

EXECUTIVE SUMMARY

SMALL BUSINESSES IN THE ARAB SECTOR:  
AN EMPIRICAL COMPARATIVE  
EXAMINATION

Mahmood Khatib and Shimi Solomon

Koret-Milken Institute Fellows

## About the Koret-Milken Institute Fellows Program

The Koret-Milken Institute Fellows Program accelerates Israel's economic growth through innovative, market-based solutions for long-term economic, social, and environmental issues. The program focuses on connecting government, philanthropic, and business resources that are vital to national growth and development.

Directed by the Milken Institute Israel Center, the Koret-Milken Institute Fellows Program awards annual fellowships to outstanding graduates of Israeli and international institutes of higher education. Fellows serve yearlong internships at the center of the nation's decision-making—the Knesset, government ministries, and other Israeli agencies—and aid policymakers by researching and developing solutions for various economic and social challenges.

In addition, fellows craft their own policy studies aimed at identifying barriers to economic and employment growth in Israel. The fellows' studies, carried out under the guidance of an experienced academic and professional staff, support legislators and regulators who shape the economic reality in Israel. The program offers the ultimate educational exercise, combining real-life work experience with applied research five days a week.

Throughout the year, fellows receive intensive training in economic policy, government processes, and research methods. They acquire tools for writing memorandums, presentations, and policy papers, and they develop management, marketing, and communication skills. The fellows participate in a weekly workshop, where they meet senior economic and government professionals, business leaders, and top academics from Israel and abroad. They also participate in an accredited MBA course that awards three graduate-level academic credits that are transferable to other universities in Israel. The course, which focuses on financial and economic innovations, is taught at the Hebrew University of Jerusalem's School of Business Administration by Professor Glenn Yago, Director of the Milken Institute Israel Center and Director of Capital Studies at the Milken Institute in California.

Fellows Program alumni can be found in senior positions in the public and private sectors. Some serve as advisers to government ministries while others work at private-sector companies or go on to advanced studies at leading universities in Israel, the United States, and Great Britain. Within the program's framework, more than 80 research papers have been published, catalyzing reforms, reducing barriers, bringing about economic growth, and improving the quality of life for Israeli citizens.

The Koret-Milken Institute Fellows Program is nonpolitical and nonpartisan. It is funded by the Koret Foundation, the Milken Institute, and other leading philanthropic organizations and individuals in the United States and Israel.

More about the program: [www.kmifellows.org](http://www.kmifellows.org)

Contact us: [info@kmifellows.org](mailto:info@kmifellows.org)

# Small Businesses in the Arab Sector: An Empirical Comparative Examination

Mahmood Khatib and Shimi Solomon

## **Recommendations:**

- Economic opportunity in the Arab sector in Israel continues to lag far behind the Jewish sector. Although the lack of available credit on reasonable terms affects both sectors in the Galilee, this obstacle is more than twice as problematic for the Arab sector.
- Small businesses in both sectors are the primary means of employment and economic development, especially in the Arab sector. Facilitating small businesses development in the Galilee can generate benefits for the entire Israeli economy by increasing efficiency, reducing inequalities, and strengthening societal interaction.
- Common and separate failures in both sectors are disadvantageous to the Israeli economy. Action by the Bank of Israel, government authorities, credit sources, non-government public institutions; third-sector organizations; and local representatives is necessary to remedy long standing problems that have become more severe in the past 15 years.

## **Introduction**

In order to assess factual realities, we conducted a survey of 20 small businesses in each of two Arab communities, Kfar Kana and Umm el Fahm, and 20 in one geographically adjacent Jewish community, Migdal Haemek. In order to eliminate variables we chose communities of similar size, socio-economic ratings, unemployment levels, wage scales and deficits, as far as was possible; we also conducted in depth in-person interviews to ensure the accuracy of our survey. The only previous study of the Arab sector, by Aziz Haidar in 1993,<sup>1</sup> surveyed 20 businesses in Umm el Fahm and Taibe in 1993; after consulting with Haidar, we chose communities representative of the wider Arab community.

Our study describes the current status and obstacles of businesses in the Arab sector in comparison to similar businesses in the Jewish sector. No similar published study has been conducted since 1993.

The four main findings of the study are as follows:

1. Small businesses in both sectors have substantial problems financing, both new and expansion business initiatives.
2. Small businesses in both sectors suffer disconnection from public institutions; many, particularly in the Arab sector, are unaware of their rights and responsibilities.

3. Small businesses in both sectors lack any significant business advisory services.
4. Arab sector small businesses suffer from the lack of adequate infrastructure, some which fall under government responsibility (roads) and others under the responsibility of the local authorities (public services and available business locations ).

## Small Businesses in the Galilee

### Obstacles to the Establishment of Businesses

As shown in Table 1, the ranking of obstacles confronting small businesses is similar for both sectors. The only significant difference is that in the Arab sector, a greater importance is accorded to location and infrastructure, although not mentioned by Jewish counterparts.

**Table 1**  
**Obstacles to the Establishment of a Business**

Obstacle	Jewish businesses	Arab businesses	Haidar (1993)
Capital & Credit	35%	72.5%	57.50%
Marketing	30%	42.5%	37.50%
Location and infrastructure	0%	12.5%	12.50%
Technical difficulties	10%	37.5%	15%
Licenses and approvals	15%	10%	17.50%

Source: Aziz Haidar, *Obstacles to Economic Development in the Arab Sector: Economic Initiatives in Two Arab Communities – Taibe and Umm el Fahm* (Tel Aviv: The Center for Jewish-Arab Economic Development, 1993), p. 40, and Authors' Survey.

### Access to Capital & Credit

In the Arab sector, 72.5% of respondents suffer from problems in raising capital. This explains the role of family and friends in providing loans and assistance in financing their businesses. In practice, there is a genuine disconnect between the population and the banks – the only other source of credit.

The lack of credit acts as a critical stumbling block to entrepreneurs seeking to establish businesses or expand existing business activity. The problem exists in both sectors, but is more acute among Arab businesses. The main sources of initial financing of businesses in both sectors are private and family capital, and bank loans. Business owners in Jewish development towns rely mainly on personal capital (60%) and ordinary bank loans (35%).

Essentially all initial capital for Arab businesses surveyed came from the private funds of the business owners themselves (50%) and of their nuclear families (40%). A notable finding is the lack of reliance on government aid in the form of grants and aid funds. When loans are taken to establish businesses, Arab owners continue to rely on their families (25%) for additional financial support.

Aversion to banks is the norm. Only 10% of respondents applied for bank loans, and most were denied credit. Researchers have reported in the past on the tendency towards familial

financing and the lack of bank or institutional financing in the development of Arab industry. Among other factors, this situation has been attributed to a desire by some Arab entrepreneurs to reduce risk.<sup>2</sup>

The absence of non-bank financing sources for Israeli Arab businesses is perhaps the key obstacle confronting this sector. Previous studies confirm that only a small number of Arab entrepreneurs have benefited from favorable credit terms.<sup>3</sup> Our data indicate that 75% of business owners reported intentions and ideas to expand their business that did not materialize. In 50% of these cases, the reason was a lack of capital (the number was 60% when Haidar executed his 1993 study). 72.5% encountered this problem when establishing the business. Thus credit for small Arab businesses at Israeli banks remains scarce. These figures of course may reflect a problem in supply (on the banks' side) or a problem on the demand side (the businesses), but neither explanation is in any way realistic. Financing remains the significant barrier to small Arab businesses wanting financial growth and expansion – and of course employment opportunity for others.

### **Initial Marketing**

The second most frequently cited problem of business owners was the problem of marketing. Many businesses (30% and 42.5% in the Jewish and Arab sectors, respectively) have encountered this problem, and the ad-hoc solution is to again involve family and friends to help market the business.

A possible common explanation for both difficulties – capital and marketing – in the Arab sector is that business owners do not trust risk-reducing institutions in the setup stage of the business. 20% of businesses used the assistance of a financial advisor when starting out; 20% were assisted by a banker; and only 5% were assisted by any government agency. 60% and 70% of businesses respectively were assisted by friends and family.. These figures indicate that friends and family are the basic foundations that business owners rely on when starting out, and serve as a substitute for banks. Again, the banking sector is viewed as a negative – contrary to the norm in the Western world.

## **Other Obstacles to Business Development**

### **Management Knowledge and Capability**

A characteristic of all the Arab businesses surveyed was the absence of an employee in a managerial position. Management of the business is carried out by the business owners themselves, with the assistance and participation of family members. The absence of professional management may be a factor inhibiting growth.

### **Competition**

*Competition within the Arab sector* – The findings indicate that a considerable number of entrepreneurs in the Arab sector seek a model to imitate. The result is a multiplication of competitors in competition-saturated markets. One of the notable characteristics of this imitation model is a failure to seek the assistance of financial advisors or to use market surveys. This behavior threatens the profitability of the more rational businesses in the market..

*Inter-sector competition* – Competition between the Arab and Jewish sectors has two main characteristics: The Arab-Israeli economy suffers from an inferior variety of available jobs, and therefore fails to create the appropriate conditions for attracting skilled personnel. Only 40% of workers in our sample are professionals in their field. In contrast, the Jewish economy offers a wide variety of occupations with varying degrees of professionalism, and this attracts many Arab employees, particularly Arab professionals.

The second characteristic of inter-sector competition involves the quality and type of products. Only 4% Arab business marketing reaches the Jewish sector. The vast majority is focused on, and remains in, the Arab community itself, or nearby Arab communities.

The difficulty in attracting skilled employees and the difficulty in marketing products to the Jewish sector slows the growth of businesses in the Arab sector and impedes integration with the Jewish sector.

### **Payment Ethic**

One of the important problems described by Arab business owners is a deficient payment ethic in this sector. As a direct result of the sector's difficult financial condition, the payment ethic raises the risk exposure in the sector. The most common manifestation of this problem is bounced checks, which inhibit businesses planning and development. This problem affects sales adversely and significantly increases the risk of bankruptcy. Business owners in the Jewish sector did not complain of this problem.

### **Infrastructure and Location**

Both sectors are dissatisfied with the services they receive from their local authorities (mainly infrastructure such as roads, sewage, and buildings). Arab sector entrepreneurs complain of a lack of industrial space and deficient public infrastructure. The situation is less severe in the development towns, but there too, resentment was expressed towards the central and local government. The overcrowded nature and lack of space in industrial areas in the Arab sector inhibit growth, as does as the poor level of infrastructure. No space shortage was noted in the development towns, but there was a problem of neglect and a lack of interest by the relevant authorities, agencies of both the local and central government.<sup>4</sup>

### **Access to Information and Public Institutions**

The data in both sectors indicate a de-facto isolation of entrepreneurs who are not in contact with government agencies, municipal institutions, or one another.

In development towns, the survey indicates that 20% of respondents were familiar with state-backed aid programs. Of these, one quarter had applied for aid (none had actually received aid), and one quarter planned to apply; i.e., an additional 5% of the sample. 20% had heard of state grants for investment in small businesses, none had applied, and one-third of these planned to apply – about an additional 7% of the sample. In the Arab sector, only 35% of business owners knew of various state guarantee programs and grants for investment in small- and medium-sized businesses, and none of the respondents had applied or planned to apply for them. Only 15% received credit from a bank in the ongoing operation of the business, 10% received assistance from the municipal government, and 5% received assistance from the Ministry of Industry, Trade, and Labor.

Accessibility is a pervasive, severe problem for business owners in Umm el-Fahm and in Kfar Kana, as a result of several factors, including a lack of information, lack of physical accessibility, cumbersome handling of problems, and a shortage of expertise. These problems are common to all business owners, lead to extremely low expectations and foment alienation in relationships with the Jewish sector in general, and government and public institutions in particular.

### **Advice and Training**

One of our most salient conclusions of the survey is that both new and existing business owners have little if any external assistance available on matters of marketing, technical issues, feasibility, and logistics. The result is increased risk levels, which undermine the stability of small businesses in both sectors. In the area of training, it is apparent that there is no suitable institutional support available to business owners.<sup>5</sup>

## **International Survey**

### **Institutional Obstacles to Small Businesses**

International research shows that failures in the conduct of public institutions are a material barrier to the growth, expansion, and prosperity of small and medium-sized businesses. The commonly mentioned problems are bureaucratic and administrative impediments, and difficulties stemming directly from the collection of taxes, duties, and fees. Also, small-business owners tend to have more difficulty managing the business as it develops and grows.<sup>6</sup>

### **Financial Obstacles**

Financing to start a business and sources of capital for new investments – short and long-term credit, credit from suppliers, and so forth – are the key to business survival and growth.

Studies show that the capital structure and financing sources of a company change according to its size.<sup>7</sup> Credit discrimination against small businesses, the high cost of credit, a lack of financial tools in remote areas, and different strategies applied by company managers are all possible reasons for the differences in the availability of financing. Credit discrimination by financial institutions normally occurs against small businesses that are new or in crisis.<sup>8</sup>

### **External Obstacles**

“External” factors are non-institutional factors that are external to a company that affect its activity. This category includes competition, the rules of operation in the particular industry, costs and accessibility of raw materials, availability of professional services, relationships with customers (i.e., a poor payment ethic), and more. Among the factors negatively influencing small business owners, studies have noted a shortage of raw materials in Thailand, relationships with banks in Japan, and a poor payment ethic that burdens the activity of small businesses in Slovenia.<sup>9</sup>

### **Small Businesses among Minorities and Outlying Communities**

A study that examined the financial difficulties of businesses among specific groups in

Canada – women, young people, Aborigines, and linguistic minorities – found that small businesses among minority groups encounter financing difficulties because of “objective” financial characteristics (traditional, undeveloped businesses; a weak economic environment), rather than because of their minority status. Among other things, businesses owned by minorities in weak areas do not attract the attention of investors (“angels”<sup>10</sup> or venture capital funds), because of their natural financial weakness.<sup>11</sup> A study conducted in the UK on businesses owned by ethnic minorities found that while as a group minorities were no different in choosing sources of credit (and in its allocation by financial institutions), there were differences among the different minorities. One minority group (Afro-Caribbean) tended to suffer from deficient credit allocation and applied for such credit less often. The study also emphasized the importance of informal credit options, with the findings indicating that most initial credit for small minority-owned businesses comes from sources other than banks.<sup>12</sup>

The international literature demonstrates that most of the obstacles confronting small businesses in Israel also face small businesses abroad. However, this finding merely shows that the problem is widespread, and does not alleviate it for any of those concerned. Below, we present our recommendations for dealing with these obstacles, with the aim of resolving the localized failures we have identified and improving the business environment.

## Recommendations

### Financing

The availability of credit for the small businesses we surveyed is low, reflecting a lack of both demand and supply. Steps should be taken to encourage small businesses to apply for loans, while concurrently increasing the supply of such loans on the part of the banks and other entities.

- A. The Bank of Israel should obtain data from banks regarding the distribution of credit offered to small businesses in the Jewish and Arab sectors, and the cost of such credit. Based on precise, comprehensive data, the current market failures on the supply side can be evaluated, and appropriate action plans can be proposed to remedy these failures. Another option is to carry out a comprehensive survey on the subject of credit among small businesses, as was done by the US Federal Reserve Bank.<sup>13</sup>
- B. Further research is needed into the lack of demand for credit among small businesses in the Arab sector. The current failures in terms of demand for credit in this sector should be addressed.
- C. Public and government support should continue for philanthropic and private financing, and state agencies should seek and share data with non-profit institutions and philanthropic foundations.

### Advice and Training

The institutional advisory channels, including the Israel Small and Medium Enterprise Authority, Small Business Development Centers (“Mati”), and the banks, do not fulfill the function for which they were created, as far as the sectors surveyed are concerned. This stems from a lack of public awareness, inaccessibility, faulty strategy, and a lack of appropriate skills



among the advisors. We recommend reevaluating the function and structure of the existing government centers, based on research from around the world:

- A. Expand the variety of training programs supplied by advisory centers, while increasing assistance and improving accessibility for remote communities and the Arab sector. Businesses should be encouraged to create self-training programs, in order to be able to cope with the tactical and strategic difficulties unique to these areas (a shortage of manpower, financial difficulties in the population).
- B. Transfer government advisory programs into private professional hands. The government should look for ways to encourage large businesses to play a role as advisory agents to small businesses in every relevant industry. Thus the experience and knowledge of leading companies in various sectors can be harnessed to provide advice and guidance to small businesses, within the format of practical business cooperation that will contribute financially to all parties. In addition, small businesses and industrial organizations should consider establishing communication channels to encourage inter-business cooperation.<sup>14</sup>
- C. Improve access to information for small business owners in Israel to clarify their rights and obligations, and the means of contacting those public institutions necessary or beneficial to their activity. Distributing printed information, opening contact bureaus in the Arab or outlying Jewish sectors, increasing public relations activities, creating a website for training<sup>15</sup> – all of these would help small businesses in these sectors overcome their unique problems and contribute to their own growth as well as the growth of their entire sectors.

### **Public Infrastructures and Business Atmosphere**

The many years of distress and neglect in public infrastructure and commercial and industrial space in the Arab sector are problems that cannot be instantly solved. As a solution in the initial stage, local authorities should formalize channels of communication and cooperation with representatives of business owners in the communities, and be receptive to concrete suggestions made by small businesses. Such cooperation can boost existing business activity and encourage new initiatives.

<sup>1</sup> Aziz Haidar, *Obstacles to Economic Development in the Arab Sector: Economic Initiatives in Two Arab Communities – Taibe and Umm el Fahm* (Tel Aviv: The Center for Jewish-Arab Economic Development, 1993), pp. 16-18.

<sup>2</sup> Michael Sofer, Izhak Schnell, Israel Drori, & Aas Atrash, *Entrepreneurship and Industrialization in Arab Society in Israel: Research Report* (Kfar Saba: The Institute of Israeli-Arab Studies and Beit Berl, 1995), pp. 21-23.

<sup>3</sup> Yitzhak Klein & Daniel Polisar, *Decisions for the Israeli Economy: Economic Policy for 1997-2000*. Quoted in Haidar, *Obstacles to Economic Development in the Arab Sector*, p. 184.

<sup>4</sup> We were granted no cooperation by the municipal government (repeated attempts to contact the municipality's spokesperson and the head of the business licensing department received no response), but conversations with business owners as well as a visit and first-hand observation of the reality in the field indicate that the municipality's departments do not coordinate efforts in the

matter of sanitation in business areas, construction and maintenance and gardening. On the central government's side, it is apparent that physical infrastructures such as roads are in extremely poor condition and have not been maintained for years. Buildings in the "old" industrial zone surveyed in Migdal Haemek belong to the Industrial Buildings Corporation. Business owners in this area complain of continuous neglect and a lack of dialogue with their representatives.

- <sup>5</sup> We would like to emphasize that because of time and space constraints, and the importance we accord to training and advice by various government institutions, this study did not address the supply side, i.e., existing professional guidance and training for small businesses. All references to this subject in this study are derived from information gathered on the demand side (i.e., from interviewees), or based on quoted research conducted worldwide on the subject of guidance and training and Business Support Centers (BSCs). There is no doubt that, because of its importance, a full study should be devoted to an examination of this subject.
- <sup>6</sup> See research on training of employees in small businesses: Gerald Vinten, "Training in Small and Medium Sized Enterprises," *Industrial and Commercial Training* 32, No. 1, (2000), pp. 9-14.
- <sup>7</sup> Allen N. Berger and Gregory F. Udell, "The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle," <http://www.amciconsulting.com/Economics%20of%20Small%20Business%20Finance.pdf>, pp. 1, 37, 50. (March 28, 2006).
- <sup>8</sup> Francesca Pissarides, "Is Lack of Funds the Main Obstacle to Growth? EBRD's Experience with Small- and Medium-Sized Businesses in Central and Eastern Europe," *Journal of Business Venturing* 14, No. 5 (1999), p. 534.
- <sup>9</sup> Ibid., p. 99; Paitoon Wiboonchutikula, "Small and Medium Enterprises in Thailand: Recent Trends," *Small Business Economics* 18, No. 1-3 (2002), p. 222; Will Bartlett and Vladimir Bukvic, "Barriers to SME Growth in Slovenia," *MOCT-MOST: Economic Policy in Transitional Economies* 11, No. 2 (2001) pp. 193, table 5.
- <sup>10</sup> An "angel" is a common term for a private investor who invests capital in a company or factory in a non-institutional process (usually at the initial stages of the activity), with the aim of obtaining a return.
- <sup>11</sup> Ted Heidrick and Sherrill Johnson, "Financing SMEs in Canada: Barriers Faced by Women, Youth, Aboriginal and Minority Entrepreneurs in Accessing Capital" (n.p.: Small Business Policy Branch, Industry Canada, 2002), pp. 2-3, 9.
- <sup>12</sup> David Smallbone, Monder Ram, David Deakins and Robert Baldock, "Accessing Finance and Business Support by Ethnic Minority Businesses in the UK," (paper presented at conference of Public Policy and the Institutional Context of Immigrant Businesses, Liverpool, March 22–25, 2001), pp. 8, 11, 17-18.
- <sup>13</sup> <http://www.federalreserve.gov/pubs/oss/oss3/ssbf98/april2001bulletin.pdf>. (March 20, 2006).
- <sup>14</sup> See discussion in: Paul J. A. Robson and Robert J. Bennett, "SME Growth: The Relationship with Business Advice and External Collaboration," *Small Business Economics* 15, No. 3 (2000) pp. 201-202, and also Ideas regarding small and larger businesses cooperation in Gary Loveman and Werner Sengenberger, "The Re-Emergence of Small-Scale Production: An International Comparison," *Small Business Economics* 3 (1991), p. 35.
- <sup>15</sup> For example, <http://www.homebusinessmanual.com.au/hbm/>. (March 14, 2006).

FELLOWS | KORET  
PROGRAM | MILKEN INSTITUTE

תוכנית עמיתי קורת – מכון מילקן  
בית מילקן, רחוב תל חי 13  
ירושלים, 97102

[info@kmifellows.org](mailto:info@kmifellows.org)  
[www.kmifellows.org](http://www.kmifellows.org)