West Bank and Gaza

Recent Fiscal and Financial Developments

October 2006

The Palestinian government has been facing a very difficult fiscal situation since end-March 2006. During April–September, resources available to fund the government's recurrent expenditures fell sharply, as an unprecedented drop in tax revenues—largely because Israel stopped transferring indirect taxes it collects on the Palestinian Authority's behalf—was only partially offset by an increase in external support. The scarce resources that were available were used mainly for payments to government employees and to finance fuel imports. Government workers on average received payments equivalent to only about 40 percent of their normal incomes. As a result, little was left for ministries' running costs and social transfers.

I. Introduction

1. **This note focuses on fiscal developments since the Hamas-led government took office at the end of March 2006.** Following the diplomatic and financial isolation of the new Palestinian Authority (PA) government, monitoring of fiscal developments has become much more difficult. Government finances have become increasingly fragmented and public finance reforms implemented in recent years are being compromised. Government receipts and expenditures, instead of being channeled through the Ministry of Finance's (MoF) Single Treasury Account, are now received or made by various institutions, including the MoF (now only to a very limited extent), the Office of the President, directly by international donors, such as via the Temporary International Mechanism (TIM), or through other sources outside the PA, such as the Palestine Investment Fund (PIF).[1, 2] This note presents a preliminary consolidated picture of the central government recurrent budget, on a cash basis, by combining the information from these various sources, as well as some estimates of data not yet available.[3] In addition to describing recent fiscal trends, this note also provides a brief update on financial sector developments.

[1] The PIF is a public endowment fully controlled by and reporting to the President. Its Board of Directors are largely from the private sector.

[2] Any funds that may have been received in cash and that may not have entered any government accounts are difficult to track.

[3] The preliminary picture of public finances presented in this note will need to be updated once MoF reports for the third quarter of 2006 become available. Nonetheless, since much of the government's finances now by-passes the MoF, the broad picture presented here is not expected to change very much.

II. Fiscal Developments in the Second and Third Quarter of 2006

2. **Overall, the Palestinian government has been facing a very difficult fiscal situation, stemming from an unprecedented drop in available financial resources.** Last year, in the period April–September 2005, the PA received a little over $1.2 billion in budget resources, comprising tax revenues, domestic financing, and external financing (Figure 1, Table 1). By contrast, the envelope of available resources shrunk to an estimated $0.5 billion in the same period this year—a 60 percent decline. As a result, the government has been unable to meet all its commitments, in particular the wage bill. While resources fell sharply, the wage bill continued to rise. At close to $100 million per month, it is now substantially higher than in mid-2005, when the wage bill amounted to about $80 million per month. The increase reflects the generous wage increases of on average 20 percent granted in the second half of 2005, combined with a government work force that was continuing to grow.

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

In millions of U.S. dollars

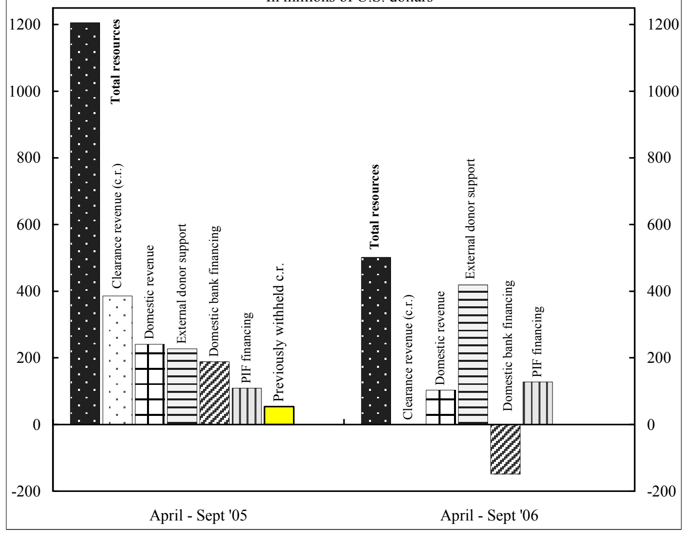

Table 1. West Bank and Gaza: Central Government Finances (cash basis) 2005-06

	2005 QII-QIII 1/	2006 QII	2006 QIII	2006 QII-QIII
	(In millions of U.S. dollars)			
Resources (net)				
Tax revenues (net)	627	59	45	104
Domestic revenues	247	59	45	104
Clearance revenues	380	0	0	0
Domestic financing	298	-22	1	-21
Banks	189	-89	-60	-149
Palestine Investment Fund	109	67	61	128
Previously withheld clearance revenues	54	0	0	0
External financing	227	102	317	419
Total	1,206	139	363	502
Expenditures				
Wages and allowances	488	49	222	271
Transfers	203	2	22	25
Operating and capital expenditures	161	28	28	56
Net lending (subsidies) 2/	178	70	66	136
Total	1,030	149	339	489

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

1/ 2005 figures include some unpaid pension contribution commitments.

2/ In 2006, mostly fuel payments. Also in 2006, does not include deductions from clearance revenues for payment of utilities supplied by Israeli companies.

A. Resources

3. **The main factor behind the fall in resources was a sharp decline in the PA's own revenues.** While the PA received some $630 million in gross revenues in the period April–September 2005, the PA was able to collect a mere $100–110 million in revenues in the last six months. To a large extent, this reflects the Israeli government's decision earlier this year to no longer transfer the indirect taxes (or so-called clearance revenues[4]) it collects on behalf of the PA. In the second and third quarter of 2005 combined, the PA received some $386 million in gross clearance revenues, as compared with nothing in the same period this year (although the Israeli government is estimated to have collected some $360 million). At the same time, the PA's domestic revenues have been declining steadily, from an average of $33 million per month in the first quarter of 2006, to just over $20 million per month in the second quarter and even less in the third quarter, mainly reflecting the decline in economic activity.[5]

4. **A significant increase in external support partially offset the decline in revenues.** Donor financing to support the central government's recurrent budget operations reached some $420 million in the period April–September (Table 2). This was significantly higher than the $230 million in external support received in the same period last year and even higher than the $350 million received in the whole of 2005. The bulk of the external support came from Arab donors, who, in the last six months, provided about $300 million, or an average of $50 million per month. Of the non-Arab donors, the European Union (EU) was the largest contributor, providing about $90 million in assistance.

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

	2005	2006			
		Q1	Q2	Q3	Year-to-date
	(In millions of U.S. dollars)				
PA government	349	130	67	0	197
Bilateral donors	194	88	66	0	154
Arab countries	194	78	66	0	144
Other countries	0	10	0	0	10
Multilateral donors 1/	155	42	1	0	43
Office of the President	...	0	16	246	262
Arab countries	...	0	0	246	246
Other countries	...	0	16	0	16
EC Interim Emergency Relief Contribution	...	24	20	6	49
Temporary International Mechanism	...	...	...	65	65
Total	349	154	102	317	573

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

1/ In 2005 and Q1 2006, includes the World Bank administered Emergency Services Support Program and Reform Trust Fund.

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[4] These include customs duties, VAT on imports, and excises on petroleum products.

[5] The decline in revenues, to a much lesser extent, also has started to reflect taxpayers refusing to pay taxes as they themselves do not receive payment for goods and services they provided to the government. More recently, the strike of a majority of government workers has brought revenue collection further down.

5. **Much of the support received by-passed the PA government.** As the Hamas-led government's platform fell short of the conditions set by the Middle East Quartet—representing the UN, the US, the EU, and Russia—major donors stopped providing budget support directly to the PA government. Donors still willing to finance the PA government directly were faced with the obstacle that banks were no longer willing to channel support to the PA government, for fear of possible repercussions under anti-terror legislation abroad. Consequently, direct budget support virtually came to a halt. Donors did find alternative ways to provide assistance, however, mainly via the Office of the President and through the TIM.

6. **Arab donors channeled their support largely through the Office of the President.** Earlier this year, the Presidency had opened its own bank accounts, with the consent of the MoF as required by the law governing public finances. Arab donors transferred $246 million to the account of the Office of the President in the third quarter; some of these funds had initially been accumulating in Arab League accounts in Egypt, pending commercial banks' cooperation to transfer them. Some smaller amounts, totaling $16 million, were also received by the Office of the President from a few European countries.

7. **The TIM, which provides direct support of the Palestinian people, became operational toward the end of June 2006.** In May, the Quartet had expressed its willingness to endorse a temporary mechanism, limited in scope and duration, to ensure the direct delivery of assistance to the Palestinian people. The European Commission (EC) took the lead in developing a proposal for the TIM, in close consultation with other donors and international financial institutions. The proposal was endorsed by the Quartet in June (see Box I for more details on the TIM). In the third quarter of 2006, the TIM disbursed an estimated $65 million, with all funds coming directly from the EC budget. Prior to the establishment of the TIM, the EC disbursed some $26 million in assistance in the second and third quarter of 2006, by paying directly for the delivery of fuel to the Palestinian territories through its Interim Relief Financing Facility (now covered under the TIM). The World Bank signed an agreement with the Office of the President in September to administer the Emergency Services Support Program (ESSP), a grant program funded by donors to support the delivery of basic public services under the TIM. No payments were yet made under this program in the period covered by this note.

Box I. Temporary International Mechanism

The Temporary International Mechanism (TIM) is a mechanism to channel assistance directly to the Palestinian people, by-passing the Hamas-led government. It aims to relieve the current socio-economic crisis in West Bank and Gaza and to help ensure the continued delivery of essential public services. The TIM consists of three windows:

- Window I covers nonwage running costs of ministries to sustain essential health, education, and social services delivery, through the World Bank's Emergency Services Support Program (ESSP), a multi-donor trust fund;

- Window II aims to support the uninterrupted supply of utilities, including fuel for generators, through the European Commission's (EC) Interim Emergency Relief Contribution;

- Window III provides allowances to health care workers, and to the poorest part of the population, including low-income government workers and retirees, and social hardship cases.

The World Bank manages Window I, while the EC manages Windows II and III. The Office of the President acts as an interlocutor (and is the formal beneficiary) to the TIM, and will make payments under Window I, but payments by the TIM under Windows II and III are made directly to eligible beneficiaries and suppliers. In a majority of cases, beneficiaries receive payments directly to their private bank accounts. Eligible beneficiaries that do not have a bank account are paid through the network of branches of Palestinian banks against proper identification. Monitoring mechanisms have been established to ensure that payments are made as intended.

So far, some $244 million has been pledged to the TIM. The EC had initially allocated $113 million (€90 million) to the TIM, with an additional contribution of $21 million (€16.5 million) in the pipeline. Other European donors have, to date, pledged $110 million to the various TIM windows.

About $65 million was paid out by the TIM in the third quarter of 2006, all funds were from the EC contribution. This included $20 million under Window II in fuel deliveries and other utility payments, and some $45 million in allowances. Close to 12,000 health care workers received three allowances of on average NIS 2,000 (about $455), while almost 50,000 low-income government workers and retirees and 36,000 social hardship cases received one allowance of NIS 1,500 (about $340).

8. **While the PIF continued to be a substantial source of financing, the banking sector became a drain on the government's finances.** Under the instructions of the Office of the President, about $130 million in payments were made directly by the PIF during April–September, thus further depleting its assets. These payments served mainly to help cover fuel bills and to meet debt service obligations due to commercial banks. Banks, meanwhile, significantly reduced their exposure to the PA government, mainly for fear of possible legal repercussions abroad if seen as financing the PA government. Credit lines were reduced, to some extent by offsetting against banks' own tax liabilities and by withholding tax revenues accruing in the MoF's bank accounts, and loans falling due were not rolled over. Although September data are not yet available, bank loans to the government are estimated to have been reduced by some $150 million in the last six months. Outstanding PA debts to commercial banks (including banks abroad) are now estimated at about $500 million, down from its peak of $695 million in February this year.

B. Spending

9. **With limited financial resources, fiscal policy has been reduced to carefully selecting which payments to make when funds become available.** Within the current environment, preparing a budget for 2006 had become a meaningless and impossible exercise. The Palestinian Legislative Council had extended the deadline for the submission of a 2006 budget until September 1, but this deadline has not been met. Therefore, the PA government continues to operate under the legal authorization to make monthly expenditures of up to one-twelfth of 2005 expenditures.[6]

10. **The Office of the President has been coordinating closely with MoF staff and other ministries on how to allocate available funds.** The Office of the President is relatively small and lacks the expertise and capacity to fully take over the functions usually performed by the MoF. Therefore, coordination between the Presidency and the MoF remains necessary and also desirable, to avoid creating duplicating systems. Regular meetings take place between officials from the Office of the President and technical counterparts from the MoF, as well as from other ministries, to ensure proper prioritization, oversight, and implementation. The Presidency, however, now bears formal responsibility for many of the overall government's receipts and expenditures. This puts pressure on its small number of staff, which at times contributes to delays in execution.

11. **About 80 percent of the $0.5 billion in the resources that were available during April–September 2006 were used for two main purposes: payments to government employees and payments to cover the cost of fuel imports.** Combined, these two categories absorbed a little over $400 million, with payments to employees accounting for the bulk of this.[7]

12. **Payments to government employees, in one form or another, have picked up in recent months, because of the support received via the Office of the President and from the TIM.** Nevertheless, on average, workers have received payments equivalent only to about 40 percent of their normal incomes. Payments to employees in the period April–September (with a small overflow into the first days of October) amounted to some $270 million, compared with almost $600 million in wages due during this period.[8] Payments included a payment by the MoF in June, three payments from the accounts of the Presidency, and the payment of three allowances by the TIM to health care workers plus one to low-income civil

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[6] The MoF sent out a budget circular for the preparation of the 2007 budget to ministries in August, but given the continuing uncertainties about future resource flows, this remains an almost impossible exercise.

[7] In this presentation, principal repayments to banks are treated as a (negative) financing item, reducing the envelope of available resources. But if debt service payments (principal and interest payments combined) instead would be treated as an expenditure, this would be the second largest spending category, with an estimated $160-170 million in debt service payments.

[8] These amounts do not include payments to security trainees, whose number had risen further to over 17,000 by end-June 2006, nor do they include retirees.

servants.[9] All of these payments were equivalent only to a fraction of the normal wage entitlements, except for the lowest-paid workers who received the equivalent of their full pay. Thus, behind the average payment, there were large differences between the various categories of employees, with the lowest-paid civil servants receiving the equivalent of five months of their normal incomes, while higher-paid employees received a much smaller fraction of their normal incomes. See Box II for more details on these payments.

Box II. Payments to Government Employees

PA employees did not receive any payment for more than two months following the formation of the new Hamas-led government, because of the lack of resources.

Only in late-May/early-June, once some domestic revenues had accumulated and combined with external donations brought in cash into Gaza, could a first round of payments be made by the government. With slightly less than $50 million available, the government gave priority to paying low-paid employees. Full salaries were paid to employees earning up to NIS 1,500 ($330), and a flat allowance of NIS 1,500 was paid to all other employees. These payments were made in cash through the post offices, because of the unwillingness of banks to channel the transfers. After the Office of the President could receive funds from Arab donors, it started making another round of payments in late July through the banks. A different formula was used, with employees earning up to NIS 1,400 being paid full salary, those earning between NIS 1,400 and NIS 2,800 getting NIS 1,400, and those earning more than NIS 2,800 receiving half their salary. The Office of the President made two other payments, in August and September, of a flat NIS 1,500 allowance to all employees, again through the banking system.

A large number of civil servants also received payments of allowances through the TIM. Priority was given to health sector employees, who received three payments during July–September. Each time, a minimum of NIS 1,400 was paid to all healthcare workers, and those earning more than NIS 1,400 received, in addition, half of the difference between NIS 1,400 and their salary level. Other civil servants with a basic salary of up to NIS 2,000 received one flat allowance of NIS 1,500 in late August–early September.

13. **The need to ensure the continued availability of energy also consumed a large share of available resources.** Some $136 million was spent on energy bills—most for oil imports—during the last six months by the PIF, the EC, and the TIM. The payments made by the PIF, besides covering the PA's own use of petroleum products, also covered a domestic subsidy on petroleum products, as prices charged at gas stations in WBG remained below import prices.[10] The Israeli supplier threatened to interrupt deliveries at times in the past several months, as payment arrears accumulated, and fuel crises could only be avoided by contributions from the dwindling PIF funds to the Office of the President, which were made available by the Presidency for these payments. Payments by the EC were initially covering

[9] In addition, the TIM paid similar allowances to retirees and social hardship cases (see Box I).

[10] Selling prices of main products, such as regular gasoline and diesel, were some 8–10 percent below import prices during the period under review.

fuel deliveries to the Gaza power plant, but following the damage done to the latter in an Israeli air raid in late June, this shifted to fuel for electricity generators for hospitals, water pumps, and water treatment plants. Meanwhile, payments of utility bills by consumers appear to have declined further, requiring the government to pick up indirectly an even larger share of the cost of energy use. Although the Israeli government has stopped transferring the clearance revenues, it continued to deduct amounts for the utilities (electricity, water) that Israeli companies still supply to the Palestinian territories. Adding estimates for these deductions to the cash outlays for petroleum products would bring the total cost for the use of energy and other utilities borne by the government to about $240 million during April–September, well above the amount for the same period last year of $178 million.

14. **After paying wages and energy bills, very little was left over for other operating expenditures and social transfers.** Only an estimated $56 million was spent on operating expenditures during April–September, including $15 million in interest payments to commercial banks. As a result of the liquidity squeeze, line ministries have hardly received funds to cover their nonwage expenditures. In the absence of transfers from the MoF, ministries are likely to have accumulated sizable arrears.[11] Social transfers amounted to a mere $25 million. Of this, the MoF and the Office of the President provided some $11 million to social hardship cases and the unemployed, while $14 million was paid to social hardship cases and government retirees under the TIM.

C. Looking ahead

15. **Underlying the current financial difficulties is an increasingly unsustainable fiscal position**. The government wage bill had already become unaffordable at the end of 2005, following the sizable wage increases granted that year and the continuing expansion of government employment (see Table 3 for the government wage bill on a commitment basis). The government payroll has risen further in 2006, by another 5,400 employees to over 142,000 by end-June, with the increase concentrated in the security forces. In addition, close to 20,000 new security recruits are in training and may eventually be added to the payroll as well. Government payments to cover the cost of the production and consumption of fuel and utilities also continue to rise, reflecting the increasing nonpayment of bills by consumers and the subsidization of petroleum products. Furthermore, pension contributions and allowances have gone up with the implementation of the Unified Pension Law in 2005, and the number of potential beneficiaries of various social programs has increased. At the same time, the government's revenue base has been declining with the faltering economy, due to the fiscal crisis combined with the intensified restrictions on the movement and access of goods and people imposed by Israel.[12] Wage arrears accumulated over the past several months will need to be cleared; nonwage arrears should be inventoried and audited before any are settled. Even if

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[11] No reliable data on arrears are available.

[12] Clearance revenues are estimated to have fallen by almost 20 percent between the last quarter of 2005 and the third quarter of 2006.

the political situation were to improve substantially, strong and politically difficult measures would be needed to put the government finances on a sustainable path. In particular, the PA government will need to find ways to reduce its wage bill, improve the collection of utility fees, streamline social transfers, and reform a generous (but unaffordable) pension system. The significant efforts needed to achieve fiscal sustainability would however be undermined in the absence of continued external assistance and a revival in economic activity.

III. Financial Sector Developments

16. **The banking sector in WBG remains relatively sound, despite the depressed economy.** Private sector deposits continue to grow, albeit slowly, and banks are liquid. While banks have a sizable exposure to the PA and to its employees, the situation looks manageable, at least for the near future. Assets of the PIF guarantee most bank loans to the PA, and PA employees' debt service obligations currently due are small. Some banks recently deducted small amounts from the latest partial wage payment to government employees to help cover interest due. Banks did not suffer much from the decline in the stock market—which has fallen by about 50 percent since mid-January 2006—as their exposure was fairly limited and book values of equity investments had not reflected the substantial gains that had been made prior to the drop in share prices.

17. **Israeli banks have not acted on their threat issued earlier this year to sever their relations with banks in WBG.** Two major Israeli banks had announced that they would stop facilitating transfers, check-clearing, and trade financing between the two sides, allegedly for fear of litigation under anti-terror legislation. The Palestine Monetary Authority (PMA) is working closely with the Bank of Israel (BoI) to ensure continued relations between Israeli banks and those in WBG. Measures under discussion appear to focus mostly on strengthening the AML/CFT framework.

Table 3. Central Government Fiscal Operations, 2004–06

	2004	2005					2006	
	Prel.	QI	QII	QIII	QIV	Year	QI	QII
	(In millions of U.S. dollars, unless otherwise stated)							
Revenue	954	254	342	291	346	1,232	289	247
Gross domestic	337	86	152	95	142	476	99	64
Tax revenues	191	53	65	67	46	231	74	42
Nontax revenues	146	33	87	28	96	245	25	22
Gross monthly clearance 1/	617	167	190	196	203	757	190	183
Expenditure	1,355	320	407	445	466	1,638	371	375
Gross wages	870	236	235	253	278	1,001	278	290
Civilian	538	148	149	153	165	614	164	169
Security	333	88	86	100	113	387	114	121
Nonwage current expenditure	449	81	155	177	180	593	92	84
of which operating	193	36	72	57	53	218	20	26
of which transfers (incl pensions)	257	45	83	120	127	375	72	57
PA financed capital spending	36	3	17	16	8	44	1	2
Net lending 1/ 2/	157	59	93	85	107	344	76	77
VAT refunds	16	1	1	5	4	12	0	5
Balance	-574	-127	-160	-244	-232	-762	-158	-210
External budget support	353	71	174	54	51	349	154	102
Balance after budget support	-221	-56	14	-190	-181	-413	-4	-107
Total other financing	221	56	-14	190	181	413	4	107
Exceptional profits and advances 3/	0	0	0	109	64	173	41	67
Gross withheld clearance revenues 4/	97	10	43	11	73	137	-52	-177
Net domestic bank financing	134	74	105	84	41	304	-21	-89
Residual 5/	-9	-28	-162	-14	3	-202	36	306
Memorandum items								
Wages								
in percent of revenue	91.2	92.8	68.8	86.8	80.3	81.2	96.0	117.1
in percent of expenditure and net lending	57.5	62.2	47.1	47.7	48.4	50.5	62.1	64.1
Exchange rate NIS/$ (period average)	4.48	4.36	4.41	4.54	4.65	4.49	4.67	4.43
Government employment (end of period)	133,106	134,984	135,811	135,226	136,772	136,772	138,110	142,187
of which civilian	76,039	77,917	78,744	78,159	79,705	79,705	81,043	81,136
of which security	57,067	57,067	57,067	57,067	57,067	57,067	57,067	61,051

Sources: Ministry of Finance and IMF estimates.

1/ Includes payments deducted from clearance revenues for dues owed to the Israeli utility companies.

2/ Transfers to electricity generation and distribution sectors; to the General Petroleum Corporation; and to cover unpaid utility bills by consumers.

3/ Advances from the Palestine Investment Fund.

4/ Includes equalization tax transferred by the Government of Israel to the PA, earmarked for employment programs.

5/ Includes repayment of arrears and accumulation of wage and pension contribution arrears; no reliable data are available on the accumulation of other arrears.