CSIS | CENTER FOR STRATEGIC & INTERNATIONAL STUDIES

Statement before the House Foreign Affairs Subcommittee on Middle East, North Africa, and Global Counterterrorism

"People to People: Examining Grassroots Peacebuilding Efforts Between Israelis and Palestinians"

A Testimony by:

Dan Runde

Senior Vice President; William A. Schreyer Chair; and Director, Project on Prosperity and Development

July 21, 2021

WWW.CSIS.ORG

1616 RHODE ISLAND AVENUE NW
WASHINGTON, DC 20036

TEL. (202) 887.0200
FAX (202) 775.3199

Chair Deutch, Ranking Member Wilson, and distinguished members of the Subcommittee on Middle East, North Africa, and Global Terrorism, thank you for the opportunity to appear before you today to discuss new programs that can facilitate economic cooperation and peaceful coexistence between the Israeli and Palestinian people.

Before I begin, I'd like to recognize the magnitude and complexity of the historical and ongoing Israeli-Palestinian conflict. The events of the recent months underscore that there is still immense work to be done to ensure that Israeli and Palestinian people can live harmoniously and without fear. I acknowledge that there are many challenges and geopolitical issues that transcend the scope of this hearing today.

My experience working in the private sector and international development, as well as my work as an architect of the BUILD Act, gives me a unique perspective to view this new initiative. My testimony today will be focused on providing recommendations as it pertains to the Lowey Middle East Partnership for Peace Act (hence forth referred to as MEPPA), particularly regarding its provision for the creation of the "Joint Investment for Peace Initiative." It is appropriate that Congress has passed MEPPA as a living memorial to Congresswoman Nita Lowey who devoted her career to peace, reducing global poverty, and increasing access to education and economic development. With the passage of MEPPA, the real work in implementing the ambitious, $50 million a year budget, begins.

Considerations for the MEPPA Programming:

My key message to you today is this: for the MEPPA investment funds to work, you will need to use some grant money to improve the business climate, and the capacity of formal businesses to ask for money and use the money wisely. There are several variables that are key to the understanding and implementation of this ambitious program, some of which I will briefly outline before I provide a series of recommendations on pathways forward.

The MEPPA will operate in a conflict-affected and fragile environment. Barriers in what are called "fragile states" lower the number of "first mover" firms, or those that develop a new process or product or break into a new market.[1] While development finance institutions (DFIs) promote private investment into developing countries to reduce poverty, their track record is not as strong in fragile places because of political instability or ineffective political leadership. In fragile areas, free market activities are disrupted, while foreign direct investment is limited due to overall instability. Other barriers include weak and underdeveloped institutions, poor business environments, and lack of physical infrastructure. Furthermore, local government often crowds out the private sector, and as a result, firms are unable to receive the financing and credit they need to grow and succeed. These challenges underscore the importance of providing businesses with technical assistance and capacity building programs to support market creation activities. These activities include skills development and support for government regulators and local banks to create a strong financial ecosystem.[2]

The business environment in this region is challenging. The West Bank and Gaza are relatively small economies with a combined GDP of $15.5 billion in 2020[3] and a population of 4.8 million. Of that population, 54 percent is under the age of 25.[4] Many are unemployed or have left the workforce altogether. At the same time, approximately 50 percent of businesses operate "formally" which means they pay taxes, obey labor and environmental laws, and operate in such a way that these businesses can access bank loans and other forms of normal financial products. The other 50% of businesses are informal: they do not pay taxes, do not necessarily follow labor and environmental laws, nor do they have access to normal forms of finance to grow.[5] The 2020 World Bank's Doing Business Report ranks West Bank and Gaza 117 out of 190 countries surveyed.[6] Those existing companies that are in the formal sector are the ones that the U.S. International Development Finance Corporation (DFC) will most likely seek to engage and encourage to apply to the Joint Investment. The smaller, often informal businesses that DFC will not be able to engage can, however, benefit from technical assistance that USAID can provide through entrepreneurship development and training programs to increase the number of investible businesses in the future.

As a result, the financing environment is also challenging. DFIs such as the DFC primarily provide loans or loan guarantees, which rely on a company's track record and past performance in their analysis. The equity program at the DFC, while limited in terms of overall capital available, focuses less on financial history but requires visibility into the long-term viability of these investments. In the case of either debt or equity financing, the DFC seeks to stimulate private sector investment, but like other DFIs, it does not want to be the only provider of capital and will work with other co-funders. In the West Bank and Gaza, partners will be limited, as investors have more attractive options for emerging market investments. Finally, the ability to screen businesses in an environment like the West Bank and Gaza can be expensive and challenging for a variety of risks, such as corruption, reputational risks, and other issues, including security. In short, for the 50% businesses that are in the small formal sector, attracting capital is challenging. If the U.S. government wants to promote private sector investment into the West Bank and Gaza, it will need to take additional steps beyond just providing investment capital to provide assurances to investors about the return on their capital and to make these investments as least as attractive as other options in safer emerging markets.

Operating a U.S. government initiative requires managing expectations on its development impacts versus its financial returns. In a piece I wrote last year, I recommended that a Palestinian enterprise fund should be established to carry on the important work of Congresswoman Nita Lowey.[7] While the Joint Investment Initiative is not exactly an enterprise fund, it has similar qualities that are worth discussing. Enterprise funds have in the past been established by the U.S. government to provide equity financing and loans to companies in developing countries, with the aim of promoting private sector development abroad. These institutions function like private equity funds; they are independently managed by outside investment professionals that take significant risks and use creative investment strategies to advance private sector development abroad.[8]

Past Initiatives:

There have been several past U.S. initiatives in the region with similar purposes to MEPPA that have had success in the region and are worth recognizing:

On such initiative that has been successful is the Middle East Investment Initiative (MEII). The MEII is a non-profit organization that offers financing and technical assistance programs to promote long-term and sustainable economic growth in the Middle East and North Africa. MEII has a $330 million portfolio that includes loans, equity, guarantees, leasing, microfinance, and technical assistance that helps drive economic development and job creation. Since starting in the Palestinian territories in 2008, MEII expanded to Tunisia and Jordan in 2015 and 2017 respectively and provided $378 million in financing and lending to 2,760 businesses and created an estimated 31,000 jobs.

The Overseas Private Investment Corporation (OPIC)—the DFC's predecessor—worked with the Palestine Investment Fund (PIF) and regional banks to stand up the Affordable Mortgage and Loan Company (AMAL) in the West Bank. AMAL provides loans intended to encourage mortgage lending to low and medium-income borrowers. In partnership with the PIF and MEII, OPIC also started a $160 million loan guarantee facility (LGF) in 2007 with the goal of encouraging local banks to provide loans to SMEs in the West Bank.

Recommendations for MEPPA Implementation:

Taking these considerations and past initiatives into account, the deployment of innovative financial instruments to spur private sector growth nevertheless can support significant change in the West Bank and Gaza. Before I discuss specific recommendations, I want to emphasize that any of the activities related to MEPPA should comply with the Taylor Force Act. In the hopefully rare case that the Palestinian Authority seizes NGO or assets that might be related to the Joint Investment Initiative, the Taylor Force Act could be undermined. Additional Congressional oversight may be required.

I have several specific, actionable steps that will be required to make the Joint Investment Initiative a success:

First, Congress should work closely with USAID to ensure that some of the USAID program budget is used to improve the business environment in the West Bank and Gaza. As I outlined above, it is hard to start a business in the region: there are many barriers to entry such as weak institutions, political instability, and high levels of government debt. Eliminating or reducing those barriers to business will produce more attractive opportunities for investors. With a finite number of formal companies that investors can support, we should help improve the business environment and seek to grow the universe of companies that the DFC can invest in. In practice, this may require higher costs for due diligence and vetting of businesses, which should be considered accordingly.

Second, there are many businesses and entrepreneurs that are not in a place today to put together "bankable" projects in the West Bank and Gaza. There is, however, a large cadre of highly educated and trained individuals and human capital in the region. USAID should apply some of its program monies to support sector-wide so-called "technical assistance" to businesses that might not meet the current DFC standards. The kind of technical assistance I envision includes:

1) Helping Palestinian businesses manage their revenue streams
2) Applying better and improved accounting practices
3) Improving approaches to human resources
4) Reviewing their corporate governance
5) Improving supply chain management

Several specific sectors that have great promise in the West Bank and Gaza include agribusiness, the ICT sector, and of tourism. DFC could compliment USAID's work, but the DFC is only now beginning to think about how it's going to implement technical assistance work on a project-by-project basis. For significant, scalable technical assistance, Congress will need to look to USAID to provide it, not the DFC.

Third, given the importance of regional partners and actors, the MEPPA programs should engage and strengthen interregional economic cooperation with Jordan and Egypt. Both countries are crucial partners for the Palestinian territories and have existing economic ties with Israel. For example, Israel and Jordan agreed to trade agreements this month that will increase Jordan's access to water and allow Jordan's exports to the West Bank to increase to $700 million compared the $160 million last year.[9] Positive economic cooperation between Palestinians and Israelis through the MEPPA programs will benefit the entire region and could bring more prosperity and stability to Jordan and Egypt.

Fourth, there are opportunities for MEPPA's Joint Investment Initiative portfolio to include targeted equity investments, specifically taking ownership shares in some companies. For the DFC to take advantage of all the investments that MEPPA envisions, Congress should consider a "fix" to allow for MEPPA funds to be exempt from the so-called "provision 1434 article J" of the 2018 BUILD Act, which was set up to prevent the DFC from financing too large a portion of its budget from the State Department and USAID. I note that the proposed FY2022 House Appropriations State-Foreign Operations bill provides for this exact “fix.”

Fifth, in addition to equity investments, the DFC should consider using “first loss guarantees” in its Joint Investment Initiative portfolio. Monies for such first loss guarantees could also come to DFC via USAID grant money. First loss guarantees are a mechanism where a third party—in this case, the DFC—compensates lenders in the case of a borrower default. First loss guarantees are particularly important in fragile settings given the perceived higher risk associated with these geographies. The BUILD Act expanded the DFC’s ability to provide first loss guarantees and other guarantee products, but there are challenges within the interagency, specifically there are concerns within the Office of Management and Budget, to deploy USAID grant money for such first loss guarantees. Congress should consider adding language to encourage use of first loss guarantees. USAID, OMB, ought to be instructed to take another look at how this might be done specifically in the West Bank and Gaza context. The Joint Investment Initiative offers an important opportunity for the DFC to further test the use of first loss guarantees to build the case for future use of first loss guarantees in other fragile contexts.

These five recommendations can be instrumental to making MEPPA a success.

I appreciate the opportunity to testify before you today. Thank you for the opportunity.