West Bank and Gaza: Fiscal Developments in 2006

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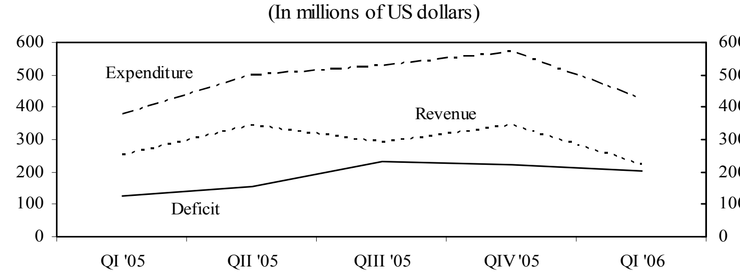
During the first quarter of 2006, the fiscal position of the Palestinian Authority (PA) was shored up by a relatively generous level of donor support, which somewhat compensated for the suspended payments of indirect taxes collected by the Government of Israel (GoI) on behalf of the PA—in response to the victory of Hamas in the January legislative elections. The situation deteriorated quickly following the transfer of powers to the Hamas government at end-March 2006. Not only did key donors withdraw their support to the PA, but domestic banks reduced unsecured overdrafts and refused to operate the PA's Single Treasury Account. As a result, government wages were not paid and other expenditures were dramatically compressed. At the end of 2005, the deficit for 2006 was projected at about US$1 billion; however, no clear deficit projection now emerges from the currently complicated fiscal situation.

I. First Quarter Developments

A. Overview

1. **By the end of 2005, the PA's fiscal situation had already become unsustainable due to the full year effect of the mid-2005 wage increases, larger social transfers and pension contributions, and the high costs of energy consumption (Figure 1).** With unchanged policies, the fiscal deficit for 2006 was projected, at end-2005, at close to US$1 billion—almost three times the annual amount secured in external budget support in 2004 and 2005. This would likely have resulted in considerable arrears accumulation. Projected gains in revenue would have been more than offset by higher expenditures.[1]

Figure 1. Fiscal Position, 2005-06
(In millions of US dollars)



2. **Following the victory of Hamas in the legislative elections of January 2006 and its formation of a cabinet at end-March, key donor countries reevaluated their support of the PA.** After the elections, the Quartet—representing the UN, the US, the EU, and Russia—stated that a new government must recognize Israel, renounce violence, and accept all previous agreements between Palestinians and Israel. At the same time, the Quartet urged support for the caretaker government. The government program presented along with the new cabinet in late March fell short of the Quartet conditions. Consequently, lead donors decided not to provide the PA with budgetary assistance and started exploring alternative

[1] The full year effect of the wage increase was estimated, at end-2005, at about $170 million.

ways to provide humanitarian and project assistance that would bypass the Hamas-led PA (see section II).

3. **The GoI considered Hamas to be effectively in control of the Palestinian government with the inauguration of the new legislature in mid-February.** In response, it stopped the transfer of indirect tax revenues (so-called clearance revenues) it collects on behalf of the PA, thereby depriving the PA of one month of clearance revenue during January–March 2006. The impact of the Israeli decision was large, since clearance revenues amount to almost two-thirds of the PA's budget revenues and had, on a gross basis, averaged some $65 million per month in 2005.

4. **Donors, however, increased their financial support to the caretaker government.** OECD donors disbursed $76 million in the first quarter, including $42 million from the World Bank-administered Reform Trust Fund. Arab League countries increased their support to $78 million in the first quarter, up from $46 million in the last quarter of 2005. As a result, the total envelope of revenues and external budget support available to the PA in the first quarter of 2006 was only slightly lower than in the last quarter of 2005.

5. **Despite this still relatively strong resource envelope, the PA was already forced to compress non-wage expenditures, since access to domestic financing sources became increasingly problematic.** Domestic banks also began to reevaluate their relationship with the PA, initially largely out of concern over the PA's financial viability, but increasingly also out of fear over possible legal repercussion under foreign anti-terror laws. Banks required the caretaker government of the PA to reduce unsecured overdrafts. Adding to this was the repayment of $50 million of unused project financing to the US[2], which had, in effect, functioned as collateral for earlier bank financing. Thus, from a source of finance, the domestic banking system became a drain on the budget. Furthermore, resources from the Palestine Investment Fund (PIF) were becoming scarcer following the large advances and dividends received from the PIF in 2005.[3] In the face of a tighter financing constraint, the PA assigned priority to wages and utility expenditures, at the expense of operating expenditures and transfers. Average monthly non-wage expenditures were cut in half compared to the second half of 2005.

6. **Overall, the PA's average monthly fiscal deficit was lower in the first quarter of 2006 than in the second half of 2005, but higher than the monthly average of $61 million for 2005 as a whole (Table 1).** The deficit would have been higher in early 2006, however, if net lending and operating expenditures had been fully accounted for on a commitment basis. While the wage bill and pension contributions are recorded on a commitment basis, payments to suppliers, some transfers, and net lending expenditures are recorded on a cash basis. Data on new arrears are not available.

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[2] Previously lent to the PA by USAID for infrastructure development.

[3] Additional PIF resources were used to repay a large part of the US funds.

Table 1. Central Government Fiscal Operations
Monthly averages 2005–2006

	2005 July–Dec.	2006 Jan.–March	2006 April
	(In millions of U.S. dollars)		
Net revenue 1/	105	79	16
Expenditure, *of which:*	152	124	116
Wages	88	93	95
Operations	18	7	5
Transfers	41	24	16
Net lending	32	23	4
Balance	-79	-68	-104
External budget support	17	51	41
Total other financing, *of which:*	62	16	63
Net domestic bank financing	21	-7	-30
Exceptional profits and advances	29	25	0
Other, including arrears 2/	12	-2	93

Source: Ministry of Finance, and IMF estimates.
1/ Net of deductions for VAT refunds.
2/ In 2005, includes a monthly average of US$14 million in clearance revenue previously withheld by the Government of Israel.

7. **The deficit was financed mostly by external budget support and some advances, including from the PIF.** Three-quarters of the recorded budget deficit were covered by external grants, which totaled $154 million in the first quarter, with about half, as noted, provided by Arab League countries and the other half by OECD countries (Table 2). This compares with only $52 million per quarter of external budget support during the second half of 2005. Advances from the PIF and the local telecommunications company Paltel reportedly totaled $76 million, while on balance $21 million in loans were repaid to banks. The latter was the balance between some additional bank financing obtained in the first two months and large repayments in March.

Table 2. External Budget Support, 2004–06

	2004	2005	2006 Jan.–March
	(In millions of U.S. dollars)		
Total Budget support	353	349	154
Multilateral assistance	333	349	144
Arab league, *of which:*	98	194	78
Saudi Arabia	77	31	57
Kuwait	0	40	0
Oman	0	1	7
Qatar	0	11	14
Libya	14	0	0
Egypt	3	1	0
Algeria	0	104	0
Tunisia	2	0	0
Other Arab	2	7	0
European Union 1/	50	0	24
World Bank (ESSP)	67	23	0
World Bank Reform Trust Fund	118	132	42
Bilateral assstance	20	0	10

Source: IMF staff, and Ministry of Finance.
1/In March 2006, includes about EUR 20 million for the purchase of fuel for the production of electricity.

B. Revenues

8. **Despite still relatively strong domestic tax collections in the first quarter, budgetary revenues suffered significantly from a lack of dividends from the PIF and the withholding of clearance revenues by Israel since mid-February.** Total revenues fell by over 30 percent in U.S. dollar terms compared to the last quarter of 2005. Overall, domestic revenues (tax and non-tax) averaged $33 million per month during the first quarter of 2006. The interruption in clearance revenue transfers deprived the PA Treasury of one full month of these revenues in the first quarter, which had averaged over $60 million during January–February 2006. In addition, the PIF was not in a position to disburse dividends, in contrast to 2005, as PIF profits were not yet assessed.[4] Yet, the performance of domestic tax revenues was stronger relative to end-2005, owing to large prepayments of estimated income tax liabilities by key large enterprises, as well as the impact of the mid-year salary increases for PA employees on their income tax liabilities.[5]

C. Government Wage Bill and Employment

9. **The wage bill has remained at its end-2005 level in the first quarter of 2006 even though the number of government employees seems to have increased further.** The

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[4] In 2005, the PA received $10 million in PIF dividends in the first quarter and $60 million in the final quarter.

[5] The income tax on the salaries of PA employees is withheld at source.

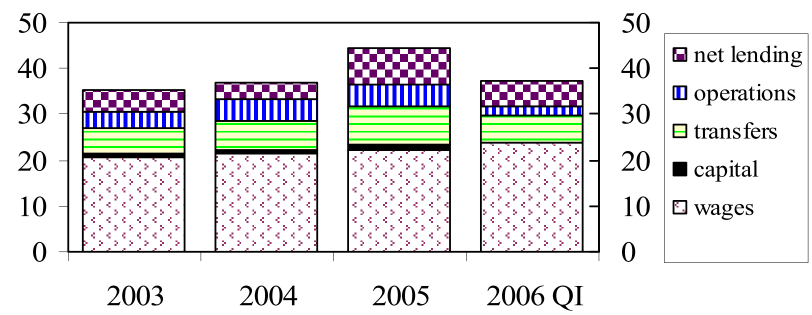
number of PA civil servants was reported to have increased by 1,338 persons between end-December 2005 and end-March 2006, while there was apparently no net increase in security personnel—not counting security trainees who are not included in the payroll but whose numbers continued to rise sharply.[6] This rise in employment reflects mostly the recruitment of new teachers, hired in September 2005 and confirmed in early January 2006. The PA wage bill was 26 percent higher, in local currency, than in the first quarter of 2005, following the mid-year salary increases granted to both civilians and security personnel.[7]

10. **Since March 2006, due to the shortfalls of budgetary revenue and financing resources, the wage bill dramatically exceeded revenue and could not be paid.** Without the transfer of clearance revenues and PIF dividends to the PA, the wage bill was almost three times total revenues in March. But even with the receipt of clearance revenues, the wage bill would now broadly equal revenues, underscoring the importance of measures to reduce the wage bill after the situation normalizes. The last actual full payment of the wage bill was in mid-March, shortly before the new cabinet was sworn in, aided by the large external budget support disbursed that month.[8]

D. Non-wage Expenditures

11. **The PA responded to the growing financial crisis by compressing operating, capital, and transfer expenditures (Figure 2).** Total non-wage expenditures were cut by half, from a monthly average of $60 million in the last quarter of 2005 to $31 million in the first quarter of 2006. Interest payments on PA debt, at $3.5 million per month for January–March 2006, accounted for an increasing share in operating expenditures from about 20 to 50 percent between these two quarters. Spending agencies that suffered a proportionally smaller cut in operating expenditures were the President's office, the Ministry of Interior, and social ministries.

Figure 2. Composition of Expenditures
(Percent of GDP)



12. **Social safety net programs bore the brunt of the financial squeeze faced by the PA in early 2006.** Total transfers were cut by almost half. Transfers for the temporary

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[6] There were 13,966 security trainees at end-2005; 20,839 trainees at end-January; and 20,793 trainees at end-March 2006. Payments for security trainees are recorded as transfers.

[7] The increases in civilian and security wage bills from the first quarter of 2005, in NIS, were 19 percent and 39 percent, respectively.

[8] Wages are reported by the PA and here on a commitment basis.

unemployment program (which averaged about $8 million per month in late 2005), along with those from the Financial Reserve and for the families of detainees were reduced the most.[9] Partial data indicate that social safety net transfers amounted to at least $9 million in the first quarter. Transfers to the ministry of interior, which include amounts for training security recruits, averaged about $5 million per month in January-March 2006.[10]

E. Net lending

13. **During the first quarter of 2006, net lending expenditures[11] were lower than in late-2005.** The shortfalls in resources forced the PA to delay paying suppliers of energy products and utilities. It is therefore likely that pending bills were accumulating without being reflected in net lending accounts.[12] Some payments have not been recorded by the PA, but have been added in this note.[13] These include an amount of about $24 million paid out in March by the EU for the delivery of fuel to the Gaza Electricity Generation Company and an estimated $11 million in payments to Israeli utility suppliers out of clearance revenues (the average monthly deduction in 2005), as Israeli companies continued to provide water and electricity to WBG. With these additions, net lending in the first quarter reached $68 million—less than two-thirds the amount paid out in the last quarter of 2005.

II. Developments since April 2006[14]

14. **Following the formation of the Hamas-led government on March 29, 2006, the resource flow to the PA all but dried up.** In addition, the PA virtually lost access to banking services, making it very difficult to make payments or receive assistance. Fearing possible anti-terror litigation abroad, no bank appeared willing to lend to the PA or to hold its treasury account. Hence, new budgetary support—mostly from Arab League countries—intended for the PA failed to reach it until very recently, accumulating instead in bank accounts in Egypt. Relying only on domestic tax revenues and cash carried through the Egyptian border with Gaza, the PA's fiscal policy was reduced to carefully selecting which expenditures to pay when scarce resources became available. Under these circumstances,

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[9] Transfers, as presented in the attached fiscal table, include PA pension contributions, which are recorded on a commitment basis but are not paid. The amount of transfers effectively paid is therefore much smaller.

[10] Monthly transfers to the ministry of interior increased sharply in August 2005, reportedly due to the implementation of the security trainee program and, following the Law on Security Services, due to the PA obligation to pay the employer contribution for the pension plan for security services.

[11] Mainly, fuel oil expenses paid by the PA to the Gaza Electricity Generation Company, loans to the municipalities for the delivery of water services, electricity and water bills unpaid by households but owed to the Israeli companies, and price subsidies for petroleum products. Additional details are provided in "Macroeconomic Developments and Outlook in the West Bank and Gaza—Ad Hoc Liaison Committee Meeting", London, December 14, 2005 (available at IMF.org).

[12] Net lending is recorded on a cash basis.

[13] Based on information from senior officials or on estimates based on past history.

[14] The data provided since April must be viewed with caution since the ministry of finance focused more on finding resources and prioritizing spending rather than reporting on its operations. Furthermore, banks no longer provided written reports of their transactions.

preparing a budget for 2006 had become a meaningless exercise. The Palestinian Legislative Council (PLC) extended until September 2006 the rule for monthly executing one-twelfth of the expenditure of the 2005 budget.

15. **In April, the deficit widened as a result of depressed domestic revenue collections adding to the loss of clearance revenues and lower nontax revenue.**[15] Total domestic revenues in April were estimated at about $20 million.[16] In these circumstances, nonwage spending was further compressed by virtually eliminating social transfers and keeping operating expenditures to a minimum.[17] Overdue bills for petroleum products delivered to the PA had accumulated to such an extent that the supplier, the Israeli company DOR, threatened to interrupt the service. A fuel crisis was narrowly avoided owing to both payments out of PIF assets to cover the price difference on oil products between Israel and the West Bank and Gaza, and to the EU transferring an additional $6 million for the purchase of fuel for electricity production in April (followed by an additional $7 million in May). External budget support of $41 million, which had been secured by the caretaker cabinet, was mostly used to further reduce PA debt to banks.[18] According to data from the Palestinian Monetary Authority (PMA), gross PA debt to banks was reduced from close to $614 million at end-February to an estimated $480 million at end-May.

16. **In this dire context, PA employees have not received their full salaries since mid-March.** This has left between one-fourth and one third of the Palestinian population without their main source of income. The PA was just able to complete before mid-July one single payment of about $300 to each employee, made in several tranches starting with the lowest paid employees. To that effect, the PA used part of its domestic revenue, as well as cash donations from abroad brought into Gaza through the border crossing with Egypt. The withholding of clearance revenue and the halting of external budget support has resulted in removing the equivalent of $85 million per month of liquidity from the Palestinian economy (about $1 billion on an annual basis), with deep and widespread consequences for the entire Palestinian economy.

17. **In July, financial support from Arab countries reached the account of the President's office, allowing another partial wage payment.** The Arab League and Kuwait managed to transfer, respectively, $91 million and about $45 million to the account of the presidency. The President's office was then able to cover some of the overdue wage bill, paying a full month's salary to PA employees earning less than NIS 1,400 (around $300) monthly, while all others received half their salary. The funds to the President's office will

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[15] This figure is mostly on a commitment basis, due to the overwhelming weight of the wage bill in total expenditure.

[16] It is unclear whether or not this amount includes income tax liabilities of banks which they are offsetting against debt service obligations due to them by the PA.

[17] In April, debt service, at about $2.8 million, was 62 percent of operating expenditures, and operating expenditures of the ministry of interior increased from $1.2 million to $1.5 million between March and April 2006, equivalent to an increase from 11 percent to 34 percent of operating expenditures.

[18] Of the total support, $35 million was received from Algeria and $6 million from the EU.

also be in part allocated to the Presidential guard and current expenses of the President's office.

18. **In June, the Quartet endorsed a Temporary International Mechanism (TIM) to channel aid directly to Palestinians, bypassing the Hamas-led government.** The arrangement, proposed by the European Commission (EC), is limited in scope and duration. It consists of three windows, of which the first two—envisaged to each provide some $6 million a month—are existing facilities managed by the World Bank and the EU. The World Bank facility will cover essential operating costs of the social sectors, and the EU facility will cover the cost of fuel oil for hospital generators, water pumps and water treatment plants in Gaza.[19] The third window would fund allowances for health care workers and for a needs-based social safety net. It is currently envisaged to disburse up to $25 to $30 million monthly. The EC started paying allowances to health care workers in late July. Payments are made directly into workers' bank accounts. The payment of social allowances has yet to start because of the difficulty in identifying beneficiaries.

19. **In the current political context, key public finance reforms implemented in recent years are now critically compromised and monitoring recent fiscal developments is becoming extremely difficult.** The Single Treasury Account is not operational, due to the refusal by key domestic banks to handle the PA's accounts and to communicate formally with the Ministry of Finance. Consequently, combined with the preference by some key donors to bypass the PA, there is an increasing amount of expenditure being executed outside normal channels, including through the PIF; the account of the President; direct payments made by donors; and cash brought into WBG and not deposited in PA accounts. Furthermore, clearance revenues collected on behalf of the PA, but withheld by the GoI, and direct payments from these clearance revenues to Israeli utility suppliers are no longer reported to the PA. In addition, the intensified restrictions of passage between the West Bank and Gaza have weakened interaction between PA employees of each area and, thus, the centralization of recording between the two territories. For all these reasons, a comprehensive assessment of PA expenditures and revenues is becoming very difficult.

[19] Following the destruction of the Gaza power plant.

Table 3. Central Government Fiscal Operations, 2004–06

	2004	2005					2006		
	Prel.	QI	QII	QIII	QIV	Year	QI		
							Total	Average	April
	(In millions of U.S. dollars, unless otherwise stated)								
Revenue	954	254	342	291	346	1,232	236	79	20
Gross domestic	337	86	152	95	142	476	99	33	20
Tax revenues	191	53	65	67	46	231	74	25	13
Non-tax revenues	146	33	87	28	96	245	25	8	7
Gross monthly clearance 1/	617	167	190	196	203	757	137	46	0
Expenditure	1,355	320	407	445	466	1,638	371	124	116
Gross wages	870	236	235	253	278	1,001	278	93	95
Civilian	538	148	149	153	165	614	164	55	56
Security	333	88	86	100	113	387	114	38	39
Non-wage current expenditure	449	81	155	177	180	593	92	31	21
of which operating	193	36	72	57	53	218	21	7	5
of which transfers (incl pensions)	257	45	83	120	127	375	71	24	16
PA financed capital spending	36	3	17	16	8	44	1	0	0
Net lending 2/	157	59	93	85	107	344	68	23	4
VAT refunds	16	1	1	5	4	12	0	0	4
Balance	-574	-127	-160	-244	-232	-762	-203	-68	-104
External budget support 3/	353	71	174	54	51	349	154	51	41
Balance after budget support	-221	-56	14	-190	-181	-413	-49	-16	-63
Total other financing	221	56	-14	190	181	413	49	16	63
Exceptional profits and advances 4/	…	0	0	109	64	173	76	25	0
Gross withheld clearance revenues 5/	97	10	43	11	73	137	0	0	0
Net domestic bank financing	134	74	105	84	41	304	-21	-7	-30
Residual 6/	-9	-28	-162	-14	3	-202	-6	-2	93
	(In percent of GDP)								
Gross revenue	23.4	5.7	7.6	6.5	7.7	27.5	…	…	…
Expenditure 7/	33.2	7.1	9.1	9.9	10.4	36.6	…	…	…
wages	21.3	5.3	5.3	5.6	6.2	22.4	…	…	…
nonwages	11.0	1.8	3.5	3.9	4.0	13.2	…	…	…
Net lending and VAT refunds	4.2	1.4	2.1	2.0	2.5	8.0	…	…	…
Deficit before grants	-14.1	-2.8	-3.6	-5.4	-5.2	-17.0	…	…	…
Deficit after grants	-5.4	-1.2	0.3	-4.2	-4.0	-9.2	…	…	…
Memorandum items									
Wages									
in percent of revenue	91.2	92.8	68.8	86.8	80.3	81.2	117.8	117.8	484.6
in percent of expenditure and net lending	57.5	62.2	47.1	47.7	48.4	50.5	63.3	63.3	79.2
Exchange rate NIS/$ (period average)	4.48	4.36	4.41	4.54	4.65	4.49	4.67	4.67	4.58
Government employment (end of period)	133,106	134,984	135,811	135,226	136,772	136,772	138,110	…	…
of which civilian	76,039	77,917	78,744	78,159	79,705	79,705	81,043	…	…
of which security	57,067	57,067	57,067	57,067	57,067	57,067	57,067	…	…

Sources: Ministry of Finance and IMF estimates.

1/ Includes payments deducted for dues owed to the Israeli utility companies, while the budget figure is on a net basis. For March 2006, includes an estimated US$11 million in clearance revenue which would be withheld for the payment of Israeli utilities.

2/ Transfers to electricity generation and distribution sectors as well as to the General Petroleum Corporation and to cover unpaid utility bills by households. In March 2006, includes an estimated US$11 million which would normally be financed through clearance revenues.

3/ In 2005, the budget includes US$240 million to finance social safety net and unemployment programs.

4/ Advances from the Palestine Investment Fund and the telecommunications company Paltel.

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

6/ Includes repayment of arrears, while accumulated arrears, other than on wages and pension contributions, are not recorded.

7/ Comprised of gross wages, nonwage expenditure, and PA financed capital spending (excluding donor financed).