



International
Labour
Organization

► Productivity growth, diversification, and structural change in the Arab States

Occupied Palestinian Territory
(OPT) Country Profile



► 1. Introduction

This country snapshot starts with a historical overview of labor productivity trends in Occupied Palestinian Territory (hereafter OPT) compared with other non-GCC Arab economies and the global economy.¹ Subsequently, it provides an overview of the contemporary business environment and prospects based on two recent enterprise surveys – the 2019 World Bank (WB) enterprise survey and the 2021 ILO survey on productivity growth, diversification, and structural change.

In addition to highlighting the position of OPT relative to other Arab economies and global frontiers in terms of labour productivity, the first part (section 2) of this snapshot documents the trends in labour productivity and the relative contributions of labour productivity and employment growth to aggregate output growth. The structure of an economy plays an important role in determining a country's productivity trends, both due to technological change and productivity growth within industries, and the potential for enhancing productivity by shifting resources to more productive uses. Therefore, this section also examines the evolution of the structure of OPT's economy, in terms of industry composition of employment and output compared to the Arab economies' average.

In the second part (Section 3), the snapshot highlights the key findings of the WB and ILO enterprise surveys regarding barriers and challenges that business enterprises face in OPT, particularly since the Covid pandemic, along with the business impressions regarding the future strategies for productivity improvement.

Finally, in section 4, a few recommendations for future productivity improvement in the country are derived based on the existing evidence on long-term productivity trends and insights from the enterprise surveys.

► 2. Historical overview of productivity growth, and structural change

► 2.1. Relative Labour Productivity levels

Relative labour productivity levels (i.e., the output per worker in a country relative to a frontier country that is technologically advancing faster) are indicative of a country's productivity catch-up with the global frontier. Figure 1 shows the levels of OPT's labour productivity (output per worker) relative to the United States.² The average worker productivity level in OPT was just 3/5th of the productivity levels in the non-GCC Arab economies in the 1970s but is currently quite similar to the region's average. However,

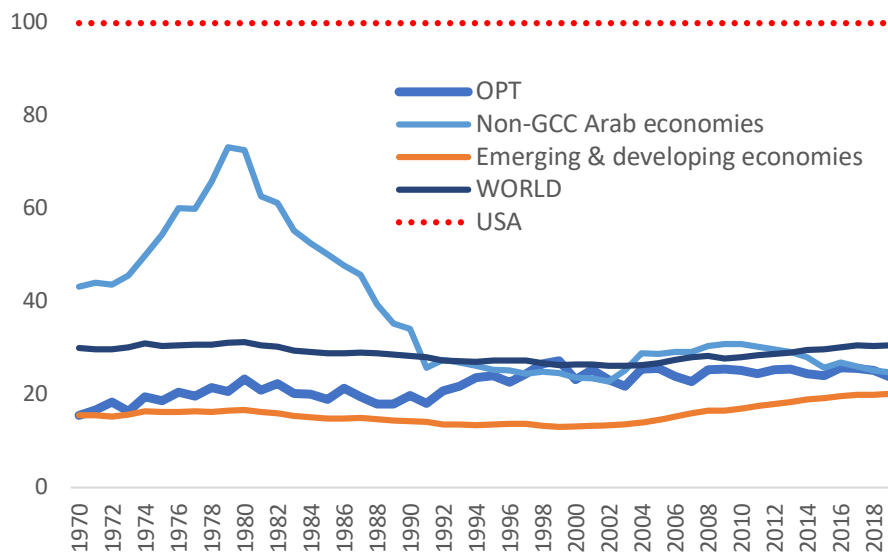
1 In this snapshot, when we refer to the Arab states, it consists of six GCC countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) and six non-GCC Arab countries (Iraq, Jordan, Lebanon, the occupied Palestinian territory, the Syrian Arab Republic, and Yemen). The global economy is an average of 132 countries covered in The Conference Board Total Economy Database.

2 Relative labour productivity level is measured as the amount of output an average worker in OPT produces in a year, compared to the amount of output an average worker produces in the United States.

looking at the evolution of productivity, it is evident that this similarity was not achieved through a catch-up of OPT with the region or the global frontiers but due to the persistent erosion of the region's productivity.

The non-GCC Arab region, consisting of Iraq, Jordan, Lebanon, Syria, Yemen, and OPT, in general, seemed to have benefitted from the oil boom and the initial development trigger in the GCC, as reflected in the high productivity catch-up in the 1970s. Although OPT shows somewhat similar trends, its productivity levels remained much below that of the region's average. For instance, when the non-GCC Arab region improved its productivity levels from 43 percent in 1970 to 72 percent in 1980, OPT improved it from 15 percent to 1/5th of the US level. The region started losing that steam after the oil crisis in the late 1970s. Since then, the region's productivity has never shown any tendency of a major turnaround. At the peak of its productivity level, it reached above 70 percent of the US labour productivity level in 1980 but has fallen since then, reaching just a quarter of the US levels in 1991. Since the 1990s, on average, its productivity level remained just above 25 percent of the US levels, with very little deviation - the lowest was 23 percent in 2002, and the highest was 27 in 2010, perhaps a little recovery effect from the global financial crisis. The consistent fall in the region's productivity levels implied a convergence between OPT and the region by the mid-1990s. For instance, in 1997, the productivity levels in both OPT and the region were quite aligned at 27 percent of the US level. Since then, their movement has been quite similar and aligned with the emerging market. Yet, OPT remained slightly below the region's average until about 2016, and since then, both show similar levels. Currently, both are at about 1/4th of the US level, which is slightly above the emerging markets average but lower than the global average. Clearly, the catch-up potential for OPT is quite substantial, for which it would require to grow faster in productivity in the coming years.

► Figure 1: Relative Levels of labour Productivity (US=100)



Note: Labour productivity levels are calculated in purchasing power parity terms for individual economies as GDP per worker and are expressed as a percentage of productivity level in the United States. For the list of countries used to obtain the aggregates of World, and Emerging & developing economies, please see Appendix Table 4 in ILO (2022)³. Non-GCC Arab economies consists of Iraq, Jordan, Lebanon, Syria, Yemen, and Occupied Palestinian Territory.

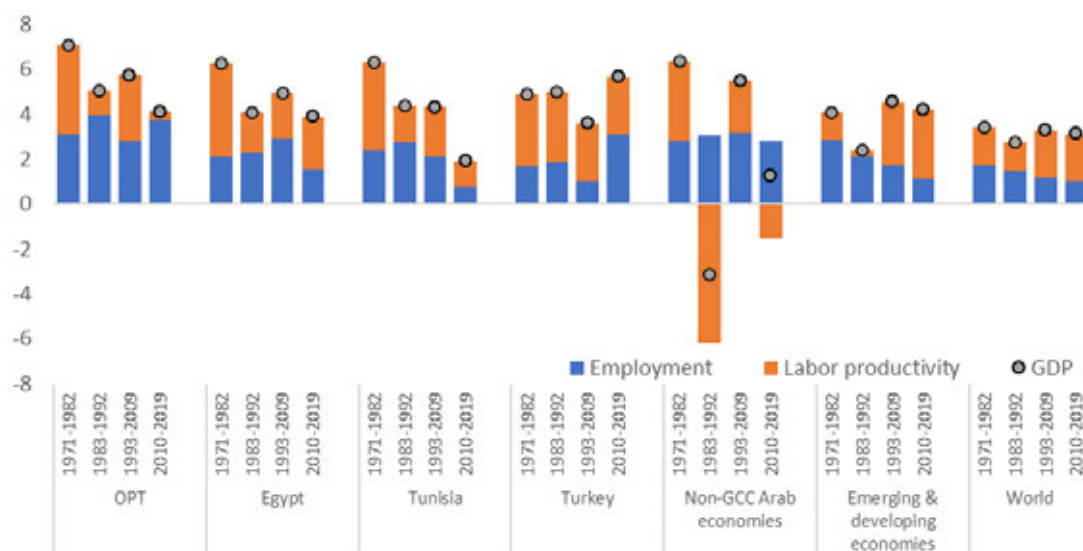
Source: The Conference Board Total Economy Database (TED), April 2021. For OPT, the TED has been extended to include GDP and employment using national accounts data.

3 ILO (2022), "Productivity growth, diversification and structural change in the Arab States", https://www.ilo.org/actemp/publications/WCMS_840588/lang--en/index.htm

2.2. Labour Productivity growth: Labour productivity vs. Employment

The output of an economy can be increased by adding more workers, increasing working hours, or raising worker productivity. OPT's labour productivity growth rates seem to be slightly better than the non-GCC Arab economies' average (Figure 2). In particular, during the 1983-1992 period and the post-global financial crisis decade, when the region suffered productivity decelerations, OPT sustained positive productivity growth, albeit very low. When contrasted with OPT's neighboring peers, OPT's productivity appears to have grown slightly worse than Egypt and Tunisia during the last fifty years, except during the 1993-2009 period. In particular, it did worse during the most recent decade. In contrast, when compared to Turkey, a relatively large economy in the region, OPT's productivity growth was not inferior in the 1970s and 1993-2009 periods, but this appears to be primarily because of poor growth rates in Turkey when compared to Turkey's impressive productivity performances during 1970s and 2010s.

► Figure 2. Contribution of labour productivity growth and employment growth to GDP growth



Notes: All growth rates are calculated as log changes. Regional growth rates are a weighted average of individual countries, using nominal value added weights. For other notes, please see Figure 1.

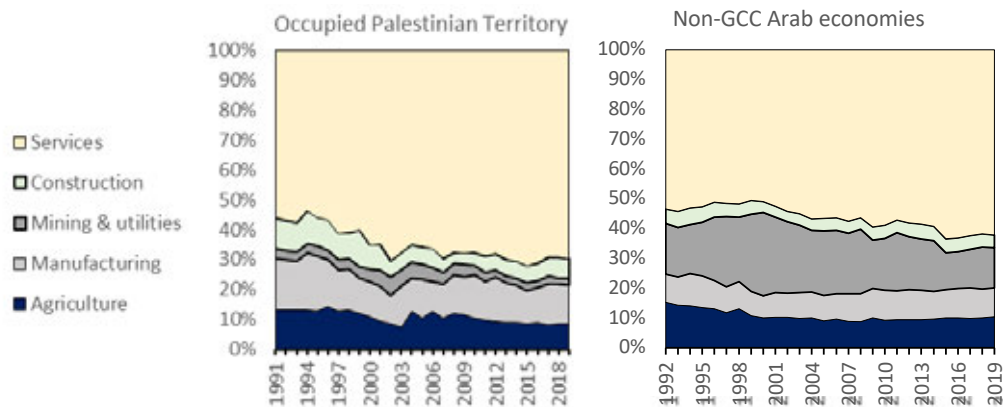
Source: The Conference Board Total Economy Database, April 2021.

Although OPT maintained positive productivity growth over the last 50 years, in general, the relative importance of productivity growth in driving growth was more prominent only in the 1970s and 1990s. In contrast, growth was primarily job-driven in the 1980s and the most recent decade. This trend is more in line with the non-GCC Arab region, where productivity growth was negative in the 1970s and 1980s. Overall, it is hard to conclude that job creation happened at the cost of productivity in OPT in general, a trend often we see in many GCC economies. But the most recent productivity erosion, even while jobs were expanding at remarkable rates, especially compared to its peers in the region and the emerging markets and global averages, raises some concerns.

2.3. Industry composition of employment and output

Enhancing productivity growth and levels can be achieved by moving workers to more productive sectors of the economy. For emerging and developing economies in their early stages of development, creating jobs in productive sectors such as manufacturing is often considered important. During the last three decades, OPT has seen a drastic decline in its reliance on agriculture for creating jobs, but more manufacturing jobs did not compensate for that decline. The manufacturing sector also saw workers leaving the sector, while the only sector that absorbed more workers on a noticeable scale was the service sector. If most service activities are low-value-added, small-scale, or low-productivity, they might drag productivity down. While the fall in agricultural jobs and rise in services jobs are similar to the non-GCC Arab economies trends, the substantial fall in manufacturing job share is more intense in OPT. Another critical point of comparison is the relatively high share of construction in OPT - close to 1/5th of the workers - compared to the region as a whole. The construction sector is generally a low-productivity one. Regarding output shares, we see a similar pattern in OPT, where all sectors - including agriculture and manufacturing - witnessed a decline, and the only sector that absorbed those lost places is the services sector. Thus, it appears that OPT is quickly falling into the phenomenon of "premature de-industrialization," which can be damaging to creating productivity-enhancing jobs in the economy.

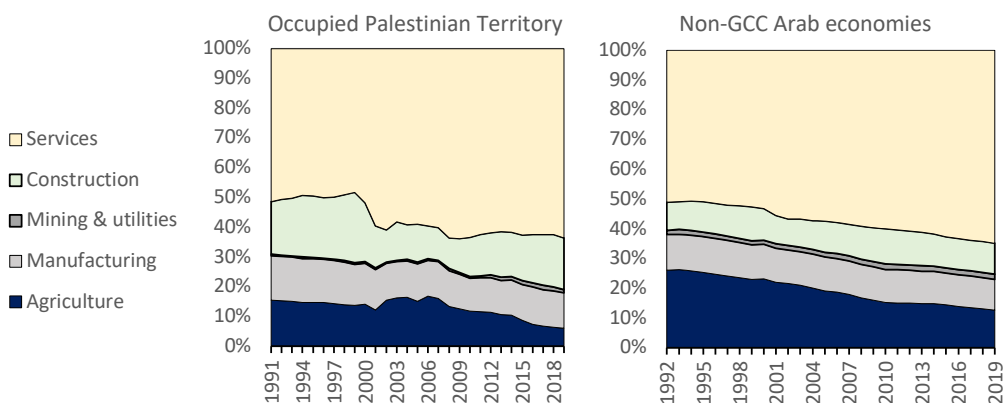
► Figure 3: Output share of industries



Note: See Figure 1.

Source: UNNAS, ILOSTAT.

► Figure 4: Employment share of industries



Note: See Figure 1.

Source: UNNAS, ILOSTAT.

► 3. Business environment, productivity, and prospects: insights from Enterprise Surveys

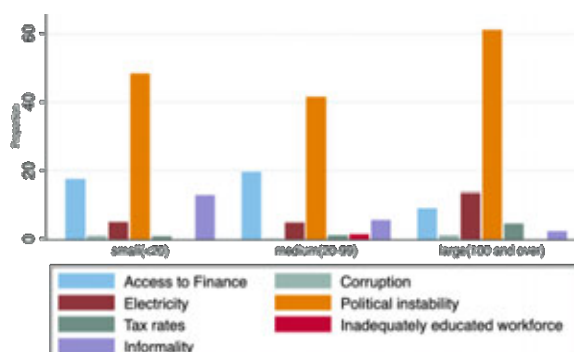
This section highlights the key findings from two enterprise surveys - the 2019 World Bank Enterprise Surveys (WB) and the ILO 2021 survey on productivity growth, diversification, and structural change. The WB survey interviewed 365 formal SMEs and large enterprises from the West Bank and Gaza Strip. The survey included questions related to the business environment and main obstacles for business operations, employment structure and wages, productivity, and management practices, among other topics. The ILO survey aimed to assess challenges and opportunities for sustainable enterprise development and economic growth amid the COVID-19 pandemic. Surveyed enterprises were asked about factors for an enabling business environment, obstacles to operating and upgrading technology, and factors that impacted productivity growth, among others. The ILO survey covered 153 micro, small, medium, and large enterprises in the OPT. Most responses came from enterprises in shopkeeping, sales, or trade activities (16 percent), other service activities (16 percent), manufacturing (12 percent), and construction (10 percent).

►► 3.1. Obstacles for business operations

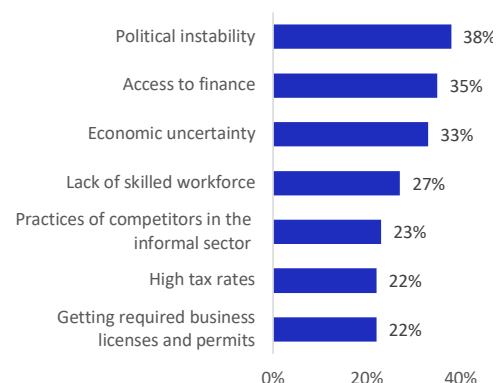
An enabling business environment that combines conditions that can improve enterprises' capacity to start up, grow, develop, and create decent jobs, is important for enterprises to harness the benefits of productivity. The extent to which governments influence and encourage innovation through policies and incentives can also have major implications on enterprises' growth and productivity. In the ILO survey, only one percent of enterprises in OPT agreed that government policies were adequate to promote innovation and technology adoption. Obviously, more proactive government intervention in promoting a productivity-enhancing business climate is warranted in OPT.

► **Figure 5. Obstacles to operate for enterprises**

Panel A: World Bank Enterprise Survey



Panel B: ILO survey



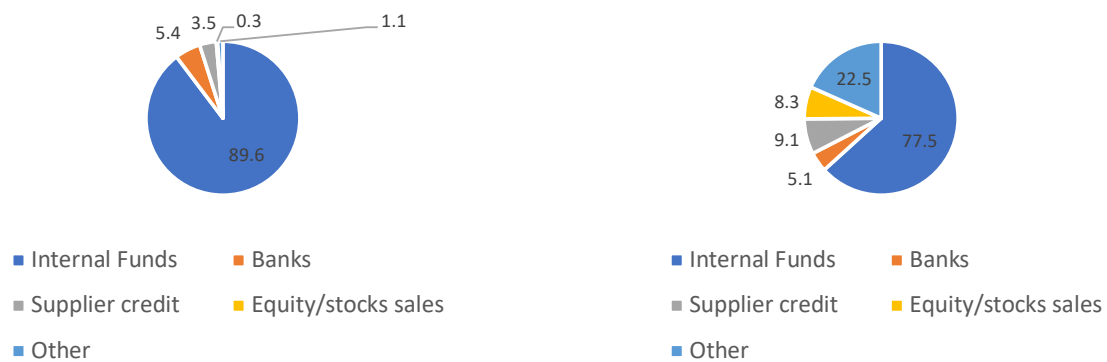
Note: Bars represent % of enterprises. Obstacles that accounted for less than 22 per cent of the sample are not displayed in Panel B.

Source: World Bank Enterprise Surveys 2019 (Panel A), and ILO's 2021 survey on productivity growth, diversification, and structural change (Panel B).

Enterprises were also asked about the biggest obstacles to operating in OPT. Respondents to both the ILO and WB surveys agree that political instability is the main obstacle in the country for businesses, followed by access to finance (Figure 6 Panels A and B). While political instability is a concern across enterprises of all sizes, access to finances is a major problem for small enterprises. A large proportion of firms reported using their own internal resources to fund investment and capital requirements (Figure 7). The ILO survey further reveals that the reliance on own resources (e.g., cash or savings) to finance business operations was more prominent among small firms, with 80 percent of micro-enterprises relying on internal resources, compared to 60 percent of small and half of the medium enterprises. Only 5 percent of micro-enterprises relied on local private banks, compared to a third of small and medium enterprises. Limited access to finance had severe adverse effects on business operations, especially after 2019, during the COVID-19 pandemic, due to more severe restrictions to getting funding from commercial banks. OPT does not have strong financial institutions, and SMEs are the most affected ones. However, our analysis suggests that firms with reviewed financial statements give more information to commercial banks and lending institutions to assess risk, increasing the probability of getting a loan.

The WB survey further suggests that access to electricity is also a concern, especially for larger firms. An average business in OPT needs ten days more to get an electricity connection than those in lower-middle economies.⁴ One-third of respondents to the ILO survey reported economic uncertainty in OPT as an obstacle to their operation, and close to 30 percent considered the lack of skilled workers a concern.

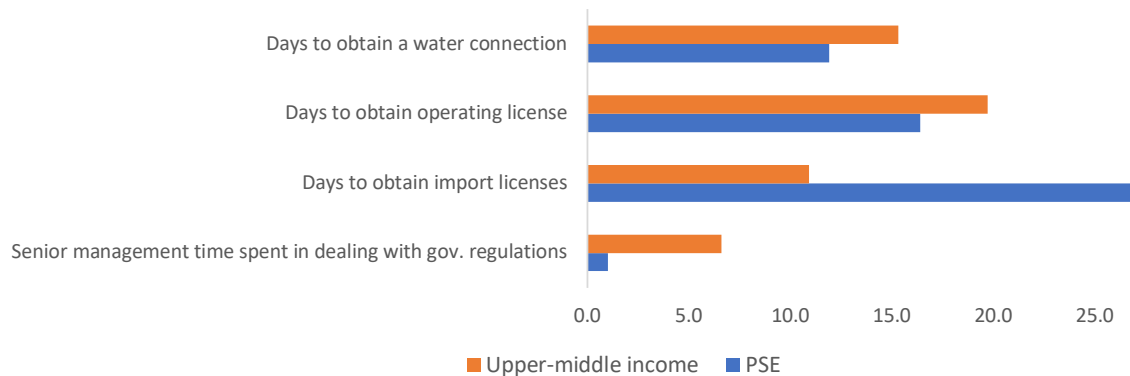
► Figure 6. Investment (left) and working capital (right) funding



Source: World Bank Enterprise Surveys 2019.

⁴ The comparison considered the average time of firms of all lower-middle-income economies that were surveyed in World Bank Enterprise Survey 2019.

► **Figure 7. Business environment main areas of concern**



Source: World Bank Enterprise Surveys 2019.

International trade is often considered an important driver of productivity. Therefore, factors that facilitate trade are essential for enterprises. A larger proportion of respondents to the WB survey indicated that obtaining import licenses is an area of concern in OPT compared to other upper-middle-income countries (Figure 8). In OPT, enterprises spend, on average, 25 days more to obtain import licenses than in similar Arab economies.

3.2 Impact of Covid on enterprises

The Covid-19 pandemic has caused substantial adverse effects on sales and revenues across enterprises in OPT. Almost 80 percent of enterprises reported revenue decreases in the first half of 2021 due to COVID-19. Micro and small enterprises were more likely to experience revenue decreases compared to medium enterprises. Nonetheless, many enterprises reported retaining their workers (44 percent) or hiring new staff (15 percent).

However, the pandemic has brought several additional challenges to enterprises in OPT. More than 60 percent of respondents to the ILO survey indicated inadequate cash flow to maintain business operations as a considerable challenge to their business during the pandemic. Although this was mostly a concern for micro and small enterprises, half of the medium enterprises also shared this concern. Nearly half of all enterprises indicated a loss in demand due to the cancellation of orders as a challenge to their business. Higher material input prices (39 percent), difficulty in accessing customers (39 percent), and difficulty in accessing suppliers (22 percent) during this period were also among the list of challenges for enterprises in OPT.

3.3 Factors that foster productivity growth

Data from the WB enterprise survey suggests an overall positive enterprise productivity growth (3 percent) in OPT between 2015 to 2018. However, employment growth declined by approximately 3 percent in the same years. The survey indicates that employment is concentrated in small enterprises - SMEs employed 83.8 percent of total personnel in 2019, compared to 16.2 percent in large enterprises. Although employment grew between 2009 and 2012 in the service sector, the sector that absorbs the highest portion of workers in OPT, that trend was not continued after 2015. Moreover, contrary to theoretical expectations,

the survey data does not provide strong evidence of productivity differences between SMEs and large firms in the country. The same applies when comparing productivity across different sectors. No substantial productivity differences could be observed between firms operating in manufacturing and services or exporting and non-exporting.

Nevertheless, the data shows that more productive enterprises operate in large localities and are operated by more experienced managers. In addition, high-tech firms that introduced new or improved products and processes show higher productivity than non-high-tech ones. These observations are important as they highlight the potential for improving productivity in OPT through better management practices and innovation. For instance, looking at the management practices index,⁵ it is evident that firms working in the OPT exhibited poor management practices in 2019 compared to other Arab economies. Therefore, firms need to work on their management practices and hire more experienced managers to help improve productivity.

Another critical factor in fostering labour productivity is improving worker skills. Worker training opportunities are essential to improve worker skills and retain talent, which will help increase business productivity growth over time. In the ILO survey, enterprises in the OPT were asked about the most important skills for their businesses. More than half of the enterprises considered technical knowledge the most important skill for their business (Figure 9 Panel A), followed by communication skills, and organization skills, and attention to detail (37 percent each). While firms realize the need to acquire skilled workers for their business operations, they also find it hard to obtain these skills in OPT. More than 40 percent of enterprises indicated that finding workers with the right skills was difficult or very difficult, compared to only 15 percent saying it is easy or very easy (Figure 9 Panel B).

Regarding training and retaining talent, half of the enterprises reported either the absence of a separate budget for staff training or allocating less than 1 percent of the total salary cost for this purpose. Only 2 out of 10 enterprises reported allocating between 2 and 5 percent of total salary to train workers. Nevertheless, 6 out of 10 enterprises reported the presence of incentive compensation programs to reward workers for achieving target results. Medium enterprises were more likely to allocate resources to staff training and have incentive compensation programs than micro and small enterprises.

3.4 Investing for future productivity

Several factors impact the extent to which businesses can grow, particularly in business environments that might need to be more conducive to sustainable enterprise development. Enterprises, however, can implement strategies to increase revenue while improving business growth and productivity. The ILO survey revealed five important strategies to improve revenue, growth, and productivity. More than half of the respondents indicated the importance of offering new products or services. The second most important strategy identified by OPT enterprises was investing in new technologies (44 percent). More than one-third of respondents suggested the role of changing payment terms, whereas 30 percent each indicated the importance of ensuring business continuity planning and reducing prices of selected products and services.

⁵ To measure management practices, we constructed an index that captures businesses' performance in four areas: operations, monitoring, targets, and incentives across firms, industries, and countries (Bloom, N., & Van Reenen, J., 2010. Why do management practices differ across firms and countries?. *Journal of economic perspectives*, 24(1), 203-24.)

Although enterprises in OPT have given investing in technologies a very high priority in fostering growth and productivity, they anticipate challenges to conducting such adoption or upgrades. The top barriers to upgrading technology identified by the enterprises were high fixed capital costs (21 percent), followed by high risk (20 percent), and lack of skilled staff to operate new technology (14 percent). While high fixed capital costs were the most common barrier among micro-enterprises, high risk was most reported by small and medium enterprises. Service and construction enterprises highlighted the lack of skilled staff to operate technology.

Looking ahead, most enterprises in OPT planned to invest in adopting new technologies (68 percent), launching new products or services (67 percent), machinery and equipment (65 percent), and workers' training (57 percent) in the next five years. Micro enterprises were more likely to plan investments to launch new products or services. By comparison, small and medium enterprises were more likely to plan investments in machinery or equipment.

► Recommendations

► Dealing with occupation and political instability. Some sectoral insights

- OPT's pre-mature deindustrialization, and the rising role of services in creating jobs and output, seems to be happening at the cost of productivity. However, these trends are also likely a function of occupation and political instability, affecting the country internally and externally, creating an uncertain business environment, especially for the manufacturing sector. The uneasy political situation and decades of occupation have made it less stable for businesses and have inflicted substantial economic costs on firms.
- Much of the service sector activities in OPT, which seem to dominate employment and output, are driven by trading activities within the domestic economy, suggesting a limited role for production activities.
- OPT would benefit from increasing agricultural productivity, while tackling structural barriers to sustainable enterprise development. Improving its manufacturing sector may still be challenging, unless it gets integrated with the global economy more rigorously, which would require political and economic stability and policies to raise business competitiveness to enable participation in global value chains.
- Integrating the country more intensely into the global markets would help it tap its comparative advantage and specialize in activities that are appropriate for its political, geographical, and demographic characteristics. Such specialization may help move resources to more productive sectors.

► Improving access to utility's infrastructure

- OPT might need to improve and expand its infrastructure, energy, and public provisions to enhance economic well-being, which eventually would also have implications for labour productivity.

► Technology adoption

- Design policies that promote innovation and technology adoption (with a focus on information and communication technology, digital marketing processes, online sales, and the use of digital

platforms) while keeping in mind that political instability is a key concern for enterprises of all sizes and sectors.

- Government needs to find ways to limit brain drain and support enterprises in finding ways to hire highly skilled managers and workers and training current personnel to upgrade their skills and knowledge.

► Access to finance

- Given its capital scarcity, OPT would also benefit from attracting international capital to support investment activities in the economy, which also requires political stability.
- Restrictions on international trade, for instance, on imports, may hinder manufacturing productivity, as it weakens the country's ability to use imported intermediates and technologies and increases transaction costs for firms.
- Addressing the root causes of credit rationing – such as lack of collateral, financial literacy, and competition – from commercial banks to MSMEs is of the utmost importance while supporting such companies in reaching a minimum efficient scale and economic viability. This has to be accompanied by measures to promote equity/stock financing. The latter has become increasingly important due to the restriction of accessing loans from commercial banks.

► Supporting women entrepreneurship

- While dealing with occupation and political instability, it is important to duly consider gender inequalities and promote women economic empowerment in the productivity enhancement efforts. This would include providing support to enterprises to ensure a non-discriminatory working environment and improve working conditions for both men and women, as well as improving management practices and workplace cooperation.



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