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Palestine Economic Policy Research Institute

Evaluation of the Legal Environment of Micro, Small and Medium Enterprises in Palestine

**Mohammed Khalifa
Ibrahim Abu Hantash**

2009

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Mission

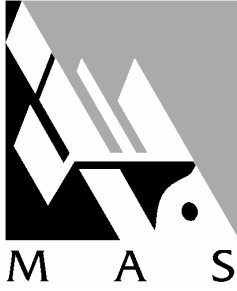
MAS is dedicated to producing sound and innovative policy research, relevant to economic and social development in Palestine, with the aim of assisting policy-makers and fostering public participation in the formulation of economic and social policies.

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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Palestine Economic Policy Research Institute (MAS)
Jerusalem and Ramallah

FOREWORD

In recent years, increasing attention has been paid by academic and policy circles to the importance of micro, small and medium enterprises (MSMEs). The Asian Financial Crisis of 1997 was particularly significant in promoting this trend since the MSMEs appeared relatively immune to the crisis while many large enterprises collapsed.

The hypothesis of a positive relation between, on the one hand, growth, employment, technical and managerial innovation, competition and poverty reduction, and on the other, the level of participation of MSMEs in the economy, has some evidence backing it. However, the correlations are still not rigorously proven. This is due to the usual statistical difficulties (such as poor data quality and autocorrelations) and the absence of a universal definition for MSMEs. For example, the European Union defines MSMEs as those enterprises employing less than 250 workers, whereas in the United States, 500 is the maximum number of workers in an MSME.

There are obvious positive advantages to MSMEs, such as their significant contribution to employment at relatively low capital cost. For example, one study estimates the intensity of employment in MSMEs to be four times that of large establishments in India. However, there are also negative implications that ought not be overlooked, such as the lack of clear business strategy, weak management, low capital intensity, difficulties in financing and overexploitation of labour, particularly family labour.

MSMEs play a significant role in economic activity and employment in most of the developing countries, and Palestine is not an exception. Despite this, there are more MSMEs per 1000 inhabitants in developed countries than in developing countries. According to World Bank figures, there are about 62 enterprises per thousand people in the developed rich countries, whereas there are 28 enterprises per thousand people in the Middle East and North Africa region and only 4 in South Asia. These figures indicate that a positive correlation exists between the number of MSMEs and income levels. The proportion of MSMEs in Palestine is comparable to that of other developing countries; while they make up 99% of total enterprises, there are just 29 per thousand people.

Given the importance of MSMEs in the Palestinian economy, and the need to scrutinize and alleviate the challenges and obstacles they face, MAS has implemented a research programme to tackle these needs. Three studies have now been completed. The first defines the challenges facing MSMEs and, on the basis of this, a number of recommendations are put forward. The second reviews the legal environment in which MSMEs operate and proposes measures including legislative amendments and policies to enhance and improve it. The third surveys international experiences in policy support to MSMEs and investigates the possibilities for Palestine to adopt and benefit from these experiences.

I, on behalf of MAS, would like to express our gratitude to the International Development Research Centre - Canada (IDRC) who kindly funded this research program.

Numan Kanafani
General Director

Executive Summary

A major factor in the operations of micro, small and medium enterprises (MSMEs) is the legal system in which they exist. As extensive literature shows, the legal system can benefit or harm MSMEs. On one hand, the legal system can facilitate MSME operations and prove beneficial: in gaining access to financing opportunities, a wider exposure to markets and through benefits from laws that promote investment. On the other hand, the legal system can be burdensome to certain economic activities, especially those operating at a smaller scale, since it is often difficult to meet the added expenses of abiding to the governing laws. There is, therefore, some incentive for MSMEs to remain in the informal sector in order to avoid the financial burdens of abiding by the laws. In this case, MSMEs incur less procedures and expenses in opening and developing businesses, can evade taxes and have more employment flexibility. The decision by MSMEs to abide by the laws in the legal system is mainly determined by the capability of the law-enforcing agencies, as well as by the extent to which the laws meet the needs of these MSMEs and the potential benefits from adhering to the law.

The motivation for conducting this study is the critical role MSMEs play in the Palestinian economy, making up 99% of the operating enterprises in the Palestinian economy and employing 82% of all workers. This study aims to review the legal environment in which MSMEs operate and the extent to which they are incorporated in Palestinian laws, especially the investment promotion law. It also suggests a series of recommendations to improve the legal environment. A summary of the findings from this review and shortcomings of the law with regard to MSMEs follows below:

Banking Regulation

Small enterprise financing institutions are regulated by the Palestine Monetary Authority (PMA). The draft of the new Banking Law explicitly states that the PMA has supervision and control over small enterprise financing institutions. They are currently set under PMA control and supervision by the PMA law. This diverges from the current Banking Law which excludes small enterprise financing institutions from its coverage. The current laws do not set lending limits for MSMEs.

Industrial Estates and Industrial Free Zones Law

This law is applied in cities and industrial zones where large enterprises exist. MSMEs have not benefited from the incentives and facilities given in this law since it is not applicable in the vast majority of areas where MSMEs operate, (internal industrial areas and municipal industrial societies).

The Palestinian Standards and Measurement Law

All enterprises in the formal sector must, under this law, adhere to certain technical regulations. The law does not distinguish between enterprises according to size or activity, nor does it take a gradient method in determining the specifications and standards to which MSMEs should abide.

Palestinian labor Law

This law imposed additional burdens on employers which negatively affect the competitive ability of MSMEs. The law expanded the benefits and rights of employees, not based on economic necessity or requirement, but rather due to social considerations. All enterprises are required to abide by this law, no matter what the business' size, activity or ability to finance employee benefits is. MSMEs are therefore faced with added expenses which they might not be able to bear.

Companies Law

Even though a number of Companies laws exist in the Palestinian territory, they cover just 6% of all operating enterprises. The law excludes the remaining 94% of total operating enterprises, which are sole proprietorship enterprises and particular partnership companies. Only 3% of enterprises, which are categorized as general proprietorship companies and limited shareholding partnership companies, can be affected by the Companies law since they are MSMEs and employ 7.5-11.5 workers. From the extensive review of the existing Companies laws, it is apparent that they are not inadequate to meet the working needs of MSMEs. It appears that the draft Companies law is more developed, applicable and favorable for MSME activities than the current law which is both inefficient and inadequate.

Trade Laws

The current trade laws are considered inadequate for regulating and organizing trade and trade issues in the oPt. A large number of individually owned enterprises that are active in small trade or simple handicrafts are not incorporated within these laws. Moreover, these laws

fail to incorporate consensual agreements for settling enterprise bankruptcies outside courts. This creates injustice for MSMEs in protecting the property rights of their products.

Formation of regular courts Law

This law does not decree that there be specialized courts, such as commercial courts, and does not require that there are judges with a specialism in economic or financial issues. This weakens the legal environment in which MSMEs operate since the law is inadequate for regulating their activities and settling disputes arising from trading or from financial transactions.

Trademark Laws

These laws disregard the need to protect the property and trading rights of MSMEs, and to regulate enterprise operations in regard to registering their trademarks, or to any other matter of MSMEs.

Tax Laws

Regarding income tax, current laws do not discriminate according to the size of enterprises; MSMEs are subject to 15% income tax, as are large enterprises. All companies, regardless of size or financial situation are subject to 14.5% value-added tax. Furthermore, the value-added tax law is outdated and does not provide MSMEs with preferred handling or incentives.

Investment Promotion Law

All enterprises and companies that operate with a capital equal to or above USD \$100,000 can, when licensed, receive the incentives and benefits provided by this law.

In conclusion, the existing legal environment which the Palestinian MSMEs operate in is seen to be inadequate and unsupportive, and in the large part, fail to support MSMEs' existence, activities and expansion. In light of these findings and in order to enhance the legal environment, the study makes the following recommendations:

- ✧ Amend the current banking law that incorporates micro lending institutions and requires banks to expand their lending services to MSMEs. In such a revision, it would become essential to create a guarantee fund to help alleviate risk of banks and depositors' rights.

- ✧ Expand the applicability of industrial Estates and industrial free zones law to incorporate internal industrial areas and municipal industrial societies, thus enabling MSMEs to benefit from this law.
- ✧ While keeping in mind consumer safety, apply a gradient method in regards to requiring specifications and standards of MSMEs' products and services. It is important to encourage enterprises to abide by specifications and standards. This can be achieved by providing incentives that alleviate some of the burdens of applying this law, such as fees or procedures.
- ✧ Amend the labor law with the objective of alleviating some of its burdens on MSMEs. Give MSMEs privileged treatment and, considering the size of the enterprises and owners' abilities to afford applying the law, some exceptions within the law. Such preferential treatment should aim to alleviate the burdens keeping MSMEs from expanding their business. With this in mind, preferential treatment should have a temporary timeframe.
- ✧ Amend the draft of the Companies law by expanding its applicability to incorporate the particular partnership companies which make up about 6% of operating enterprises. Adopt these changes.
- ✧ Amend the draft trade law by incorporating definitions and categories for enterprises based on number of workers. Incorporate consensual agreement decrees prior to requiring settlements by courts and finally, adopt the law.
- ✧ Amend the regular courts law as to establish commercial courts and dictate that there are special judges to deal with economic and financial cases, thus guaranteeing efficiency and effectiveness in rulings.
- ✧ Enact a new law to protect property rights and encourage MSMEs to register their products by making registration costs more bearable.
- ✧ Amend the current income tax law so as to discriminate between different enterprises, based on size and financial situation, in regard to the level of taxation. Also, it is necessary to enact a Palestinian value-added tax law with preferred treatment to MSMEs.
- ✧ Amend the current investment promotion law in order to provide MSMEs with preferred treatment and special incentives and privileges. This should be dictated by the value-added of these establishments and not the amount of capital (which is exclusive to large enterprises).

Given how many laws already exist in the legal system and the number of stakeholders involved, it is expected that many obstacles would face Palestinian policy and law makers in bringing the aforementioned recommendations into effect. In light of this, this study suggests

establishing a body, involving all MSME stakeholders, to prepare a law exclusive to MSMEs and which incorporates all issues relating to MSMEs the recommendations made in this study.

It is important to mention that this study primarily based its assessment of laws according to their relevance to the needs and working conditions of MSMEs, from their own perspectives. A focus was also given to the potential benefit of MSMEs being better included in these laws. If the study had taken a perspective from a different vantage-point, (such as for public interest, senior investors or a concern for the financial burdens of laws on the government), the results of this study may have been slightly different.