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Causes of Contractor's Business Failure in Developing Countries: The Case of Palestine

*Adnan Enshassi[1], Khalid Al-Hallaq[1] and Sherif Mohamed[2]

Abstract: The construction industry has unique characteristics that sharply distinguish it from other sectors of the economy. It is fragmented, very sensitive to the economic cycles and political environment, and has a significantly high rate of business failure. Business failure, collapse and bankruptcy are common terms in the industry due to the many risks inherited in how the industry operates. Throughout the world, the relative ease of entry gives rise to a large number of contracting firms competing fiercely in the market exposing many of them to business failure, Palestine is no exception. The objectives of this paper are to report on a research study which aims at exploring the causes of contractor's business failure in Palestine, and investigating their severity from the contractor's point of view. The study's results shows that the main causes of business failure are delay in collecting debt from clients (donors), border closure, heavy dependence on bank loans and payment of high interest on these loans, lack of capital, absence of industry regulations, low profit margin due to high competition, awarding contracts by client to the lowest bidder, and lack of experience in contract management. Based on these findings, recommendations to the Palestinian National Authority (PNA) and local contractors are presented in this paper.

Keywords: Business failures, Bankruptcy, Contractors, Construction industry

INTRODUCTION

The construction industry is the tool through which a society achieves its goals of urban and rural development. However, it is becoming increasingly more complex partly because the complexity of the construction process itself, and the large number of parties involved including clients, users, designers, regulators, contractors, suppliers and others. The industry's fortunes tend to fluctuate with the general economy, and it has a cyclical nature and quick response to the changes in the economy (Olomolaiye et al., 1998). The industry, in the developed countries, is supported by the social and political infrastructure that are manifest, *inter alia*, in the legal systems, forms of contract, *de jure* responsibilities of specific aspects of the process and the formal accreditation of professional competence. Such supportive infrastructure systems do not exist in the developing countries which tend to rely on infrastructure and procedures that are borrowed from, or imposed by, the developed countries (Drewer, 2001).

[1]School of Civil Engineering, IUG, P O Box 223 – Gaza City, Gaza Strip, PALESTINE. [2]School of Engineering, Griffith University, AUSTRALIA. *Corresponding author: enshassi@jugaza.edu.ps

A number of scholars have addressed the industry's problems in the developing countries setting and discussed ways to alleviate such problems (Hillebrandt, 1997; Ofori, 1993, 1994; Wells, 1986; Turin, 1973). However, lack of progress was noted in solving such problems due to a number of reasons. These reasons include in-appropriateness of some of the recommendations and the initiatives adopted poor executive capacity of the implementing agencies, lack of resources for implementation and initiatives, and neglect of the construction industry by governments and their lack of commitment to solve its problems (Ofori, 1994). Ofori also added that another important possible reason for the lack of progress in construction industry development is the absence of measurable targets in programmes for improving the industry's overall performance.

Ogunlana et al. (1996) stated that the industry's problems in developing economies can be categorized into three areas: (1) problems of shortages or inadequacies in industry infrastructure, (2) problems caused by clients and consultants, and (3) problems caused by contractor's incompetence/inadequacies. Ogunlana and Olomolaiye (1989) indicated that the major problems faced by contractors in developing countries have been classified as problems imposed by the industry's infrastructure, problems of inaccurate information and frequent changes in instructions and failure to meet obligations on the part of clients and consultants, and problems imposed by their own shortcomings.

The construction industry in Palestine was one of the leading sectors that achieved high rates of economic growth in the 1970s and up to the mid-1980s. During that period of time, the contribution of this sector has increased in terms of providing job opportunities for the Palestinian labour force and the generation of local production. Since then, this sector has been subjected to many setbacks which have decreased its role in building up the Palestinian economy in contrast with its counterparts in many developing and neighboring countries. The aim of this paper is to explore the causes of contractor's business failure and to investigate the severity of these causes from the contractor's viewpoint.

DEVELOPMENT OF THE CONSTRUCTION SECTOR IN PALESTINE

The reconstruction of Palestine presents opportunities and challenges unparalleled to modern times. Comprehensive development in Palestine will take place alongside with the creation of entirely new political, social, economic, technological and cultural structures and institutions. Urban and rural reconstruction are among the most enduring and far-reaching activities which Palestinians will undertake in the coming decades. The long historical process of the

national self-expression and development are reflected in the present revival of construction activity in its many forms.

In addition to its social role in providing homes, public facilities and infrastructure for economic enterprises, the construction and housing industry is a driving force in the Palestinian economy. Gross domestic capital formation in the Palestinian territories rose from US$10.8 million to US$520.3 million (4,717.6%) between 1968–1987, that is by annual average of 248.3%. This was primarily attributable to the contribution of the construction industry, which ranged 43–82% during the same period (UN, 1994). In summary, the construction industry has been a vital contributor to the Palestinian economy. It represented 26% of the gross domestic production (GDP) in 2000 (MAP, 2002).

The second half of the 1970s and the first half of the 1980s witnessed huge investments in the Palestinian construction industry. These investments came primarily from remittance sent by Palestinian expatriates abroad, and financial assistance given to the Palestinian by foreign and Arab countries. Most of these funds were directed toward the building sector. Private investment represented 55.3–88.2% of gross domestic capital formation in 1968–1987. This indicates the minor role played by the public sector in construction industry compared to the private sector. Private sector investment represented 60.0–85.8% of total investment in the industry, most of which was directed into housing (World Bank, 1993). The remarkable growth in capital flow and investment came to halt in 1987 – the year of the Palestinian Intifada outbreak – giving rise to a notable recession in the Palestinian territories which, in turn, had a devastating impact on the local construction industry. To demonstrate, the annual rate of growth in the construction industry was negative in both the West Bank and Gaza Strip, amounting to –24% and –20%, respectively (World Bank, 1993). This notable depression in investment continued until the signing of the declaration of principles agreement between the Palestine Liberation Organization (PLO) and Israel in Washington in September 1993. Since then, the construction industry began to witness a noticeable activity improvement. This was due to the optimistic atmosphere fostered by the peace process, which was supported by many international donors and attracted the interest of private Palestinian investors both inside and outside the Palestinian territories.

The local construction industry also plays a distinguished role in the absorption of Palestinian labour force as opposed to the manufacturing and agriculture industries. A large number of Palestinian workers has been engaged in this industry via working in either the Palestinian territories or Israel. The construction industry's share in the employment of the Palestinian labour force has increased continuously. To demonstrate, the volume of Palestinian workforce working in the construction industry, in the

Palestinian territories and Israel increased from 23,900 workers in 1970 to 97,000 workers in 1993. Meanwhile, the Palestinian workforce in the construction industry in 2000 comprised of 13% of the total volume of the Palestinian labour force (World Bank, 2001).

Despite the substantial success achieved by the construction industry in the Palestinian territories, in terms of economic growth, its contribution to the local output, employment and meeting partially the local needs of the Palestinian society, this industry suffers from a number of problems that have prevented it from assuming its big role in the Palestinian economy as is the situation in neighboring and developing countries.

BUSINESS FAILURE: DEFINITION AND CAUSES

The construction contracting business has the second highest failure rate of any business, exceeded only by restaurants (Clough and Sears, 2000). A contractor is at far more risk than his counterpart in almost any other industry (Kangari, 1988). Also, compared to other industries, the client is subjected to a greater degree of risk for a longer period of time during the construction process. Although many firms that experience business failure are small in regard to their owned assets, there is evidence of business failures among large firms (Sanvido et al., 1992). Palestine is no exception, the increasing number of business failures in the local construction market warranted this research study.

A number of scholars have studied this failure at project level, rather than company level (Hall, 1982; Kharbanda and Stallworthy, 1983; Morris and Hough, 1987). Others have developed an operation system for identifying construction companies in danger of failure (Kangari, 1988; Russel and Jaselskis, 1992; Abidali and Harris, 1995). Abidali and Harris (1995) found that lack of engineering skills, lack of a strong financial director, inadequate cash flow plan, poor budgetary control system and defective bidding system contributed to company failure.

There are many definitions of business failure. According to Dun and Bradstreet Corporation (1986), a business failure is defined as a business that: (a) ceases operation following assignment or bankruptcy; (b) ceases operation with losses to creditors after such actions as foreclosure or attachment; (c) voluntarily withdraws, leaving unpaid debts; and (d) is involved in court actions such as receivership, reorganization of arrangement or voluntarily comprising with creditors. Frederikslust (1978) stated that failure is the inability of a firm to pay its obligation as a consequence of a sharp decline in sales, as

a result of recession, the loss of an important customer, shortage of new materials and deficiencies of management.

Altman (1968) defined failure from an economic viewpoint; a company is considered to have failed if the realized rate of return on invested capital, with allowances for risk considerations, is significantly and continually lower than prevailing rates on similar investments. Another criterion is insufficient revenues to cover costs and situations where the average return on an investment is below the firm's cost of capital. Watson and Everett (1993) attributed business failure to four different situations: (1) discontinuance for any reasons, (2) ceasing to trade and creditor loss, (3) sale to prevent further losses, and (4) failure to make a go for it. Hrebiniak and Joyce (1985) summarized the phenomenon of failure as a function of two factors, that are environment-dependant factors and strategic leadership-dependant factors.

Dun and Bradstreet Corporation (1986) have identified the major causes of business failures; they are economic factors, inexperience, poor sales, expense, customer, fraud and neglect, asset and capital, and disaster. They found the most significant failure cause is economic factors. Within the economic factors category, there are five subcategories that are bad profit, high interest rates, loss of market, no customer spending and no future. Arditi et al. (2000) attributed business failures to the following factors, that are budgetary issues, human/ organizational capital issues of adaptation to market conditions, business issues, macroeconomic issues and natural factors. Argenti (1976) listed seven main causes of business failure as lack of capital, under costing, lack of control, lack of advice, government regulation, trade fluctuation and fraud. Clearly, failure is the outcome of a complex process and is rarely dependant on a single factor.

RESEARCH METHODOLOGY

A total of 56 factors that may lead to contractors' business failure were identified through a detailed literature review of relevant research studies (Argenti, 1976; Frederikslust, 1978; Hrebiniak and Joyce, 1985; Kangari 1988; Sanvido et al. 1992; Arditi et al. 2000). Factors of similar nature were grouped together; giving rise to five main groups, that are managerial, financial, business growth, business environment and political. The factors were then used to develop a postal questionnaire with the objective of determining the main causes of contracting business failure in Palestine. The questionnaire was reviewed by two groups of experts to test its content validity. This test led to the

introduction of minor amendments – to better suit the local market conditions – prior to sending out the questionnaire to the target research population.

The target population is all contractors of the first, second and third categories for building works that have valid registration by the Palestinian Contractors Union. The target population was distributed between the three categories as follows: (1) 47 of first category, (2) 32 of second category and (3) 13 of third category – a total of 92 contractors. The following formula has been used to determine the sample size of unlimited population (Ayoub and McCuen, 2000; Creative Research System, 2005) in order to ensure that the chosen sample fully represents the target population.

$$ss = \frac{z^2 * p(1-p)}{c^2}$$

Where ss = sample size
z = z value (e.g. 1.96 for 95% confidence level)
p = percentage picking a choice, expressed as decimal (0.5 used for sample size needed)
c = confidence interval (0.5)

$$ss = \frac{1.96^2 \times 0.5 \times (1-0.5)}{0.5^2} = 384$$

Correction for finite population

$$\text{New } ss = \frac{ss}{1+\frac{ss-1}{pop}}$$

$$ss = \frac{384}{1+\frac{384-1}{92}} = 74.4 \longrightarrow 75$$

Therefore, the calculated sample size is 75 contractors based on a 95% confidence level. To ensure good representation of each category (class), the sample was then distributed as follows:

$$\text{First class} = \frac{75 \times 47}{92} = 38$$

$$\text{Second class} = \frac{75 \times 32}{92} = 26$$

$$\text{Third class} = \frac{75 \times 32}{92} = 11$$

The questionnaire was sent out to a total of 75 contractor companies asking their contribution in ranking the identified 56 factors in terms of severity using an ordinal scale. Given the nature of ordinal scales, the numbers assigned to degree of influence (i.e. 1, 2, 3, 4 and 5) do not

indicate that the interval between scales are equal nor do they indicate absolute quantities. They are merely numerical labels. The ordinal scale that was used are 1 = very low influence, 2 = low influence, 3 = moderate influence, 4 = high influence, and 5 = very high influence. Only a total of 65 completed questionnaires were returned representing a high response rate of 87%.

RESULTS AND DISCUSSION

Managerial Factors

Table 1 shows the mean value of and rank for each managerial factor in a descending order. The descriptive results indicate that lack of business and contracting experience are the top two factors that may lead to business failure. These are closely followed by making bad decisions in formulating company policy, neglect and adopting unsuitable procurement practices complete the list of the most five important causes of business failure under this group of managerial factors. The analysis shows no statistically significant differences between the three classes of responding contractors towards this group of factors. The lowest ranked managerial factors were claims, using computers application, communication system, fraud, and using documentation system. This may interpreted as most of contracting firms in Gaza are of

Table 1. Means and Ranking of Managerial Group Factors

Factor	Mean	Rank
Lack of experience in the line of work	4.25	1
Lack of experience in contracts	4.15	2
Bad decisions in formulating company policy	4.03	3
Neglect	3.91	4
Adopting unsuitable procurement practices	3.75	5
Lack of control system	3.69	6
Lack of labour productivity and improvement	3.68	7
Replace key successful personnel	3.62	8
Owner absence from the company	3.62	8
Lack of commitment	3.58	10
Centralized decision making	3.54	11
Inflation	3.54	11
Company structure	3.52	13
Lack of using project management techniques	3.43	14
Assigning unqualified site engineer	3.38	15
Internal company problems due to bad organization	3.35	16
Lack of using qualified consultant	3.34	17
Lack of adjusting to changes	3.25	18
Lack of using efficient documentation system	3.25	18
Frauds	3.18	20
Lack of communication system	3.05	21
Lack of using computers applications	3.00	22
Claims by contractors	2.80	23

small size nature; hence, their needs to claims, computers application, communication system, fraud and using documentation system is much lower than large companies. Small size firms have also a direct and close control in minimizing fraud.

Financial Factors

Table 2 illustrates the mean value of and ranking for each financial factor in a descending manner.

It can been seen from Table 2 that depending on bank loans and paying high interest (i.e. cost of capital), cash flow mis-management, lack of capital and low profit margin due to tough competition are the top ranked four factors. This result is not surprising as most of contracting firms in the Gaza Strip have major problems in cash flow, capital and harsh competition in a very difficult situation. The result showed that the following financial failure causes had the lowest means values; that are employees' benefits and compensation, dealing with variation orders, controlling equipment cost and usage, material wastages, and evaluation of profit yearly.

It is commonly known that small firms have no dedicated accounting department that publishes financial reports on a regular basis and therefore, monitoring financial ratios is rather difficult. Gaza Strip contracting firms never put into consideration the employee's benefits and compensation, variation orders, controlling equipment cost and usage, material wastage and yearly profits evaluation as a priority which may affect the financial situation of the company.

Table 2. Means and Ranking of Financial Group Factors

Factor	Mean	Rank
Dependence on bank loans and paying high interest	4.32	1
Cash flow mis-management	4.26	2
Lack of capital	4.26	3
Low margin of profit due to competition	4.22	4
Estimating practices	4.03	5
The increase in capital expenditures	4.00	6
Bill and collecting effectively	3.92	7
Difference of local currency exchange with contract currency	3.75	8
Evaluation of profit yearly	3.34	9
Material wastages	3.32	10
Controlling equipment cost and usage	3.29	11
Dealing with variation order	3.26	12
Employee benefits and compensation	2.77	13

Business Growth Factors

There are six factors under this group as outlined in Table 3. Lack of managerial development as the company grows and increasing the size of projects were ranked first and

second with mean values of 3.98 and 3.62, respectively. This is followed by change in type of work and increase numbers of projects were ranked in the third and fourth position. Both, opening a regional office in other governorates and change work from private to public or vice versa were ranked at position 5 and 6 with mean values of 2.69 and 2.74, respectively (Table 3).

Table 3. Means and Ranking of Business Growth Group Factors

Factor	Mean	Rank
Lack of managerial development as the company grows	3.98	1
Increase size of projects	3.62	2
Change in the type of work	3.58	3
Increase number of projects	3.38	4
Change work from private to public or vice versa	2.74	5
Opening a regional office in other governorates	2.69	6

The first factor is related to the capability of the company to adjust itself to industry growth. It is directly related to managerial development while company is going through a rapid phase of growth. There seems to be a wide agreement that one of the almost tedious repetitive mistakes that lead to business failure is the underestimation of project's costs and overestimation of revenues. Opening a regional office had the lowest rank since Gaza Strip is small enough to be considered one governorate. Also, few construction firms have opened a regional office in the West Bank. Over-expansion can drive a company to a higher-risk investment with financial debt; hence, increasing its chance of business failure. Construction contractors must avoid the increase of the number of projects that the company cannot afford both organizationally and financially.

Business Environment Factors

There are eight factors listed under this group as shown in Table 4. The highest three business failure causes are absence of construction regulations, award of contracts to the lowest price and national slump in economy.

The Palestinian National Authority (PNA) has been recently established so relevant industry and trade regulations are yet to be developed and implemented. Moreover most of public as well as private clients continue to award contracts based on the lowest bid price. On the other hand, the lowest ranked three causes of failure are insufficient award of contracts, accounting and tax practices and owner involvement in construction phase.

Table 4. Means and Ranking of Business Environment Group Factors

Factor	Mean	Rank
Absence of construction regulations	4.22	1
Award contracts to the lowest price	4.15	2
National slump in economy	4.02	3
Absence of specialized courts	3.65	4
Owner involvement in construction phase	3.28	5
Accounting and tax practices	3.11	6
Insufficient award of contracts	2.88	7

Political Factors

Table 5 illustrates the ranking of nine factors under this group. Most factors have been ranked with high means. The top-ranked factors are delay in collecting debts from donors, border closure, segmentation of Gaza Strip and high cost of materials, with mean scores of 4.45, 4.37, 4.25 and 4.03, respectively. While the lowest three mean values are dealing with suppliers and traders, banks policy and monopoly, with mean values of 3.34, 3.65 and 3.74, respectively.

Table 5. Means and Ranking of Political Group Factors

Factor	Mean	Rank
Delay in collecting debt from donors	4.45	1
Border closure	4.37	2
Segmentation of Gaza Strip	4.25	3
High cost of materials	4.03	4
Lack of resources	3.91	5
Limitations on material import	3.82	6
Monopoly	3.74	7
Banks policy	3.65	8
Difficulties in dealing with suppliers and traders	3.34	9

It should be mentioned that most construction projects in Palestine are funded by donors. During Al-Aqsa Intifada, local construction companies have traditionally complained about the delay in collecting debts from donors as a direct impact of local business political environment. This cause is also directly related to cash flow management and lack of financial resources. Border closure has great adverse impact on Palestinian economy in terms of a reduction in productivity, income reduction, the introduction of more strict policies and regulations of banks and suppliers, and monopoly as a result of task in resources.

Segmentation of Gaza Strip means dividing the Gaza Strip into two or more parts, which totally limits or prevents the movement of manpower, goods and services. Segmentation has a very bad impact on work activities due to shortage of workforce and construction materials. High costs of materials, lack of resources, limitations on material import, monopoly and banks policy are a result of closure and segmentation of the Gaza Strip.

Overall Factors Ranking

Table 6 outlines the ranking of the highest ten factors causing business failure and their related groups. From Table 6, it can be observed that the five severe factors leading to contractor's business failure are delay in collecting debt from donors, border closure, lack of capital, cash flow mis-management and lack of capital. Also, it can be noticed that these factors are related to either political or financial group. Although delay in collecting debt from donors, banks policy due to intifada, is listed under political group, they are directly related to finance.

Ranking of Groups

Table 7 shows the mean value and rank of the main groups that may lead to contractor's business failure. It is clear that the political group of factors is the most critical.

Table 6. Top Ten Causes and Related Groups

Factor	Main group	Mean	Rank
Delay in collecting debt from donors	Political	4.45	1
Border closure	Political	4.37	2
Dependence on bank loans and paying high interest	Financial	4.32	3
Lack of capital	Financial	4.26	4
Cash flow mis-management	Financial	4.26	4
Lack of experience in the line of work	Managerial	4.25	5
Segmentation of Gaza Strip	Political	4.25	5
Absence of construction regulations	Environment	4.22	6
Low margin of profit due to competition	Financial	4.22	6
Award contracts to the lowest price	Environment	4.15	7

Table 7. Mean and Ranking of Main Groups

Group	Mean	Ranking
Political	3.95	1
Financial	3.75	2
Managerial	3.53	3
Business growth	3.44	4
Business environment	3.44	4

It is quite interesting to note that business growth and business environment groups had the same mean value and rank, although each group has different factors in terms of context and number. This feature is common in statistics science, when mean values are equal; the suitable comparison of two sets of data is the variance.

CONCLUSION

The main objective of this paper is to identify the factors that have the potential to cause contractor's business failure in the Gaza Strip and to determine their level of severity from contractor's viewpoint. Fifty six subfactors were considered in this study and were listed under the following five groups: (1) political, (2) financial, (3) managerial, (4) business environment, and (5) business growth. Contractors have ranked the following factors as highly influential with huge potential to cause contractor's business failure:

a. delay in collecting debt from donors;
b. border closure;
c. dependence on bank loans and paying high interest rate;
d. lack of capital;
e. lack of experience in the line of work;
f. cash flow mis-management;
g. segmentation of the gaza strip;
h. low margin of profit due to competition;
i. lack of experience in contracts; and
j. award contracts to the lowest bid price.

The following recommendations are proposed:

a. The PNA should take the risk when donors delay the debts of the contractors, since most contracting companies in the Gaza Strip are small size with lack of capital.

b. The PNA should establish proper industry regulations and suggest the appropriate mechanism for their enforcement.

c. The PNA should connect the contract price with the price index.

d. The PNA should conduct continuous training program, with cooperation of Palestinian Contractor

Union and universities in order to improve managerial and financial practice of local contractors.

e. Tenders must be awarded to the best respondent bid with accurate cost estimate and not necessarily to the lowest bidders.

f. Contracting companies should not increase the number of projects that cannot be controlled.

g. Contracting companies should consider political and business environment risk in their estimate.

h. Contracting companies should improve their managerial and financial abilities and practice in order to meet the challenge.

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