INTERNATIONAL MONETARY FUND

MIDDLE EAST AND CENTRAL ASIA DEPARTMENT

WEST BANK AND GAZA: FISCAL PERFORMANCE IN 2006

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The Palestinian government was confronted with a severe fiscal crisis in 2006. Resources to fund the government's recurrent expenditures fell by more than one third compared to the previous year, despite a strong increase in external support, forcing a major compression of expenditures. Government employees received on average only about 50-55 percent of their regular incomes. As new financing mechanisms were set up to by-pass the government and banks were reluctant to transact with the government, the public financial management system became increasingly fragmented, with no proper budget framework, no central control, and less transparency and accountability. At the same time, the PA's already unsustainable underlying fiscal position deteriorated further in 2006. The government's wage bill continued to expand and now exceeds revenues (adding the indirect tax revenues still withheld by Israel). Strong adjustment will be needed to put government finances on a sustainable path, but sizable external support will remain needed in the adjustment period. A strong economic recovery would greatly assist the adjustment process.

I. Introduction

1. **This note provides an overview of the fiscal outturn in 2006**.[1] Fiscal developments in 2006 were largely shaped by the domestic and international political difficulties that followed Hamas' victory in the January 2006 parliamentary elections. After the first quarter of 2006, resources to fund recurrent government expenditures fell sharply. As a result, the Palestinian Authority (PA) government was unable to pay full wages and faced increasing pressures to reduce non-wage expenditures and transfers, while also building up arrears. This situation has contributed to a deepening in the PA's fiscal difficulties, which were rooted in the unsustainable policies, including a rapidly expanding wage bill and large budget transfers to cover losses from the production and consumption of energy and utilities. At the same time, the crippling of the Palestinian economy, including through restrictions on movement and access, further reduced the government's ability to mobilize domestic revenues, put added pressure on the labor market in Gaza, and contributed to a further decline in collection rates of utility fees. In this note, fiscal performance is mostly discussed on a cash basis, with some reference to revenues and expenditures on a commitment basis, to emphasize the underlying trends. The note combines information received from the Ministry of Finance (MoF), the Office of the President, the Palestine Investment Fund (PIF), and from donors, to provide a consolidated picture of the central government's finances.[2]

[1] See also "West Bank and Gaza: Recent Fiscal and Financial Developments", October 2006, which can be found at http://www.imf.org/wbg and which provided an overview of fiscal developments in the second and third quarter of 2006.

[2] This information includes MoF figures on amounts of external support received in cash. Additional amounts may have been received, as suggested by various press reports, but these are not reflected here.

II. Fiscal Developments in 2006

A. Public Financial Management System

2. **The public financial management system suffered substantial damage in 2006.** Much of the progress achieved in the years prior to 2006 to strengthen the MoF's control over government finances and increase transparency was lost.[3] The system became increasingly fragmented as the MoF's Single Treasury Account (STA) was suspended, because of the reluctance of banks to transact with the government. Funds were routed through a variety of channels, outside the MoF's control, including via accounts of the Presidency and mechanisms set up by donors for the direct delivery of assistance to the Palestinian people. Funds were also brought in in cash through the Rafah border crossing. No proper budget framework existed in 2006, as formulating a budget had become a fairly meaningless exercise given the uncertainty about available resources.

3. **With multiple spending centers and accounts, the MoF faced great difficulty in trying to reconcile various financial statements and ensuring that all resources and expenditures were properly accounted for.** Regular reporting was interrupted during most of 2006. Only recently did the MoF issue reports on government finances in 2006, in which it aimed to provide a consolidated picture. The Office of the President—which had little alternative but to adopt a larger, albeit temporary, role in the coordination and management of a large part of the external assistance received in 2006, despite having a very limited capacity—has yet to present a full report on the funds channeled through its accounts.[4] In addition, the MoF payroll department had difficulties in tracking all the payments made to PA employees from various sources, and may not have fully reflected yet all new staff hired by the government. Last, the recording of tax payments, which was previously done with the assistance of the Israeli Postal Bank, was interrupted in mid-2006, leaving the PA tax administration unable to properly monitor tax compliance and determine eligibility for VAT refunds.

B. Resources

4. **In 2006, resources to fund recurrent budget expenditures fell by more than one third compared to the previous year.** Cash resources—including domestic tax and non-tax revenues, the share of indirect taxes collected by Israel on behalf of the PA (or so-called clearance revenues) that could be used, and domestic and external financing—totaled \$1.4 billion, as opposed to \$2.2 billion in 2005 (Table 1 and Figure 1).

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[3] See for more details on the public financial management system also a World Bank Public Expenditure Review, published February 2007, at http://www.worldbank.org under countries, West Bank and Gaza.

[4] A report by the Office of the President on the external assistance it coordinated and managed in 2006 is expected to be released soon.

5. **The shortfall in resources was mainly the result of a sharp decline in the PA's revenues.** This mainly reflected the withholding of clearance revenues by the Israeli government since March 2006. Out of an estimated $730 million in clearance revenues collected by Israel, preliminary and unreconciled estimates suggest that only about $270 million was directly or indirectly available to fund government spending.[5] In addition, only $290 million in domestic tax and non-tax revenues were collected in 2006, down from $476 million in 2005. This reflected mainly a drop in non-tax revenues as the Palestine Investment Fund (PIF) had paid exceptionally large returns to the budget in 2005. Tax revenues fell by a little over 10 percent to $206 million, broadly in line with the decline in economic activity, but also reflecting weaker enforcement during the strike in the latter part of the year. Reportedly, a significant part of tax revenues was withheld by banks to help cover the government's debt servicing obligations.

Table 1. West Bank and Gaza: Central Government Finances (cash basis) 2005-2006

	2005 1/	2006				
		Q1	Q2	Q3	Q4	year
	(In millions of U.S. dollars)					
Resources						
Tax revenues (net) 2/	1,220	237	71	152	104	564
Domestic revenues	476	99	70	55	66	290
Clearance revenues 2/ 3/	745	138	1	97	38	273
Domestic financing	477	70	-22	29	23	99
Banks	304	29	-89	-32	-4	-96
Palestine Investment Fund	173	41	67	61	27	196
Previously withheld clearance revenues	137	0	0	0	0	0
External financing	349	154	110	305	178	747
Total	2,184	461	159	485	305	1,410
Expenditures						
Wages and allowances	1,001	278	49	222	107	656
Transfers, operating and capital expenditures	637	74	76	105	113	367
Net lending (subsidies) 2/	344	76	39	154	68	337
Total	1,982	427	164	482	288	1,360

Sources: Ministry of Finance, Office of the President, European Commission, World Bank; and IMF staff estimates.

1/ 2005 figures include some unpaid pension contribution commitments.
2/ Net of VAT refunds.
3/ In 2006, includes estimated deductions from withheld clearance revenues for payment of utilities supplied by Israeli companies.

[5] Before VAT refunds and including $57 million as settlement for January 2006 that had been received already in the last few days of 2005. Israel made only one transfer in 2006, in February, of $68 million. In the period from March to December, it is estimated that the Israeli government deducted over $150 million from the withheld clearance revenues for payments to Israeli utility companies to meet the obligations owed by Palestinian municipalities.

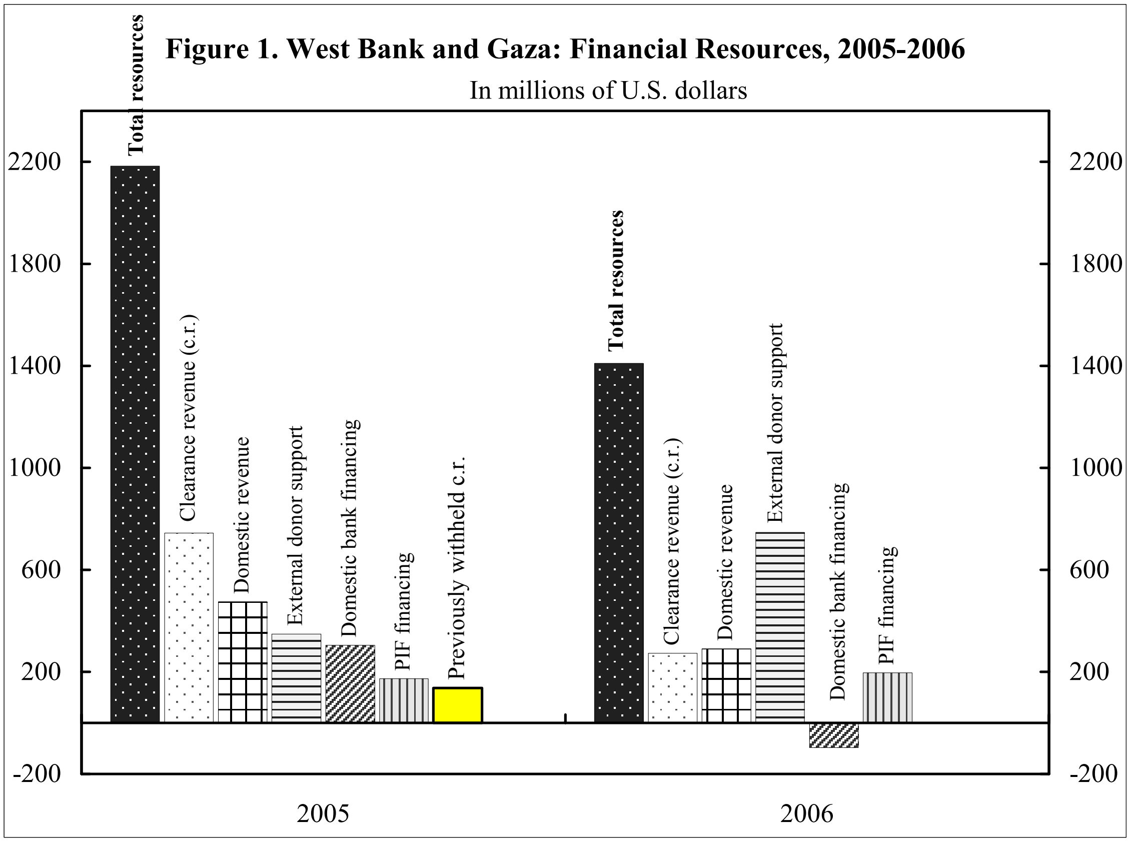

Figure 1. West Bank and Gaza: Financial Resources, 2005-2006

6. **Also, while domestic financing had been a major funding source in 2005, little could be mobilized in 2006.** The PIF continued to provide substantial financing—almost $200 million in 2006—thus continuing to deplete its assets. At the request of the Presidency, PIF funds were used to help finance fuel imports and repay a USAID grant. In addition, banks liquidated PIF assets that had previously been provided as collateral for banks loans to the PA, to cover debt service obligations due. Banks sharply reduced their exposure to the PA, mainly for fear of possible legal repercussions if seen as financing the PA government. During 2006, the PA's net debt to commercial banks was reduced by close to $100 million, including, as noted, by banks liquidating PIF assets they held as collateral.[6] As a result, outstanding PA debt to commercial banks (including one bank abroad) fell to about $500 million by end-2006.

7. **The decline in revenues and domestic financing was offset in part by a strong increase in external financing.** While most donors refrained from providing direct financial assistance to the PA government, nonetheless they continued to provide funds to support the Palestinian people through a number of channels that by-passed the Hamas-led government. In fact, external financing to support recurrent budget operations reached almost $750 million in 2006, more than double the amount received in 2005 (Table 2). The funds were mainly channeled in the following ways:

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[6] One loan contracted by the PA in 2005 from a foreign bank and that was repaid by half in 2006 is included here under domestic financing.

- **About $290 million received mostly from Arab donors was channeled through the Office of the President**, mostly after June 2006. These funds were primarily used to pay allowances to government employees and to social hardship cases, retirees, and unemployed, using information from the technical units of the MoF. In April, the Presidency also became the official beneficiary of the EU's Interim Relief Contribution, which disbursed about $25 million in the spring and summer of 2006.

- **Over $170 million from European donors was disbursed through the Temporary International Mechanism (TIM).** The TIM was set up by the international donor community in the summer of 2006, following proposals developed by the European Commission (EC), to channel support directly to the Palestinian people.

- **The caretaker government in office in early 2006 received over $150 million, through the then still operational STA.** This included almost $80 million from Arab donors, $42 million from the World Bank administered Reform Trust Fund and almost $25 million from the EU's Interim Relief Contribution.

- **The Hamas-led PA is estimated to have received only about $100 million in direct budget support.** This included almost $70 million in cash brought in through the Rafah border crossing between Egypt and the Gaza Strip.

Table 2. West Bank and Gaza: External Budget Support 2005-06

	2005	2006				
		Q1	Q2	Q3	Q4	Year
	(In millions of U.S. dollars)					
PA government	349	130	67	3	34	234
Bilateral donors	194	88	66	3	34	191
Arab countries	194	78	66	3	34	181
Other countries	0	10	0	0	0	10
Multilateral donors 1/	155	42	1	0	0	43
Office of the President	...	0	24	235	32	291
Arab countries	...	0	8	235	32	275
Other countries	...	0	16	0	0	16
EC Interim Emergency Relief Contribution	...	24	20	6	0	49
Temporary International Mechanism 2/	...	...	...	60	112	172
Total	349	154	110	305	178	747

Sources: Ministry of Finance, Office of the President, European Commission, World Bank; and IMF staff estimates.

1/ Includes the World Bank's Emergency Services Support Program in Q1 and Q2 2006.
2/ Includes the World Bank's Emergency Services Support Program in Q3 and Q4 2006.

C. Spending

8. **As resources fell sharply after the Hamas-led government took office, expenditures had to be prioritized.** Obviously, wages were accorded a high priority. However, while wages could still be paid in full in the first quarter, the wage bill could only be partially met in the remainder of the year. Overall, and including allowances paid by the Presidency and the TIM, government employees on average received payments equivalent to some 50–55 percent of their normal incomes in 2006. These payments absorbed almost half of the available financial resources, or a little over $650 million.

9. **Operating expenditures and especially transfers were compressed in 2006.** Although a detailed breakdown is not yet available, social benefits (including pensions) paid are believed to have been limited to well under $100 million. Also, the PA government was not in a position to pay the employer and the normally withheld employee contributions to the pension fund, further weakening its already unsustainable financial position.[7] Operating expenditures had already been reduced to very low levels in preceding years, but are estimated to have been cut back further in 2006. Combined, operating expenditures and transfers absorbed a little more than one quarter of the available resources.

10. **Spending on energy and utilities continued to take up a disproportionate share of government spending.** Payments to cover the costs related to production and consumption of energy and utilities, including the subsidization of domestic petroleum products, amounted to well over $300 million, absorbing a little less than one quarter of the available resources. This total includes the amounts deducted from the clearance revenues withheld by Israel to pay the Israeli companies that provide utilities to the Palestinian territories. Those deductions increased by about 50 percent from 2005, as collection rates for utilities deteriorated further in 2006. Spending on energy would have been even higher had the Gaza power plant been fully operational throughout the year. On the other hand, the subsidization of domestic petroleum products was steadily reduced during 2006, in part due to an increase in retail prices, but also reflecting the decline in international prices in the latter part of the year.

D. The Underlying Fiscal Position

11. **Notwithstanding the exceptional financial difficulties that the PA faced in 2006, the underlying fiscal position has deteriorated further.** Particularly worrisome is that the government wage bill continued to rise in 2006. The wage bill, on a commitment basis and in local currency terms, expanded by about 17 percent in 2006 compared with 2005. To a large extent, this reflects the full-year effect of the wage increases granted to both civil servants and security personnel in 2005, but it also reflects the continued expansion of the government payroll. While government employment had

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[7] With about two thirds of its remaining assets being frozen in the US in the context of court cases, the Gaza Pension and Insurance Company (GPIC) would deplete its available assets in about one year if it does not receive payment of contributions or external assistance.

reached almost 137,000 people at the end of 2005—not counting some 13,000 security personnel in training—this continued to rise further in 2006, to almost 150,000 people—to which one should add over 14,000 security trainees and reportedly a large number of contractual workers. With the steady appreciation of the Israeli Shekel, wages due reached almost $1.2 billion in 2006 and averaged about $105 million per month at the end of the year (compared to less than $80 million per month prior to the wage increase in mid-2005). In addition, there are indications of strong pressures for a further expansion of government employment. Even with a resumption of the monthly transfer of clearance revenues by Israel and a recovery in domestic revenues to their 2005 levels, the wage bill due would now exceed government revenues. This implies that all non-wage expenditures and spending on energy and utilities would have to be covered by either domestic or external financing.

12. **Put differently, with wages, transfers, and clearance revenues on a commitment basis, the overall fiscal deficit reached almost $1 billion in 2006** (Table 4).[8] Without any corrective measures and taking into account the latest increases in government employment and additional pension contributions for security personnel as implied by the unified pension law, the deficit for current operations would increase even further in 2007, to $1.1–1.3 billion, equivalent to some 25–30 percent of GDP. If the transfers of clearance revenues would not resume, the fiscal gap would reach almost $2 billion. This would substantially exceed the levels of external support and domestic financing obtained in recent years.

13. **Strong and politically difficult measures will be needed to address the underlying problems and reduce the fiscal gap.** A new government will urgently need to reduce its wage bill, improve the collection of utility bills, fully eliminate the subsidization of petroleum products, and streamline social transfers.

14. **A strong recovery of private economic activity would greatly ease the adjustment process.** The tax base would be broadened, new job opportunities in the private sector could absorb government workers, and the need for social benefits would be reduced. A revival of private sector activity will require a major easing of restrictions on movement and access currently imposed by Israel, starting with the full implementation of the 2005 Agreement on Movement and Access. Without an economic recovery, and absent continued strong external assistance, the PA government would face a fiscal situation that would be almost impossible to manage in an orderly fashion and renewed disruptions in public service delivery could be expected.

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[8] Estimates of the MoF for expenditure arrears accumulated in 2006 range from almost $500 million to close to $900 million, with the latter including over $200 million in arrears to private sector suppliers. Expenditures on a commitment basis may be underestimated in this note due to incomplete information.

Table 3. West Bank and Gaza: Central Government Fiscal Operations (cash basis), 2004–06

	2004 1/	2005 1/	2006				
			QI	QII	QIII	QIV	Year
			(In millions of U.S. dollars)				
Revenue	954	1,232	237	77	152	104	570
Gross domestic	337	476	99	70	55	66	290
Tax revenues	191	231	74	47	38	47	206
Non-tax revenues	146	245	25	23	17	19	84
Gross monthly clearance 2/	617	757	138	7	97	38	280
Expenditure	1,355	1,638	351	125	327	220	1,023
Gross wages and allowances	870	1,001	278	49	222	107	656
Civilian	538	614	164	26	132	93	415
Security	333	387	114	23	90	15	241
Non-wage current expenditure	449	593	73	74	102	110	358
PA financed capital spending	36	44	1	2	3	3	8
Net lending	157	344	76	39	154	68	337
VAT refunds	16	12	1	5	0	0	6
Balance	-574	-762	-191	-93	-330	-184	-797
External budget support	353	349	154	110	305	178	747
Balance after budget support	-221	-413	-37	18	-25	-5	-49
Total other financing	221	413	37	-18	25	5	49
Exceptional profits and advances	…	173	41	67	61	27	196
Withheld clearance revenues	97	137	0	0	0	0	0
Net domestic bank financing	134	304	29	-89	-32	-4	-96
Residual	-9	-202	-34	5	-4	-18	-50

Sources: Ministry of Finance, Office of the President, Palestinian Investment Fund, European Commission, World Bank; and IMF staff estimates.

1/ 2004 and 2005 figures include some unpaid pension contribution commitments.
2/ In 2006, includes estimated deductions from clearance revenues for payment of utilities supplied by Israeli companies.

Table 4. West Bank and Gaza: Central Government Fiscal Operations (commitment basis), 2004–06

	2004	2005	2006				
			QI	QII	QIII	QIV	Year
	(In millions of U.S. dollars)						
Revenue	954	1,232	289	253	230	248	1,021
Gross domestic	337	476	99	70	55	66	290
Tax revenues	191	231	74	47	38	47	206
Non-tax revenues	146	245	25	23	17	19	84
Gross monthly clearance 1/	617	757	190	183	175	182	730
Expenditure	1,355	1,638	373	383	433	446	1,634
Gross wages	870	1,001	278	290	307	310	1,184
Civilian	538	614	164	169	174	174	680
Security	333	387	114	121	133	136	504
Non-wage current expenditure	449	593	94	91	123	133	441
PA financed capital spending	36	44	1	2	3	3	8
Net lending	157	344	76	39	154	68	337
VAT refunds	16	12	1	5	0	0	6
Balance	-574	-762	-160	-174	-357	-266	-957
External budget support	353	349	154	110	305	178	747
Balance after budget support	-221	-413	-6	-64	-52	-87	-210
Total other financing	221	413	6	64	52	87	210
Exceptional profits and advances	…	173	41	67	61	27	196
Withheld clearance revenues	97	137	-52	-177	-74	-144	-446
Net domestic bank financing	134	304	29	-89	-32	-4	-96
Residual	-9	-202	-12	263	97	208	556

Sources: Ministry of Finance, Office of the President, Palestinian Investment Fund, European Commission, World Bank; and IMF staff estimates.

1/ Includes estimates of clearance revenues withheld in 2006.