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## From Theory to Practice of Formal and Informal Palestinian Small Businesses

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### 3.1 Introduction

In the Occupied Territories (West Bank and the Gaza Strip), political instability and restrictions on movement and access to markets remain the binding constraints in the investment climate resulting in uncertainty, risk, increased costs for businesses and investors, and the fragmentation of economy (Albotmeh and Irsheid 2013). As a result, private investment in the Occupied Territories remains far from sufficient to fuel adequate rates of economic growth, create enough jobs, and reduce unemployment.

Informal and formal small businesses are often perceived as being the same, while in reality there are significant differences in the characteristics

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and challenges they are facing. Growing employment opportunities in informal business is relevant to formal businesses due to the high unemployment rate in the Occupied Territories. In spite of this, informal business has remained ignored or on the margins of economic analysis and policy consciousness. A major reason for this is that Palestinian policymakers and economists view informal business participants as being without aspirations or entrepreneurial skills, with no meaningful role to play in generating employment or reducing poverty. This is often related to the narrow view of the informal business as comprising mostly street traders and home-based businesses. As a result, policymakers overlook the potential of informal enterprises, the challenges they face, their particular vulnerability, and the policy support that could make them more viable and self-standing.

This chapter shows clearly that the informal sector is an important source of employment. The chapter aims at identifying the characteristics of formal and informal businesses in the Palestinian Territories in terms of size, ownership, sector, gender, employment, and location. It aims, as well, at shedding light on the main challenges that formal and informal businesses face. The informal sector is diverse and it comprises all industries, not just trade. A proper inclusive growth strategy needs to get the poor and needy to actively participate, via employment, in promoting economic processes, producing output, and earning a decent income. Thus, policymakers should not be cavalier about losing or destroying informal sector jobs.

The other sections present the context, related theories of informal and formal small businesses, the methodology used, and the results that identify the main characteristics, challenges, and obstacles facing formal and informal small businesses. Then, policy recommendations are presented to foster these businesses.

## 3.2 Context

The lack of progress toward peace and reconciliation creates an unsustainable economic situation. Donor support has recently declined as the peace talks between Palestinians and Israelis keep failing. The Palestinian

internal community remains divided between Gaza and the West Bank with grave uncertainty about the reconciliation process. Palestinian living standards continued to decline in 2018, with aid flows no longer providing an impetus to growth. The unemployment rate was 32.4% in the second quarter of 2018, the highest rate in two decades, while the 2017 poverty rate was 29.2%. A recent liquidity squeeze in Gaza has led to a rapid collapse in humanitarian conditions, including access to medical treatment, electricity, and clean water. In Gaza, 54% of the labor force is unemployed, including 70% among the youth (World Bank 2018a).

After the establishment of the Palestinian Authority in 1994, the new Palestinian institutions had limited capacity to cope with the restrictions and the conditions placed upon them by the Israeli policies. During the period of relatively limited self-rule, the Palestinian Authority was not able to articulate a comprehensive national agenda of reconstruction and development. This was due, in part, to the Palestinian Authority's structural weaknesses and lack of coherent vision. Furthermore, the vision, agenda, and conditionality of the donor community overburdened the already weakened Palestinian institutional and economic capacity, therefore limiting the scope for development of a national development strategy and policy (Khalidi and Samour 2011).

The Palestinian Authority has kept importing sensitive items such as cement, iron, and petroleum products, which has led to higher production costs. The absence of a clear development-driven objective and wide-ranging donor demands and conditions have led to a curious mix of Palestinian Authority policies, which often lack sustainability and coherence. In addition, donors' involvement in the institution-building process together with their aid conditionality have resulted in a shrinking Palestinian policy space; Palestinian Authority policies on the one hand are made within a framework offered and approved by donors, and on the other hand are mere responses to the numerous and sometimes contradictory donor aid conditionality. These limitations have not only reduced the capacity of the Palestinian institutions to respond to the needs of the Palestinian economy, but have also created fragmentations within Palestinian institutions and ministries (Khalidi and Samour 2011).

The West Bank and Gaza were ranked 114th out of 190 economies in the 2018—Doing Business report—26 spots better from the 2017 rank-

ing (140th). Private investment levels in the Palestinian economy have been low at about 15% of GDP in recent years, far below that in most middle-income economies (World Bank 2018b). Moreover, the investment is concentrated in the less productive non-tradable sectors including internal trade activities and residential constructions. Foreign direct investment inflows have been only about 1% of GDP on average over the last decade.

One of the greatest constraints in expanding or upgrading the Palestinian private sector is the small sizes and traditional characters of businesses. Even after huge support for developing the private sector over the past few years by different donors, this sector has remained—despite certain improvements—fundamentally unchanged since 1967. The available data show that the Palestinian business sector is small in size and organizational structure, engaged largely in services employing an average of 2.5 people and capitalized for no more than \$10,000 (Khalidi and Samour 2011). This particular fact—apart from the many difficulties currently plaguing the business environment—represents a formidable obstacle to the development of the private sector. Because of these and other inherent limitations, only 23% of private sector earnings came from exports in 1999; this is another indication of the sector's weakness (Roy 1998).

Palestinian firms were already in a weaker competitive position vis-à-vis their Israeli counterparts. Indeed, Palestinian businesses, seeking to export or import through Israeli ports, faced transaction costs that are on average 35% higher than that for an Israeli firm in the same industry. Because of increased overall costs, many suppliers have raised their prices, further undermining their market competitiveness (Khalidi and Samour 2011).

There is an ongoing debate on the significance of the informal sector in the Palestinian Territories (Fallah 2014). Many authors do highlight its economic role in stimulating the growth of the market economy, promoting a flexible labor market, promoting productive activities, and absorbing retrenched labor from the formal sector. Others claim that informal labor has become a convenient means of pursuing the global agenda of liberalization. As both sectors (formal and informal) significantly contribute to the Palestinian economy, understanding their char-

acteristics and challenges will be vital to designing the appropriate policies to foster these businesses.

Fallah's (2014) study shows that the majority (about two-thirds) of informal Palestinian entrepreneurs believe that there is no benefit in joining the formal sector. Moreover, the majority of informal entrepreneurs stated that they are not willing to join the formal sector. These findings clearly indicate that, from the point of view of informal entrepreneurs, the benefits of joining the formal sector do not outweigh the entry cost (registration cost) and other costs such as direct and indirect taxes or employees' benefits and minimum wage (Fallah 2014). Thus, staying in the informal sector could be a profit-maximizing decision.

In the Palestinian Territories, formal entrepreneurs are more educated. About 27% of them have at least 13 years of education compared to 12% for informal entrepreneurs (Stevenson et al. 2010). In terms of type of economic activity, most notably, the construction sector is disproportionately informal, constituting around 12% of the informal sector but only about 4% of the formal sector. As for the manufacturing sector, the majority of informal manufacturers operate in the apparel and stone-cutting industries. Formal manufacturers, on the other hand, produce mainly metal products and furniture.

According to the Palestinian Central Bureau of Statistics (2014), women in the Palestinian Territories form half of the society, which consists of around five million in the Gaza Strip, and the West Bank, albeit the female participation rate of the labor force is 19.4%. Nevertheless, women entrepreneurs increasingly run their own enterprises; however, their socio-economic contributions and entrepreneurial potential remain largely unrecognized. They are concentrated in informal, micro-sized, low-productivity, and low-return activities. One reason behind the fact that women's contribution is not adequately recognized in the Palestinian Territories would be that—in the majority of cases—women businesses are family run and in the informal sector with many women involved as unpaid family workers (Farr 2011).

Although policies are developed to solve practical problems in formal and informal small businesses, there is a lot of criticism for not having an impact on practice. In interventionist research, the shaping of an intervention to solve a practical problem is an important step. The purpose of

this chapter is to explore how the findings of formal and informal small business research can be reviewed to make them practically applicable in shaping an intervention.

### 3.3 Formal and Informal Businesses

The informal sector could be defined as the unregulated, non-formal portion of the economy that produces goods and services for sale or accepts other forms of remuneration. In effect, the term ‘informal economy’ or ‘gray economy’, as it is often used to symbolize the informal sector, refers to all economic activities by workers and economic units that are not covered or are insufficiently covered by formal measures (Becker 2004; Feige 2016). The informal economy is largely characterized by (1) low entry requirements in terms of capital and professional qualifications; (2) small scale of operations; (3) skills often acquired outside of formal education; and (4) labor-intensive methods of production and adapted technology (De Soto 2000; Bruhn and McKenzie 2014).

The size of gray economy (i.e. informal economy) varies widely across countries. A study in the MENA (Middle East and North Africa) region reveals that informal businesses produce about 27% of its GDP and employ 67% of its labor force informally (Angel and Tanabe 2012), meaning that more than two-thirds of all workers may not have access to health insurance and/or are not contributing to a pension system that would provide income security after retirement. In the Palestinian Territories, there is a lack of available data on the contribution of the informal sector to GDP and employment (Fallah 2014).

For the purpose of this study, informal small business is defined as an economic activity that works from home, on the street, or in premises that is not officially registered at any of the governmental or semi-governmental institutions. As explained below, a large informal sector tends to impede the rate of economic growth via other effects. These include lower productivity due to lack of economies of scale, and distorting policies conducive to growth due to extensive tax evasion and weak linkages with financial markets. In the same vein, the government’s ability to increase tax revenue, for instance, by modifying tax rates, might be

ineffective in economies with poor tax compliance such as the one in the Palestinian Territories.

Castells and Portes (1989) and Portes (1994) have highlighted non-compliance with government regulations as the main identifier of the informal sector. In this regard, informal firms generally include all employers and self-employed workers who fail to comply with state regulations, including firm registration, tax rules, and labor law (Pratap and Quintin 2006). Therefore, the informal sector usually includes all economic activities that contribute to the GDP but are not officially reported (Schneider 1994; Feige 1997; Williams and Lansky 2013; Kus 2014; La Porta and Shleifer 2014).

A large informal sector usually reflects substantial government revenue losses because of tax avoidance. This would likely lead to a lower level and quality of public services (Schneider and Enste 2000). Poor public services in addition to an excessive tax burden might therefore aggravate formal businesses and decrease their trust in public institutions, as they see little benefit in paying taxes. The outcome of this consequence decreases the incentive to join the formal sector, leading to a vicious circle of expanding the informal sector and low provision of public services (Schneider and Torgler 2007; McCaig and Pavcnik 2015, 2018).

Some researchers link informality to firm characteristics such as low productivity, small firm size, and hiring of unpaid family members (Perry et al. 2007). Others have focused on the social protection dimension with special emphasis on employment. The concept of informal employment in the literature, however, is not limited to employment in informal firms but includes regulations requiring firms to pay social security contributions, give paid vacations, and give severance pay upon termination of employment (McCaig and Pavcnik 2015; McKenzie and Woodruff 2013).

Loayza (1999) highlights the negative impact of a growing informal sector on productivity via the lack of economies of scale. When operating informally, firms are likely to maintain small-scale operations in order to decrease the probability of government detection (Pratap and Quintin 2006). In addition, lack of access to credit, usually due to insufficient collateral, tends to preclude expanding informal business operations (Straub 2005). In addition to lowering productivity, a larger informal sector might impede growth by distorting economic policies.

Specifically, a large informal sector might render monetary policy less effective as informal firms enjoy lower connection to the financial system. This is also true regarding the fiscal side. Decreasing the tax rate might have a less stimulatory effect on economic growth, while increasing the tax rate might have a less restraining effect on growth or inflation due to excessive tax evasion (Eilat and Zinnes 2002; Martin et al. 2017). In many developing countries, informal workers often operate in a poor environment such as low safety and health standards with lower pay and inadequate workers' rights and social protection. Therefore, a large informal sector tends to impose social costs.

### 3.4 Methodology

Palestinians have no control over sea, air, or borders (Abuznaid 2014). West Bank is divided, according to the Oslo Agreement, into three different administrative areas (Abuznaid 2014). Area 'A' comes under the Palestinian administrative and security control. This area includes civil gatherings in major cities. Area 'B' comes under the Palestinian and Israeli security control. This area includes the communities around cities and towns. Area 'C' comes under the full Israeli control. This area is a state land outside the inhabited areas. Area 'C' comprises 61% of the Palestinian land under which the Palestinian Authority has no control.

Although it is difficult to verify the estimates of the size of the informal sector in the Palestinian Territories, there are 152,262 informal workers, representing 36.3% of total employment in the private sector as listed in the Palestinian Central Bureau of Statistics (2014). Given that the vast majority of informal firms are extremely small (one to two workers), there are about 100,000 informal firms constituting 49.7% of the total number of companies. Regionally, 45.3% of firms in the West Bank are informal compared to 65.7% of enterprises in the Gaza Strip. The majority of informal and small formal firms report that their market is limited to their locality. Informal firms, however, are un-burdened by regulations and taxation, but have more restricted access to finance, export markets, and government contracts (Fallah 2014).



The research team used both quantitative and qualitative methods. A questionnaire, as a quantitative tool, consists of four parts. Part one covers the profile of the business (formal/informal and location). Part two discusses the characteristics of the business in terms of location, ownership, bookkeeping, type of premises, and number of employees. Part three enquires about the main challenges that the formal/informal small business is facing in terms of movement, supplies, competition, and so on. Finally, part four questions about the policies needed to foster these businesses such as access to market and access to finance.

The research team developed a sampling frame for formal businesses with the assistance of the Federation of Palestinian Chambers of Commerce, Industry, and Agriculture (FPCCIA) in West Bank and the Gaza Strip. A convenient sample of 150 businesses (100 businesses in West Bank and 50 businesses in the Gaza Strip) were selected and approached. The database of the FPCCIA shows that there are 60,000 members, while only 15,000 (two-thirds are located in West Bank and one-third are operating in the Gaza Strip) of these firms are effectively small firms (i.e. employing between 4 and 25 staff and paying the fees during the last three years). Based on this fact, the research team aimed to approach 1% of the effective members as a minimum convenient sample size, that is, 150 formal firms. The same number were chosen for informal businesses (i.e. there is no clear sampling frame for informal businesses).

The research team developed open-ended questions to understand the context of the small formal and informal businesses working in the Palestinian Territories. The deputy minister of National Economy, the deputy head of the VAT department at the Ministry of Finance, representatives from chambers of commerce and industry, representatives from business associations, and representatives from microfinance institutions were interviewed.

The research team was keen to receive 300 clean questionnaires. The collected questionnaires were coded and entered into the SPSS software. Means and percentages were used to identify the characteristics, challenges, and needed policies, while t-test and one-way ANOVA were used to assess any significant differences in the main challenges and needed policies between the formal and informal businesses.

## 3.5 Results and Analysis

This section presents the results of the survey and semi-structured interviews. The results present the characteristics and challenges facing formal and informal small businesses.

### 3.5.1 Characteristics of Formal and Informal Small Businesses

Results of the survey show that 78 firms (26% of the respondents) work in the industry sector; 94 firms (31.3%) in the trade sector; 88 firms (29.3%) in the service sector; 26 firms (0.9%) are in the handcraft sector; and only 14 firms (0.5%) work in other sectors. The national statistics in 2014 show that industry contributes 13.9% to GDP, trade contributes 19.2%, service 30.6%, construction 8.3%, and other sectors contribute 28.0%. Almost 5% of the respondents use their homes to do business activities, 76.3% are using business premises (i.e. own or rent), 4.3% are based on farms, 5% use streets, and 12.7% do not have any fixed address.

Results show that 226 firms (78.6% of the respondents) are located in cities; 42 firms (14%) are located in villages while 22 firms (7.4%) are located in refugee camps. There is a phenomenon of moving businesses to cities, as the economic situation there is better than that in villages and refugee camps. As well, results show that 240 firms (80% of the respondents) are located in area 'A', 16 firms (5%) in area 'B', and 44 firms (15%) in area 'C'. Palestinians, in general, prefer to work under the Palestinian control because getting licenses in areas 'A' and 'B' is much easier than that in area 'C', which needs special approvals from the Israeli authorities. Most of the businesses, based in villages and refugee camps, work informally and sell mainly groceries and bakeries.

Almost three-fourths (77%) of the respondents were male and 23% were female. The gender situation in the Palestinian Territories is based on the traditional and socially accepted concept developed from both tribal cultural values of the Arab region and Islamic values. While the increasing number of women taking up the role of worker as a coping strategy required for the family survival is increasing, it neither changes their

traditional role of caretaker at home nor lessens the burden of that role. They are simply to assume the double burden as some women, especially those with less education, find it disempowering that they have to work outside home out of necessity.

Results show that 31% have written contracts without fixed durations; almost a third have verbal agreements with the employers while another third have no contract at all. Half of the respondents are paying salaries to their employees on a monthly basis, and a third of the respondents are paid on a daily basis or per hour; 17% are paid per job or per task. Unfortunately, informal firms do not pay social security contributions nor give paid vacations, or severance pay upon termination of employment.

Respondents were asked about their bank accounts. Results show that 56% of the respondents have bank accounts in the name of their business, while 44% do have bank accounts in their personal names. Due to non-registration, informal businesses do not benefit from banks' loans or other financial schemes. Respondents were also asked if they have a bookkeeping or not, and what type of bookkeeping they have. Almost 30% of the respondents do not have any written bookkeeping documents while 20% have informal records. Of the respondents, 41% use simplified accounting, and only 9% have detailed formats. Informal small businesses do not distinguish between business and personal expenses.

The majority of informal small businesses do sell their products/services in the same location as the majority of them work in handcraft, service, and trade of consumable products. In perceiving the lack of resources and information as a key constraint at various stages of internationalization, this theory proposes a phased approach especially for small businesses with a limited knowledge of foreign markets (Festa et al. 2017).

Palestinian purchases from Israel account for about two-thirds of total Palestinian imports, and Palestinian sales to Israel account for about two-thirds of total Palestinian exports as well. Formal businesses do benefit from the trade exchange with Israel, as official invoices are needed for that.

Both formal and informal small businesses share the same reason for choosing their businesses. Almost one-third of the respondents mention

family tradition as the main reason for choosing their business activities; the other respondents mention the profession they know. While 13% chose their business activities in which they can receive better income, almost 17% chose their businesses in which they can receive stable returns.

Both formal and informal small businesses share the same source of financing. For almost 83% of the respondents, the main source of financing is the family; nearly 5% get their finance from neighbors or friends, and 10% get finance from banks or microfinance institutions. Reasons to borrow money from families and friends are due to the strong family and social ties on the one hand and the high interest rates and high collaterals asked by banks and microfinance institutions on the other hand.

### 3.5.2 Challenges Facing Informal and Formal Small Businesses

As shown in Table 3.1, there are significant differences in the challenges facing formal and informal small businesses except in the lack of space, and organization and management difficulties. Results indicate that informal small businesses are facing higher challenges than formal small businesses in the supply of raw materials, finding customers, competition, access to finance, access to machines, revenues, movement, and business environment.

These challenges extend from internal, as stated by Loayza (1999) and Perry et al. (2007), and external pressures, as stated by Castells and Portes

**Table 3.1** Main challenges

Challenges	Business	Mean Differences	Sig.
Supply of raw materials	Informal vs formal	0.68879	0.000*
Lack of customers	Informal vs formal	0.82717	0.000*
Too much competition	Informal vs formal	0.78667	0.000*
Financial difficulties	Informal vs formal	1.02919	0.000*
Lack of space	Informal vs formal	0.27778	0.278
Lack of machines	Informal vs formal	0.45222	0.001*
Management difficulty	Informal vs formal	-0.00899	0.927
Too little revenue	Informal vs formal	1.03859	0.000*
Movement	Informal vs formal	0.65040	0.000*
Laws and regulations	Informal vs formal	0.68879	0.000*

(1989) and Portes (1994), to legal and survival issues, as stated by Schneider (1994), Feige (1997), Williams and Lansky (2013), Kus (2014), and La Porta and Shleifer (2014). Results show that informal small businesses have lower revenues and higher financial difficulties than formal small businesses in the Palestinian Territories. Informal small businesses also seem to be struggling with business financing as many respondents indicate the limited access to finance or loans, as stated by Fallah (2014).

On the contrary, formal small businesses are having an edge over informal small businesses in raw material supply, customer reach, lower competition, better movement, and benefiting from the incentives raised up by the national laws and regulations.

In addition to the above list of challenges, the results of semi-structured interviews show other challenges facing Palestinian small businesses such as high competition between businesses themselves and from imported products, especially from China. As well, the Palestinian businesses are suffering from outdated laws and regulations, as mentioned by Abuznaid (2014). Therefore, these enterprises are working in a weak legal environment and have poor financing sources for starting new ventures. The difficulty in accessing new markets and newly developed technologies is also considered a main barrier facing Palestinian businesses.

Other challenges are the inability of banks to access information on businesses from government authorities with regard to enterprise registration and authorized signers, and the inability of banks to enquire about deferred checks drawn on customer accounts and presented for collection by other banks. Poor level of financial documentation reporting by businesses and poor understanding by the owners of the significance of preparing economic feasibility studies and business plans.

### 3.5.3 Policy Recommendations

This section discusses the policies needed to foster the formal and informal small businesses. Table 3.2 indicates that there are significant differences in the policies needed to foster small businesses recommended as perceived by the formal and informal small businesses. This indicates that

**Table 3.2** Recommended policies

Needed Policy	Business	Mean Differences	Sig.
Technical training	Informal vs formal	0.81000	0.000*
Managerial training	Informal vs formal	0.55000	0.000*
Supplies	Informal vs formal	1.27000	0.000*
Access to machines	Informal vs formal	1.01000	0.000*
Access to loans	Informal vs formal	1.12000	0.000*
Access to information	Informal vs formal	0.32000	0.017*
Access to large businesses	Informal vs formal	0.38000	0.011*
Problems with government	Informal vs formal	0.43000	0.004*
Litigations with competitors	Informal vs formal	0.82687	0.000*
Security and movement	Informal vs formal	0.81000	0.000*
Interaction with employees	Informal vs formal	0.55000	0.000*

there are significant differences in the policies needed to foster formal and informal small businesses.

As shown in Table 3.2, there are significant differences between the policies needed as perceived by the informal small businesses and formal small businesses. Informal businesses ask for policies to foster supplies, access to machines, and access to finance, while formal small businesses ask for policies to foster training, access to information and access to large businesses, as well as policies to ease the movements and interactions with employees.

Irrespective of the degree of formality, the Palestinian government, in liaison with the local authorities and private sector institutions, shall record the informal businesses so that their operations can be regulated and monitored especially on compliance issues. As well, the government shall put in place mechanisms and systems to ensure the fundamental labor rights to all workers and provide better infrastructure and working environment. The government shall put in place policies that allow informal firms to access soft loans. In case stringent measures like ‘collateral security’ are removed or harmonized, that will enhance the informal sector to recapitalize its businesses. This should culminate in business expansion and growth.

All these policies are mutually interacted, since they work together; if some are omitted, the remaining policy changes may not succeed in fostering the Palestinian informal and formal small businesses. For example, if the government manages to simplify the registration procedures while banks do not respond to the needs of businesses or these businesses do

not build their internal systems, then the results will not have a solid impact.

### 3.6 Practical Implications

In an exceptional context and an economy in transition such as that of Palestine, both informal and formal small businesses have potential to grow into the more sustainable way and help improve Palestine's precarious unemployment levels, which in turn would improve welfare of its citizens including standards of living. Thus, closing the gap between theory and practice, both formal and informal businesses are important to an economy in transition such as that of Palestine.

Political risk is an external pressure and is considered a major risk facing Palestinian businesses whether they are formal or informal. Other challenges include low income and high competition because of market size limitations and low variety of products (i.e. low differentiation), in addition to the outdated laws and regulations. The size, non-regulation, low cost, and low capital requirements make the informal sector a more favored choice for those who are out of formal employment, or who—after completing some form of training or equipping himself or herself with some skill—fail to be absorbed into the formal sector. Some people are self-employed in the informal sector because they want to avoid registration and taxation. However, many people work in the informal sector through necessity not choice. The informal sector seems to embrace all facets of economic activity though with a high tendency for a high level of non-compliance with the business best practices.

Today, there are two features of the informal sector that are well recognized. Firstly, much of the informal economy contributes greatly to the formal economy. Secondly, women constitute the majority of precarious, under-paid, informal workers. Thus, closing the gap between theory and practice, the performance of businesses run by women who work from home shall not be assessed based on purely economic measurements while ignoring the socio-cultural dimensions.

To date, it is not known how many businesses currently conduct some or all of their activities informally. Such a research is desperately needed.

Until this is known, it will be difficult to be certain whether policy initiatives are targeting the major sectors where this work prevails and the principal types of informal work and worker. A larger sample size is needed to cover other neglected sectors such as home-based businesses or large-scale businesses, which were not included in the study. Also, is it worth inspiring Palestinian informal businesses to move to formal ones?

### 3.7 Conclusion

The chapter identifies the significant differences in the characteristics of Palestinian formal and informal small businesses in terms of location, access to finance, sales, and import. The chapter also outlines the challenges that need to be taken seriously before recommending policy instruments. Finally, the chapter recommends a list of policy instruments to foster informal and formal small businesses in the Palestinian Territories such as training, access to new markets, access to finance, access to information on markets, suppliers, and registration processes, and changing laws and regulations.

Obtaining a true picture of the size and dynamics of the informal economy has proven to be a daunting task. There is a lack of studies in the Palestinian Territories on dealing with how violent conflict impacts firms working formally or informally at the micro level. This chapter addresses this lacuna. There is a wonder whether the informal businesses might prosper in the long term in the Palestinian Territories or whether it should be curbed as a hindrance to development. Paradoxically perhaps, the sector contains both entrepreneurial potential and the struggle for subsistence. From one perspective, informal businesses have an unfair advantage in avoiding taxation. On the other hand, these businesses lack legal rights, and are unable to access public services or formal sources of credit. So, what is an appropriate policy response?

Identifiable obstacles and constraints lead to the failure of informal enterprises and loss of jobs. These include a lack of suitable and secure premises in good locations, limited or no bookkeeping skills, a lack of finance, credit, and insurance, and being the target of crime – as well as annoyance by local government. Several constraints are structural and



fundamental to the concentrated nature of the economy. These hinder informal enterprise owners' efforts to reach beyond local markets, graduate to upper tiers of the sector, or step up to higher-value markets and formal sector value chains.

The solution is neither to encourage nor to suppress informal economic activity but rather to reduce barriers for all businesses (formal and informal). Opening routes to formality creates new job opportunities for the poor to realize their potential and raise national competitiveness. Acquiring the formal status allows women entrepreneurs to access formal markets, invest with security, obtain new sources of credit, and defend their rights. An effective route to formality, however, requires more than registration and enforcement. It requires the tearing down of barriers at the origin of informality to improve the business climate for all entrepreneurs. Lowering barriers increases business opportunities while facilitating compliance.

So, what is the way forward for the Palestinian policymakers? The informal sector needs to be supported by a development-oriented policy approach in which enterprises are enabled to become self-standing institutions that are organizationally and financially separate from the household. A good place to start is by teaching enterprise owner-operators basic bookkeeping skills and providing them with suitable sites for their businesses; these are factors associated with employment growth. Such policies—instead of enforced formalization, which is often limited to tax registration and business licensing—could make a significant difference to the job opportunities, earnings, and working conditions of the poor.

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