sector representatives requires a decision by the Council of Ministers, a term that the new amendment failed to notice.

The new amendment gave the Board of Directors broad powers, including the right to ratify the 'Incentives Package Contracts' presented by the PIPA. In the 2011 amendments, the Board of Directors' power was confined to recommending specific incentives (as additional incentives apart from those expressly mentioned in the law) before referring them to the Council of Ministers for approval. Under the new amendment, the Board of Directors has the right to issue licenses for projects if concerned public agencies fail to issue a decision regarding the licensing transaction within thirty working days from the date of applying for a license. This power was also given by the 2011 amendments; yet the 2014 amendments expanded the period from thirty days to thirty working days. Whether in the original law or in the new amendment, this provision would create a state of mix-up when the potential projects require approvals from government agencies such as the Environment Quality Authority, the Tourism and Antiquities Department and perhaps the Spatial Planning Department in the Ministry of Planning. Such approvals require in-depth, long-term studies, and may not be completed within the specified time limit.

Paragraph 17, pertaining to commissioning the representative of the Ministry of Finance to submit an annual report on direct and indirect taxes on investment projects benefiting from the law, is an unnecessary addition, as such a job falls within the routine tasks of each representative– who is supposed to provide the necessary reports and statistics that facilitate the work of the PIPA and further the goals of the Law. Moreover, the addition of paragraph 18, regarding the role of the Board of Directors to participate in the promotional activities of the PIPA, is a repetition of Paragraph 15 in Article 15 of the original law, which instituted the role of the Board of Directors in approving promotional activities designed to attract investment. The authors should have restricted this role to approving such promotional activities rather than taking part in them. Paragraph 20 is probably the most controversial addition as it allows the chairperson of the Board to oversee the executive administration. Concerns are also voiced regarding the addition of a new paragraph to Article 17 of the original law, which makes the CEO subordinate to the chairperson of the Board. This power overlap between the executive body and the Board of Directors is in stark violation of the good governance principles, which entail separation of powers. It is unclear how the Board of Directors will supervise the CEO at a time when this CEO reports to the chairperson of the Board. Under this term, both the supervisor and the supervisee are partially responsible for the actions of the CEO. Furthermore, these additions are expected to constrain the executive administration abilities in exercising its business according to the law, as legislation in Palestine since 1993 compels executive bodies to behave only in accordance with the powers assigned to them by the law (Article 17), provided financial and administrative periodical reports are submitted to the Board of Directors for approval. Thus, the true power of the boards of directors is to endorse policies and monitor their implementation (in furtherance of the goals of the institution), but not to directly supervise the work of the executive bodies.

Tax breaks and incentives

Article 8 in the 2014 law has substantially amended the incentives and exemptions granted to investment projects. Unlike the 2011 amendments to the Income Tax Law (which did not include income tax exemptions for natural persons working in farming), the 2014 amendment bestowed income tax breaks for agricultural projects. The authors might argue that an agricultural project often has a company legal form (legal person), and therefore there is no conflict with the Income Tax Law. However, conflict will still there when the beneficiary is a natural person.

The 1998 law granted the target projects a partial exemption from income tax (5 percent and 10 percent). The 2011 amendments abolished this privilege, but 2014 amendments restored it. While the 2011 amendments stated that granting incentives starts in the fiscal year following the year in which production commences, the new amendment allows projects to claim incentives when these projects start to make profits for a period that may not exceed four years; and thus giving investors more lavish incentives.

Among the projects that could benefit from the incentives contained in the amendments are those that employ at least 25 workers, those whose exports exceed 40 percent of their production and those whose local component of equipment and raw material represents 70 percent of their input. Below, we highlight some observations about these terms:

- The requirement to employ at least 25 workers may run against the status of Palestinian enterprises, with data showing more than 90 percent of the projects in Palestine employing less than 10 workers, while those with more than 25 workers have a scant 1 percent representation. On the other hand, this condition requires follow-up procedures that can be complex and might need an ad hoc regulation. Several questions might arise: Part-time or full-time? Would the system require wages no less than the minimum wage? Will the continuation of granting incentives be contingent on keeping the number of workers no less than 25? Will the system demand that a part of these workers be university graduates?

- Regarding the exports-production 40 percent ratio, what are the criteria the law will use to calculate the ratio? Wouldn't it be better if the law distinguished between projects that export raw materials (such as stone and marble) and those that manufacture products with high added value? When the amended law referred to 'production', did the authors of the new amendment mean sales (as it is not necessary that all production is sold)? It would have been more convenient if the law drafters had considered exports with relation to total sales, where such data are made available by the PCBS economic surveys.

- Concerning incentives bestowed to projects whose local component of equipment and raw material represents 70 percent of their input (the ratio in the original law was 40 percent), obviously the amendment is intended to encourage the use of local component in the production processes. This condition might, however, be hindered by the challenges of the status quo, the restrictions on the use of local raw materials, the lack of locally manufactured equipment and weak correlation between front and rear production linkages. This would unquestionably reduce the probability of benefitting from the incentives under this condition.

5. Questions and themes for discussion

- *A question directed to* the *Ministry of Economy- Investment Promotion Agency* What are the main justifications for the amendment of the law? What results do you expect to achieve? How far can the new amendment contribute to the improvement of the investment climate and reducing the negative impacts of investment risks and constraints?

- *A question directed to the Ministry of Finance*
  What are the expected financial costs of the new amendments as compared to the original law? How will the application of the amendments influence the budget tax and non-tax revenues?

- *A question directed to the representative of the private sector*
  What is the private sector's position regarding the new amendments? To what extent will these amendments contribute to increasing incentives, reducing investment costs, attenuating the adverse effects of other determinants of investment and attracting new investments? How transparent and univocal is the amended law?