Investment Co-Financing Facility (ICF)

Supporting private-sector investment projects to create sustainable jobs for Palestine's workforce

Market Failures Overview

F4J is implemented by DAI on behalf of the Ministry of Finance & Planning, and Funded by the World Bank
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The Finance for Jobs (F4J) Series of Projects (SOP) has as its development objective the testing of innovative financial products that can foster increased private sector investment and job creation in the Fragile and Conflict-Affected (FCV) setting that characterizes West Bank and Gaza (WB&G). A key proposition of the F4J is that the creation of jobs through private sector investment generates benefits above the market returns to the factors of production (capital, labor and land). Moreover, in instances where the market returns would not be sufficient for the investment to take place, because of elevated FCV risks, market and/or institutional failures, these benefits constitute additional social returns that can justify and merit public financing support to enable the investment to proceed and the benefits to be generated. On this basis the F4J is testing a financial product (herein referred to as a Investment Co-Financing Facility - ICF) that would - in order to leverage private investment with the objective of creating sustainable new jobs - provide the marginal financing needed so that a fundamentally sound commercial private investment (that falls short of financial viability due to the FCV risks and/or other market/institutional failures can proceed. The allocation of ICF funding would be conditional on eligibility and performance criteria.

This discussion note further explains the ICF – both its rationale and how it is proposed to function. It comprises the following sections: (i) the rationale for extending public financing to private investment to create jobs in FCV setting;

The Rationale for Targeted Job Creation Initiatives in Fragile, Conflict and Violence-affected environments

Jobs constitute a high priority for the FCV agenda. Given their contribution to household earnings, productivity and economic growth, and positive feedback loops on social cohesion and reducing the risk of violence, jobs can play a very important role. The 2011 World Development Report, highlights the additional threat to stability that arises from joblessness and the resultant increased risk of criminality, violence and radicalization that can come with unemployment. The jobs environment is particularly challenging in the FCV context, where high political, economic and social risks, together with weak institutional capacity and limited financial resources can seriously impede recovery and reconstruction. This provides a prima facie reason to prioritize initiatives that can foster increased job creation that can meet the job aspirations of the working age labor population and mitigate against these threats.

The framework also responds to the WBG's IDA17 commitment to "develop a more realistic medium to long-term framework for inclusive growth and jobs in FCS" that would broaden the WBG's perspective beyond fostering a better investment climate, and toward embracing a stronger focus on shared growth and economic opportunity. The note was jointly prepared by the Jobs Group and the FCV CCSA.

As the Jobs World Development Report 2013 suggests, a framework for job creation critically includes establishing a conducive macro-economic environment that encourages the private sector investment that generates jobs and fostering the development of a labor market that delivers the skills and abilities that the private sector need and provides the safety nets and support that the labor force need. However, in FCV settings in general, and in WB&G in particular, the extent to which these reforms can be undertaken and the impact they can have are impeded by exogenous constraints (e.g. Israeli access and mobility policies, tax revenue controls) as well as deep-lying political and capacity constraints of the PA.

The challenge in WB&G, from the private sector perspective, is that the highly risky business environment and market and government failures increase costs, reduce demand, and compromise the return of investment. Even where it is a fundamentally sound commercial venture, high risk, high cost, and low and uncertain demand imply a reduced rate of return, and hence, lead to low overall investments and job creation. The market and institutional failures facing the private sector in WB&G are myriad, including:

1. **Factor market failures**:

- **Limited financing available in the financial sector** – in terms of tenor, price. What is available significantly circumscribes investor options and reduces appetite for longer term investments that entail given a range of risks specific risks;
- **Shortfalls in public infrastructure -** that would, in more normal market setting, be provided by the public sector, to support economic activity but which is not feasible in West Bank\Gaza setting due to constraints on PA budget and inability of the non-sovereign PA to raise funds on capital markets;
- **Labor market weaknesses** – shortages of suitably trained job seekers arising from information asymmetries, normally mitigated through targeted government support (including training, job search etc.) which is not feasible due to PA fiscal constraints.

2. **Institutional failures:**

- **Lack of control over trade borders -** requiring importers and exporters to operate through Israeli intermediaries at mark-ups estimated between 2-10%;
- **Non-honoring of government obligations** – including provision of power in Gaza due to absence of fuel etc., attributable to fiscal and mobility constraints (e.g. transportation between West Bank and Gaza and within Areas B,C in West Bank).

3. **Greater probability of force majeure events**:

- **Security actions that can result in border closures and destruction of assets** – requiring private sector to delay projects, replace assets, etc.;
- **Government of Israel Dual Use policy.** This can result in a range of additionally heightened risks to investors. This includes: (i) cost and quality risks to capital equipment due to confiscation of assets, resulting in delay to investments and replacement purchases, often with sub-optimal and less effective inputs; (ii) construction risks due to dual use limitations on access to materials; (iii) commercial risk due to constraints on mobility and marketability of good production that depends for profitability on scale and access to markets between and outside of West Bank and Gaza.

All the above represent policy areas over which the PA has limited\no control and for which the private sector nor other institutions currently have means to mitigate. As a result, investments that would proceed in most other economic settings are forestalled in WB&G and the economic and social returns that these investments would make possible are also lost. What corrective actions are possible to mitigate risk and\or increase return to the private sector in order to realize the job and associated wider social outcomes the investment promises? In this context, it is important to distinguish between financial, economic and social returns, as this will provide the basis on which the eligibility and performance criteria for the ICF will be designed.