



Palestine Economic Policy Research Institute (MAS)

# **Evaluation of the Efficiency of the Palestinian Labor Market**

**Belal Fallah**

**2016**



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### **The Palestine Economic Policy Research Institute (MAS)**

Founded in Jerusalem in 1994 as an independent, non-profit institution to contribute to the policy-making process by conducting economic and social policy research. MAS is governed by a Board of Trustees consisting of prominent academics, businessmen and distinguished personalities from Palestine and the Arab Countries.

### **Mission**

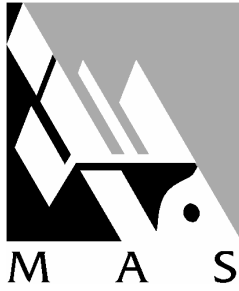
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### **Strategic Objectives**

- ◆ 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)  
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## **Foreword**

MAS has always placed special emphasis on the employment sector and the policies that govern and regulate its performance. Indeed, MAS has so far published 24 studies on issues related to this sector, and the present study, which evaluates the efficiency of the labor market, is an important addition to the existing literature. MAS usually consults with the stakeholders, in particular the PNA ministries, before planning the Institute's research program for a given year. Our interest in the labor market efficiency was inspired by discussions that we had with the Ministry of Labor. Moreover, the efficiency of the labor market is one of twelve indicators that measure the competitiveness of business environment in a certain economy, which is of particular interest to MAS. The author used World Economic Forum criteria in his evaluation and reached conclusions, on the basis of which government interventions intended to impact labor market efficiency and unemployment in other countries were examined as to suitability in the Palestinian context. We at MAS are confident that policy-makers will find the research findings and recommendations highly relevant in reconsidering the labor policies in question.

On behalf of MAS, I would like to express our gratitude to the main researcher and the rest of the research staff for their effort, as well as to the reviewers and the participants at the seminar at which the study findings were presented for their valuable remarks. We are particularly indebted to the Islamic Development Bank for its ongoing support to MAS and its programs, in particular the "PNA Research Priorities Program" that the Institute implements with funds from the Arab Monetary Fund via the Al-Aqsa Fund.

**Nabeel Kassis, PhD**  
**Director General**



## Executive Summary

- Enhancing labor market efficiency is often of central interest to economists and policy-makers. The reason hinges on its linkages to labor market performance and competitiveness. Utilizing several efficiency criteria, devised by the World Economic Forum (WEF), this study aims at assessing the Palestinian labor market efficiency. The efficiency criteria include: employment rigidity; redundancy cost; flexibility of wage determination; pay and productivity; taxes and incentives to work; and female labor force participation. These criteria generally reflect the extent of government intervention in the labor market. The underlying assumption is that enforcing strict labor regulation may have adverse impact on employment, productivity, and labor market flexibility.
- The assessment strategy of this paper is based on two dimensions. The first is to identify the labor regulations related to efficiency criteria and explore their flexibility (strictness) relative to other countries. The second measures the extent of compliance to labor market regulations in the private sector and the associated effect on unemployment and unemployment duration. Furthermore, the study explores the significance of labor market regulations in comparison to the impact of the Israeli occupation in explaining the weak performance of the Palestinian labor market. Following is a summary of the main results:
  - **Employment rigidity and redundancy cost:** Using the World Bank's labor regulation index of 2007, the results show that Palestinian regulations related to firing and hiring practices are relatively flexible. On the other hand, regulations related to the cost of firing are considered stricter than in many countries. Still, this comparison says nothing about compliance. Therefore, the study examines the extent of actual compliance focusing on regulations related to firing and hiring costs.
  - Utilizing PCBS's labor force data of mid-2015, the results show that compliance to paid annual vacations, paid sick leaves, and severance payment is low. The compliance rate in the West Bank is 17% and only 8% in the Gaza Strip. The results also show that compliance to insurance against work related injuries is at a low rate (20% in the West Bank and 9% in the Gaza Strip). Markedly, compliance to these regulations rises in the service sector and in firms that employ highly educated workers (more than 12 years of education). The results show that compliance is disproportionately concentrated in large and medium size firms. The reason may hinge on the positive relationship



between probability of government detection and firm size. Another factor is related to the economies of scale effect. Greater productivity in large firms may neutralize the negative effect of compliance.

- Regarding the regulation of hours worked, the results show that the share of workers who often work more than the maximum limit (45 hours a week) is 49.5% in the West Bank and 33.5% in the Gaza Strip. A difference in the hours of work surfaces between males and females, amounting to 53% for males in the West Bank and 36% in Gaza and to 30% for females in the West Bank and 13% in the Gaza strip. These gender differences may be related to societal restrictions imposed on females. Unfortunately, the labor force survey lacks information about overtime pay for individuals working more than 45 hours a week. Though, akin to the results of the aforementioned regulations, it is expected that compliance to this overtime pay is low.
- In conclusion, the low compliance rate is expected to diminish the impact of government intervention in the labor market. The study utilizes the Instrumental Variable (IV) regression technique to examine the effect of labor market regulation on the unemployment rate and unemployment duration. This exercise focuses on selected regulations that increase hiring and firing costs, including: annual paid vacation, paid sick leaves, and severance payments. The results show no statistical evidence that documents a negative impact of these regulations. However, one must be cautious to generalize this finding on the general relationship between labor market outcomes and labor regulations. The findings may be specific to low compliance rate and concentration of compliance in larger (more productive) firms.
- **Flexibility in wage determination**, which reflects the extent to which wages are affected by labor demand and supply versus government regulations: These regulations take different forms, including minimum wage policies, and allow labor unions to negotiate wages with business owners. This study assesses wage flexibility by assessing compliance to these regulations. The findings show that compliance to the minimum wage is very weak. In specific, the share of workers earning below the minimum wage (1,450 NIS) did not change in the first year after the law went into effect (beginning of 2013). The share, however, reduced by three percentage points in the second year and by two percentage points in the first half of 2015. Nevertheless, the decrease in the share is not entirely related to compliance. The results show that it is mainly related to labor demand and supply. This analysis excludes the Gaza Strip as the minimum wage policy was approved only by the government in Ramallah.

- As for the role of labor unions in the wage determination, the findings show that it is very weak. The labor force data of 2014 show that the share of workers affiliated with labor unions is about 12% in the West Bank and 36.5% in the Gaza Strip. Importantly, the share of workers with collective agreement contracts, which negotiate the wage level, is only 4% and is mainly concentrated in Gaza. Thus, one can infer that the lack of minimum wage compliance and the utilization of collective agreements have set the stage for a demand and supply mechanism to determine the wage level, leading to greater wage flexibility. To quantify the extent of wage flexibility, the study utilizes quarterly labor force data for an extended period (1999-2014) to estimate the so-called "wage curve", which examines the impact of the unemployment rate on wages. Consistent with findings from other countries, the result indicates that increasing the unemployment rate by 1% reduces wages by 0.9%.
- **Wages and productivity:** Economists have often stressed that parallel growth in wages and productivity is key to sustainable economic development. Otherwise, increasing wages at a greater level than productivity is likely to deteriorate competitiveness and reduce export capacity. This, however, can be caused by strict government intervention mainly with respect to setting a minimum wage close to or more than the average wage and granting labor unions the leverage to impose high wages with less regards to worker productivity. Nonetheless, as indicated above, these factors are less likely to have an effect. This study highlights the impact of the Israeli occupation and the Israeli demand for Palestinian workers as a main factor explaining the deviation between pay and low productivity.
- **Taxes on incentives to work,** which addresses the effect of payroll tax on raising unemployment and reducing labor force participation. These factors seem to have only a weak impact, at best, in the Palestinian labor market. Utilizing the labor force survey data of mid-2015, the results show that the share of workers who declared that their employers cut payroll tax off their wages is only about 12%. Most of these workers are employed in large and medium firms. Consistent with this finding, income tax contributes minimally to the government's total tax revenue. For example, in 2009, the share of income tax amounted to only 5%.
- **Female labor force participation:** The labor force data show that female linkage to the labor market is weak. The female participation rate in 2014 was as low as 16%, owing to the minimal participation of less educated females (7%) as opposed to educated ones (52%). Interestingly, the unemployment rate for females rises with the level of

education, amounting for the educated to 41% for the educated in the West Bank and 63% in the Gaza Strip. The unemployment rate for those less educated is 6% in the West Bank and 33% in the Gaza Strip. Nonetheless, labor regulations for female workers, such as paid maternity leave, seem to have little contribution to the low demand for educated females. In particular, compliance to such regulation is limited: about 41% in the West Bank and 13% in the Gaza Strip. Importantly, low female wages, relative to those for males, in firms that comply with labor regulations may neutralize, or at least limit, the negative effect of compliance on female employment.

- In sum, the study provides evidences that, according to the WEF's standards, the weak role of government intervention and labor unions have enhanced labor market efficiency and flexibility. Yet, this has not improved the performance of the Palestinian labor market. The unemployment rate in the West Bank is still high and skyrocketing in the Gaza Strip. The ill outcomes of the long-lasting Israeli occupation is the main contributing factor. This can be manifested by barring investment and infrastructure development in Area C (comprising about 60% of the land in the West Bank), imposing a strict blockade on Gaza, and isolating economically Jerusalem. In other words, these measures counteract the benefits that can be gained from an efficient and flexible market. In this framework, the study highlights the impact of restricting mobility for Palestinian workers into the Israeli labor market. The results show that changes in the unemployment rate, mainly for the less skilled, are directly related to the flow of workers to the Israeli labor market. In specific, decreasing the share of those working in the Israeli market by 1% would increase unemployment by 0.7%.
- In the light of the aforementioned findings, the study discusses and evaluates a number of government policies aimed at limiting the increase in unemployment. These policies include: employment services, employment/wage subsidies, training programs, and public work. The study also discusses reforms to enhance flexibility of regulations related to severance payments. In fact, if widely enforced, the associated cost of this regulation would be high and may be unbearable for small firms if a number of workers quit at the same time. Accordingly, this study proposes an alternative scheme, namely unemployment insurance that is based on mutual cost sharing between workers and business owners.