IMMEDIATE ATTENTION

SM/03/320

September 16, 2003

To: Members of the Executive Board

From: The Acting Secretary

Subject: **West Bank and Gaza—Economic Performance and Reform Under Conflict Conditions**

Attached for the **information** of the Executive Directors is a paper on economic performance and reform under conflict conditions for the West Bank and Gaza. This paper should be treated as confidential until it is released for publication on the Fund's external website on Saturday, September 20, 2003. If no objections are received by the **close of business on Friday, September 19, 2003**, it will be posted and made available to delegates and the general public during the 2003 Annual Meetings in Dubai

Questions may be referred to Mr. Toujas-Bernaté (ext. 36936) and Ms. Beidas (ext. 38922) in MED.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

WEST BANK AND GAZA

Economic Performance and Reform under Conflict Conditions

Prepared by a staff team comprising
Messrs. A. Bennett, K. Nashashibi, S. Beidas, S. Reichold, and J. Toujas-Bernaté

Approved by the Middle Eastern Department

September 15, 2003

Contents

Boxes

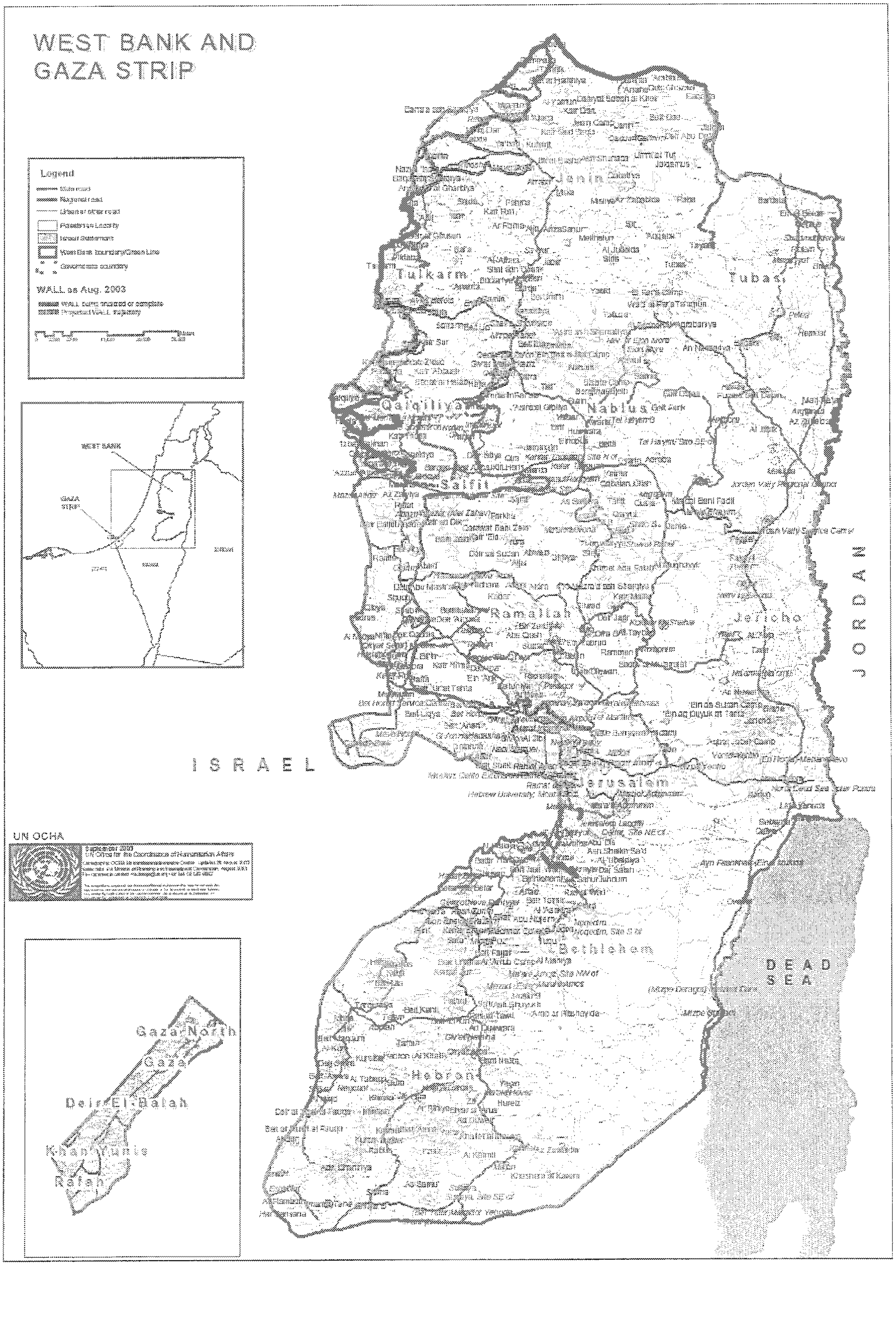
Tables

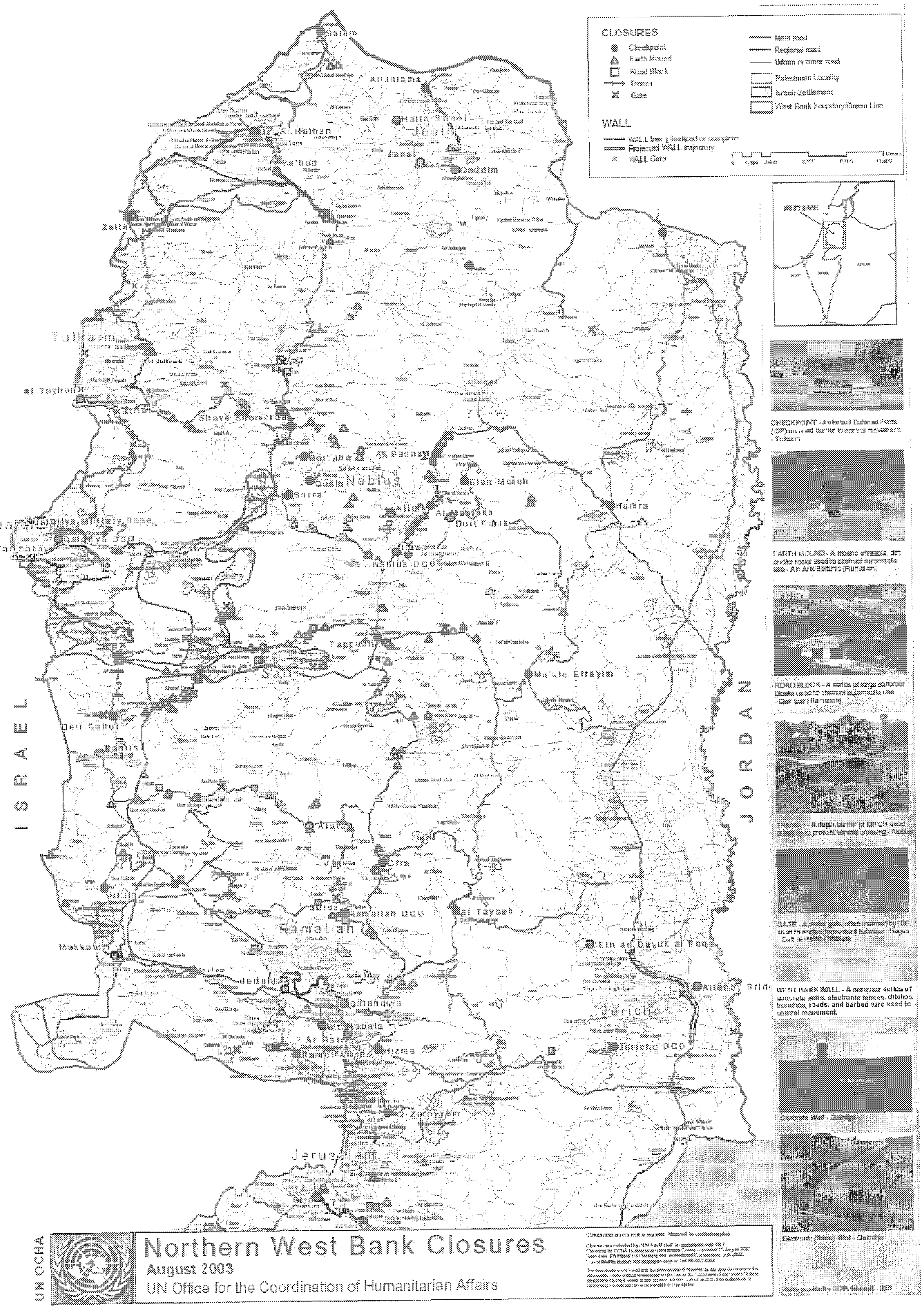
Figures

Annex

Acronyms

AHLC	Ad-Hoc Liaison Committee
CPI	Consumer Price Index
DOR	One of the Israeli Petroleum Companies
EPF	Economic Policy Framework
EU	European Union
FAFO	Institute for Applied Social Science (Norwegian Acronym)
GDP	Gross Domestic Product
GNI	Gross National Income
GNP	Gross National Product
GOI	Government of Israel
GPC	General Personnel Council
GPIE	Gaza Pension Insurance Corporation
IAD	International Audit Department
IDB	Islamic Development Bank
IDF	Israel Defense Forces
IMF	International Monetary Fund
JLC	Joint Liaison Committee
LACC	Local Aid Coordination Committee Institute (Arabic Acronym)
MOPIC	Ministry of Planning and International Cooperation
NGO	Non-Government Organizations
NIS	New Israeli Shekels
OCHA	Office for the Coordination of Humanitarian Affairs
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PDP	Palestinian Development Plan
PECDAR	Palestinian Economic Council for Development and Reconstruction
PLC	Palestinian Legislative Council
PLO	Palestine Liberation Organization
PMA	Palestinian Monetary Authority
STA	Single Treasury Account
SWG	Sector Working Group
TAP	Tripartite Action Plan
UNDP	United Nations Development
UNRWA	United Nations Relief and Works Agency for Palestine Refugees in the Near East
UNSCO	Office of the United Nations Special Coordinator for the Middle East Peace Process
VAT	Value-Added Tax
WB	West Bank
WBG	West Bank and Gaza
WFP	World Fund Programme
WHO	World Health Organization


WEST BANK AND
GAZA STRIP
Legend
WALL as Aug. 2003
WEST BANK
GAZA STRIP
UN OCHA
Jenin
Tulkarm
Tubas
Qalqiliya
Nablus
Salfit
Ramallah
Jericho
Jerusalem
Bethlehem
Hebron
ISRAEL
JORDAN
DEAD SEA
Gaza North
Gaza
Deir El-Balah
Khan Yunis
Rafah


CLOSURES
Checkpoint
Earth Mound
Road Block
Trench
Gate
Main road
Regional road
WALL
ISRAEL
JORDAN
Nablus
Jericho
Northern West Bank Closures
August 2003
UN Office for the Coordination of Humanitarian Affairs
UN OCHA

I. Overview[1]

Following secret negotiations between the Israelis and the Palestinians during 1993 in Norway, an agreement, "the Oslo agreement", was signed by the two sides in Washington on September 13, 1993. This agreement, which formally ended the "first Intifada" (that had begun in 1987), offered the first real hope that lasting peace could be achieved between the Israelis and Palestinians, and thereby bring to a close half a century of conflict. The agreement envisaged a five year transition phase, beginning with an initial Israeli withdrawal from Gaza and Jericho (ratified on May 4, 1994 under the "Gaza-Jericho" accord), toward a "final settlement." During the transition phase, the Palestinians would be expected to establish a Palestinian Authority with responsibility for education, health, social welfare, direct taxation, and tourism, and to elect a representative council.[2] Following this, the critical elements of the envisaged final settlement, which had only been sketched under Oslo, would be negotiated.

Unfortunately, the critical elements that remained to be negotiated included some of the most intractable issues—Jerusalem, the right of return of Palestinian refugees, the future of the Israeli settlements, and the amount of land that the Palestinians would have. And while Palestinian independence was envisaged in a wide range of spheres under the Oslo agreement, there was no specific reference in the agreement to the emergence of an independent Palestinian state—merely to mutual recognition and a final settlement based on U.N. Security Council Resolutions 242 and 338. Differences soon emerged within the Israeli and Palestinian camps on what should or should not be conceded. These differences surfaced most tragically on November 4, 1995, with the assassination of the Israeli Prime Minister, Yitzhak Rabin, by an Israeli extremist opposed to the peace accord. The new Israeli Prime Minister that succeeded Rabin signaled a less accommodative stance on the negotiations. This signal was soon met by the resumption of violence on the part of Palestinian militants.

The assassination of the Prime Minister Rabin dealt a mortal blow to the Oslo peace process. Despite attempts to revive the process under the two subsequent Israeli Prime Ministers, with the "Wye" accord of October 23, 1998, and the Camp David summit of July 11–25, 2000, mistrust on the part of the Israelis and despair on the part of the Palestinians continued to

---

[1] Prepared by Adam Bennett

[2] As envisaged under the Oslo agreement, a second "interim" agreement, sometimes known as "Oslo II", was signed between the two sides on September 28, 1995. This agreement specified the nature of the elected body that would represent the Palestinians in the negotiations. Palestinian elections were held on January 6, 1996. The interim agreement also defined the areas of the West Bank and Gaza where responsibility for security would fall, during the transition phase, under the Palestinian authority (Area A), under joint Israeli and Palestinian authority (Area B), and under Israeli authority (Area C).

grow, and led eventually to the outbreak of the "second Intifada" on September 29, 2000. The renewed conflict led to further discussions between the Israelis and Palestinians in Taba during January 21–27, 2001. In their joint statement at the end of these talks, both sides concurred that they had never been closer to reaching an agreement, but with President Clinton's presidency coming to an end and another change of government imminent in Israel, the two sides could not bridge the final gap in time. The second Intifada was to continue uninterrupted for thirty three months until the shortlived truce of June 30, 2003, following the publication of the "Roadmap" for peace by the international "Quartet" (European Union, Russia, United Nations, and United States).

Although the Oslo agreement did not result in the hoped for final settlement by 1999, it did usher in important and positive changes for the Palestinians. These changes related to the creation and reform of key Palestinian institutions. They resulted in the evolution of the Palestinians from a body of refugees represented by the Palestinian Liberation Organization, led by Chairman Arafat, into a people represented by an elected parliament, the Palestinian Legislative Council, and an elected President, and with a government composed of a council of ministers and administered by the Palestinian Authority and its component ministries.

The International Monetary Fund (IMF), the World Bank and other international and bilateral donors have been continuously engaged in this reform process since soon after the signing of the original Oslo agreement in 1993.[3] In keeping with its domain of expertise, the IMF has concentrated its technical assistance and advice in the financial area, and especially on fiscal institution building. The progress that has been made in developing Palestinian economic institutions has been regularly monitored by the IMF and periodically reported in various published studies, the last of which covered the period up to the beginning of the second Intifada.[4] This study looks at the effect of the second Intifada—thirty three months old at the time of the ceasefire on June 30—on the economy, and on the momentum of reform.

Chapter II confirms the widely held view that the effect on the Palestinian economy of the conflict relating to the Intifada has indeed been severe. It explains how the regime of closures, checkpoints and curfews has made it extremely difficult to conduct normal business activity, and has curtailed the ability of Palestinians to work in Israel or even to get to their places of work in the West Bank. But the chapter also observes that the Palestinian economy still continues to function, that ways can be found to do business, and that while the conflict has exacerbated conditions of poverty, extended family networks including a large number of wealthy expatriates has prevented the situation from becoming a humanitarian crisis. And it finds that there are signs that the worst is over.

---

[3] The international institutions and bilateral donors have regularly coordinated their work, in consultation with the Israelis and Palestinians, through the Ad Hoc Liaison Committee (AHLC), created for this purpose in 1994.

[4] Zavadjil, et al. (1997), Alonso Gamo, et al. (1999), and Valdivieso, et al. (2001).

Chapter III explores the effect of the conflict on the Palestinian financial system. It shows that, mostly owing to a cautious lending policy adopted by commercial banks during the post Oslo period in the later 1990s, banks have been able to withstand the downturn in economic activity and the resulting increase in nonperforming loans. Residents continue to make deposits, withdraw cash and write checks, and so continue their daily life. The Palestinian Securities Exchange continues to trade, if at lower levels than before the Intifada. And while the closures have limited the ability of the Palestinian Monetary Authority to undertake on-site inspection of banks, it has made important progress in developing its capacity to supervise the banks under its authority. All in all, the system has weathered the recession and has emerged in 2003 with strengthened confidence, as evidenced by new lending and an upturn in deposits.

In Chapter IV, the evolution of the Palestinian Authority's budget is traced, from its beginnings with the establishment of the Palestinian Authority in 1994 and the agreement with Israel over the transfer of clearance revenues to the Palestinian Authority, to the period of crisis resulting from the conflict in September 2000 and the subsequent withholding of these revenues, including the role of international donors in making up the difference, and finally to the resumption of regular Israeli revenue transfers at the end of 2002. The effect of these changing fiscal fortunes in developing the expenditure priorities is also explained.

Chapter V describes the progress that has been made in furthering financial accountability and fiscal reform. This is perhaps the most controversial area, with allegations of diversion of funds from the budget, corruption, and even financing of terrorism. In order to secure the financial arrangements of the Palestinian Authority against such criticisms, the Ministry of Finance set out a wide ranging reform agenda which systemically addressed all the weaknesses and opacities in public finance. Over a short period of time, these reforms have placed the Palestinian Authority to a level of fiscal responsibility, control, and transparency which rivals the most fiscally advanced countries in the region.

Chapter VI discusses the circumstances that led to the renewed Palestinian reform effort in 2002, as represented in the "100 day reform program", and the events surrounding the publication of the "Roadmap" by the Quartet. It also explores the progress that has been made in the seven different areas of reform (one of which is covered by Chapter V) that are being monitored by the International Task Force on Palestinian Reform, established by the Quartet in 2002 to help the Palestinians develop and implement their reform program. It shows that, while reforms have been uneven, there has been real progress in certain critical areas.

The Roadmap was laid out in a context of more than two and a half years of violent conflict, and its credibility was tempered by the inevitable skepticism that these circumstances engender. Recent events have further tested its viability. But it remains a sign of hope that the Roadmap was accepted by both sides to the conflict, albeit with some reservations on the part of the Israelis. And unlike the Oslo agreement, this plan makes explicit reference to the creation of an independent sovereign Palestinian state at the end of the road, committed to recognizing, and coexisting peacefully with, an independent sovereign Israeli state. Much work remains to be done toward this objective, not least in the continuing reform of Palestinian institutions. The International Monetary Fund will continue to remain engaged, along with the World Bank and other multilateral and bilateral donors, in the reform process, and will seek to help the Palestinians build upon an economic recovery and ultimately work toward their goal as an independent state in the community of nations in peaceful and prosperous coexistence with Israel.

II. Economic Performance and the Impact of the Intifada: Resilience in the Face of Conflict[5]

A. Introduction

Over the past ten years the Palestinian economy has been faced with a number of daunting challenges. The population growth rate, currently at 4.2 percent, is one of the highest in the world. The population is consequently very young, with 57 percent below the age of 20. The first major challenge has been to try to provide adequate education, housing, health care, and employment opportunities for such a young and fast growing population. The second major challenge has been to do this at the same time as building a Palestinian public administration, which did not exist prior to 1994, and without which the public services demanded cannot be effectively provided. This administration, with functioning institutions and legal system, has had to be created with very limited experience and resources. The third major challenge has been to undertake these tasks while coping with the consequences of conflict: the restrictions imposed by the Government of Israel (GoI), and the uncertainty stemming from unpredictable changes of the security situation as well as from the lack of agreement on the final status of the West Bank and Gaza (WBG).[6]

Despite these challenges the Palestinian economy has proved to be more resilient than expected. Before the Intifada, between 1994 and 1999, the economy grew at a remarkable rate and was able to generate jobs and increase standards of living for its rapidly growing population. With the onset of the Intifada, the Palestinian economy went into a major decline. But it did not collapse. The decline in economic activity was large by any standard, but given the extraordinary circumstances, the Palestinian economy proved surprisingly resilient. And by early 2003, there were already signs that the downward trend had been stopped and that the economy was beginning to stabilize.

This chapter provides an overview of the major macroeconomic developments in WBG since the mid-1990s, with a specific focus on the impact of the Intifada. While structural problems such as the weak legal and regulatory environment have also affected economic performance, the discussion of these issues and the ongoing reform effort is covered separately in Chapter VI.

---

[5] Prepared by Steffen Reichold and Adam Bennett

[6] The conflict that began in September 2000 is known as the "second Intifada," because the earlier period of conflict during 1987–93, which preceded the Oslo accord in 1993, was also known as the "Intifada." Hereon, the conflict beginning in September 2000 will be referred to simply as the "Intifada."

B. Growth and Conflict

The Palestinian economy has experienced very turbulent times over the past ten years. The most important event, with the largest economic consequences, was the outbreak of the Intifada in end-September 2000, combined with the violence and the regime of closures and curfews that followed. But even before these events, economic activity in WBG was subject to large fluctuations. While the pre-Intifada years were generally characterized by high GDP growth, there was a significant slow down in growth in 1995 and 1996 as a result of the frequent border closures imposed by the GoI during that time (Table 2.1).[7] Then as the restrictions were gradually eased in 1997 and 1998, the economy was able to recover and resume growing at a fairly high rate through 1999 and the first half of 2000. Since September 2000, economic activity has fallen dramatically but, contrary to initial impressions, the economy did not collapse.

Table 2.1: Selected Macroeconomic Indicators, 1995–2002

	1995	1996	1997	1998	1999	2000	Est. 2001	Est. 2002
Real GDP growth 1/	6.1	2.5	12.2	11.8	8.9	-5.4	-15.0	-14.5
Real GNI growth 1/	8.5	0.8	12.4	16.3	8.4	-6.8	-16.2	-16.4
Real GNI per capita growth 1/	1.3	-4.9	6.3	11.7	4.1	-10.7	-20.0	-20.4
Consumer price inflation (year-on-year) 1/	10.8	9.0	7.6	5.6	5.5	2.8	1.2	5.7
Unemployment rate 2/	18.2	23.8	20.3	14.4	11.8	14.1	25.5	31.3
Nominal GDP (US$ millions)	3,517	3,668	4,009	4,258	4,517	4,442	3,765	2,974
Exchange rate (New Israeli Shequel per US$) 3/	3.01	3.19	3.45	3.80	4.14	4.08	4.21	4.74

Sources: Palestinian Central Bureau of Statistics (PCBS) and IMF staff estimates.

1/ Change in percent from previous year. For 2001, PCBS preliminary data indicates a smaller decline of 8.3%

2/ In percent of labor force, annual average.

3/ Period average.

[7] This occurred as a result of the setbacks in the peace process that began with the assassination of Prime Minister Rabin in November 1995 and ended in October 1998 with the Wye accord.

Disruption through closures

In order to better understand the factors driving macroeconomic developments in WBG, it is important to appreciate how dependent the Palestinian economy is on Israel. This economic dependency arises from several sources. First, the Israeli labor market has been, and will continue to be, a very important source of employment and income for many Palestinians (see Box 1 for an account of the role of Palestinian workers in Israel). Second, Israel is by far the most important trading partner for WBG. Israel accounts for more than 90 percent of Palestinian exports. And while some imports into WBG originate from outside Israel, virtually all imports come through or from Israel. Third, Israel collects taxes on behalf of the Palestinian Authority (PA), which normally make up about two-thirds of total PA revenues. By affecting these channels, the conflict has had an economic impact on the WBG far beyond the physical destruction of infrastructure.

As a result of the dependency of WBG on the Israeli economy, the fluctuations in economic activity over the past ten years have been closely related to the varying levels of restrictions imposed by the GoI. The most important of these restrictions have been the periodic border closures, but since the Intifada began in late 2000, the internal blockades and curfews have also played an increasingly important role. In what follows in this chapter, all such measures restricting the movement of either goods or people will be referred to as "closures." (See Box 2 for more details on the closures imposed since September 2000). These closures have impacted on Palestinian economic activity through three main channels.

The first channel is through remittances. The Palestinian economy is very dependent on remittances from Palestinians working in Israel. These remittances are a significant component of aggregate income and fuel domestic demand since a large share of that income is spent on goods and services produced in the West Bank and Gaza. Border closures and other restrictions prevent workers from crossing into Israel and the resulting lack of income depresses domestic demand. This loss in aggregate income can (and has been) very significant. Annual labor income from Israel amounted to US$888 million in 1999, which was more than 16 percent of Gross National Income (GNI). Between 1999 and 2002, labor income from Israel is estimated to have declined by nearly two thirds, with a loss equivalent to around US$530 million per annum. This decline in income has significantly reduced domestic demand in WBG and this in turn has reduced Gross Domestic Product (GDP).

Second, closures have a powerful effect on exports. Restrictions on the movement of people have typically been combined with restrictions on the movement of goods. During full closures the borders were closed for people as well as goods, preventing any goods from being exported during the time of the border closure. For perishable goods this is more than just a delay since the delivery of the goods can not be postponed very long. For durable goods this might not be a problem as long as the border closure is short. However, if the closures are either long or very frequent, exports of those goods can also be permanently affected. A particular problem is that producers tend to lose market share if the supply proves unreliable. Past border closures have been very unpredictable, thus preventing producers from adequately planning the shipping of goods. Some producers have reacted to these conditions by establishing large stockpiles outside of the West Bank and Gaza (e.g. in Jordan) in order to guarantee the reliability of their supply. But this only works for large companies in certain industries, and it raises inventory costs. The restrictions and checkpoints also increase transportation costs significantly, further adding to the competitive disadvantage for Palestinian producers.[8]

Box 2.1. Palestinian Workers in Israel and Israeli Settlements

The Palestinian economy has for a long time been dependent on employment inside Israel and settlements. Geographical proximity, and the fact that wages are much higher in Israel, makes employment in Israel a very attractive alternative for Palestinian workers to working in the West Bank and Gaza (WBG). Before the Intifada started in late September 2000, 146,000 Palestinians were working in Israel and the settlements (about 22 percent of total Palestinian employment), and average wages for Palestinian workers in Israel have generally been about 70 to 75 percent higher than those in WBG.*(/1)* This explains the importance of employment in Israel as a source of income for the Palestinian economy. In 1999, labor income from Israel accounted for about 20 percent of Palestinian GDP.

Not surprisingly, given the large wage differential, access to the Israeli labor market has always been restricted. Israel has relied on a system of work permits, which are generally issued for only short time periods. Some permits allow entry into Israel, while others only provide access to the "industrial estates" on the Gaza-Israel border, where Israeli companies operate production plants within an area under tight security control. However, not all Palestinian workers in Israel have a valid work permit. Palestinian residents of East Jerusalem can enter Israel without a permit. Additionally, there has always been a significant number of illegal Palestinian workers. Some of them commute regularly by crossing the porous border between Israel and the West Bank, while others stay for extended periods of time inside Israel, usually amongst the Israeli Arab minority.

There are several types of security measures that affect access to the Israeli labor market. These include changes in the total number of permits granted, general border closures (which prohibits access even for workers with valid permits), and partial border closures (either confined to a certain area or to workers of a specific age and gender). As a result of the periodic application of these various security measures, the daily number of Palestinian workers in Israel has fluctuated widely, reaching a peak of 146,000 in the third quarter of 2000. And with the more consistent application since the start of the current conflict, the average number of Palestinians working in Israel has been significantly reduced. By the

[8] See *"Transaction Costs in the Palestinian Economy: A Microeconomic Perspective"* p.61 in Rosa A. Valdivieso et al., "West Bank and Gaza: Economic Performance, Prospects and Policies", IMF 2001.

Box 2.1 (continued)

second quarter of 2002, during the conflict's most intense period, the number of Palestinians working in Israel had fallen to only 33,000. But by the end of 2002, with some modest easing of restrictions, this number had recovered slightly to around 56,000.

The much reduced number of permits issued and the high frequency of border closures since the beginning of the Intifada has led many Israeli companies to rely on other foreign workers instead of Palestinians. For the future, this raises the question whether large numbers of Palestinians would again be able to work inside Israel, even if the security situation before the Intifada could be restored, because many of their jobs have since been taken by other foreign workers. Palestinian workers, however, do have a certain competitive advantage: they do not live inside Israel and therefore do not create a need for social or infrastructural support. There is therefore reason to believe that the number of Palestinian workers in Israel could potentially recover to pre-Intifada levels in the event of a sustained peace, although this could not be expected to happen immediately.

1/ Data provided by the Palestinian Central Bureau of Statistics (PCBS); includes East Jerusalem

Employment in Israel and Israeli Settlements by Sector, 1999–2003

(In thousands)

	1999	2000	2001	2002	2003 Q1
Total Employment /1	135	117	70	50	49
Agriculture	13	11	5	4	4
Construction	72	63	34	21	23
Manufacturing	15	15	11	10	8
Commerce	20	17	12	10	9
Other services	14	10	7	6	6

Source: IMF staff estimates based on data from the Palestinian Central Bureau of Statistics.
1/ includes workers from East Jerusalem.

Third, closures—especially the internal restrictions that apply within WBG—have severely affected domestic production and access to local markets. The most extreme manifestation of these internal closures are curfews, which paralyze all economic activity by preventing any type of movement. But internal military checkpoints and roadblocks have also been very disruptive for economic activity, as they frequently restrict the movement of vehicles, goods, and people within the WBG.

Box 2.2. Effects of Closures, Checkpoints, Curfews and the "Separation Wall"

Prior to the second "Intifada" which began in September 2000, Palestinians were generally free to enter or exit Israel without interference, requiring permits only for work. About 146,000 Palestinians were working in Israel and Israeli settlements during the third quarter of 2000, or 23 percent of the workforce. *(/1)* Following the onset of the conflict, passage through Israel's "green line" (1967 borders) with the West Bank and Gaza (WBG) was generally closed to all Palestinians except those with permits. Exceptions have been granted only rarely and after lengthy security checks. The number of work permits issued was also significantly reduced and, during acute periods of intensified closures, even those with valid work permits were denied entry. Palestinian employment in Israel reached a low point during the period of Operation Defensive Shield and Operation Determined Path in the Spring/Summer of 2002 at around 33,000 before recovering somewhat by the end of 2002 to 56,000. Workers from Gaza were especially affected. The decline in the number of Palestinians working in Israel has led to a commensurate decline in income flowing into WBG from these workers' wages.

Free passage between the West Bank and Gaza along the "safe passage" route, which had been effective for about one year prior to the Intifada, was closed in October 2000, while crossings over the Allenby and Damyia Bridges between the West Bank and Jordan have been subject to lengthy delays and restrictions. Movement of people and goods between Gaza and Egypt has also been quite limited. It is extremely difficult for unauthorized persons (workers or otherwise) to enter or exit Gaza because the border with Israel has been entirely fenced. Some unauthorized movement across the green line between Israel and the West Bank still takes place, because the border is difficult to police in its entirety. However, the Israelis are taking steps to further limit access to Israel from the West Bank through the construction of a "separation wall" (see below).

Since the intensification of the conflict and the reoccupation of the West Bank in the summer of 2002, movement within the West Bank has also been subject to restrictions. Traffic between eight designated zones of the West Bank and into and out of major towns and cities within these zones is controlled by around 140 military checkpoints. Passage through checkpoints is governed by permits, issued by the Israeli Defense Force, and these are very difficult to obtain. Circumvention of checkpoints is prevented or made very difficult by some 200 unmanned roadblocks (concrete or earth) which cut off alternative access roads. The checkpoint/permit system has greatly reduced mobility in the West Bank and during periods of intensified security, pedestrian and vehicle access to the main roads between affected towns and villages in the West Bank is essentially prohibited to Palestinians. Gaza, which has not been reoccupied, is also subject to restrictions on movement between three designated zones, with passage between zones controlled by some 25–30 checkpoints.

Very few vehicles are allowed through checkpoints, either within the occupied territories or across the green line borders with Israel. Passengers must disembark and cross the checkpoint on foot, and take a taxi or other means of transport on the other side. The

(Box 2 .2 continued)

movement of goods within the West Bank is similarly affected by the "back-to-back" system, according to which goods must be disembarked and reloaded into other vehicles on the other side of the checkpoint, raising transactions costs considerably. The back-to-back rule is applied especially rigorously for goods entering Israel from either the West Bank or Gaza, where waiting vehicles and trucks are usually Israeli owned and more expensive. Reliance on taxis and buses and on Israeli owned transport has adversely affected the competitiveness of exported Palestinian labor and goods. Competitiveness is also undermined by the unreliability of the permit system and of clearance through checkpoints which compromises the timely availability of goods and services and may, in the case of perishable goods, result in loss of produce.

The reoccupation of the West Bank has also involved the much more widespread application of curfews. All the major towns and cities in the West Bank, with the exception of Jericho, have been subject to extensive curfews between 40 percent and 75 percent of the time since the summer of 2002. After reaching a peak of some 900,000 people (some 40 percent of the population of the West Bank) under curfew during June/July 2002, the number under curfew settled to an average of about 500,000 during the remainder of 2002. Since April 2003 the situation has further improved with an average population of 200,000 to 250,000 under curfew. These curfews are usually 24-hour curfews and can run continuously for months on end, with only occasional two to three hour breaks every few days to enable residents to shop for food and perform other necessary tasks. Curfews have prevented workers from getting to their jobs, dislocating production and shutting down markets. In the old city of Hebron, for example, where curfews have been in force for much of the time since the beginning of the Intifada, the once thriving market is completely closed. Many residents have left the old city and moved into the Palestinian controlled part of Hebron which is under less frequent curfew. *(/2)*

The economic effect of closures, checkpoints and curfews appears to vary depending on the nature of the economic activity. Anecdotal evidence suggests that exports of some of the larger companies in West Bank and Gaza are holding up quite well. This reflects the ability of large companies with good connections (especially with the Israelis) to find their way through the various checkpoints and get their goods into Israel and third markets abroad. By contrast to the larger companies, midsized companies that are not so well connected or which depend more on the internal market of West Bank or Gaza, are likely to have fared relatively poorly. Transporting goods within the West Bank, or from the West Bank to Gaza (or the other way around) involves much higher transactions costs, if at all possible. The distribution of agricultural produce has been similarly affected by the restricted market access, while production has been adversely affected by the difficulties for workers and owners to get out of their towns to tend vines, fruit and olive trees. Small producers which can operate within the confines of a given set of checkpoints are likely to have been less badly affected. *(/3)*

(Box 2.2 continued)

The closures, checkpoints, and curfews might be expected to alleviate should the conflict enter a negotiation phase. More worrying for the future, however, is the construction of the "separation wall" that is planned to run 360 kilometers along and within the western border of the West Bank. The first phase of its construction (leveling land and digging trenches) began in the summer of 2002 and extends about a third of the way down from the north of the West Bank. Some five kilometers of the wall itself has now been erected. Land on either side of the wall, varying from 30 to 100 meters has also been requisitioned from Palestinian farmers for additional barriers, trenches and fences. The land involved, from which tens of thousands of olive and fruit tress have already been uprooted, is some of the most productive in the West Bank. The wall will also cover or cut off some of the best water wells in the West Bank. While this should not affect the overall water allocation between the Israelis and Palestinians (which should continue to be governed by the Interim Agreement (Oslo 2) of September 1995), it will affect local access to water and have implications for water use. In particular, it will likely reduce the availability of water for irrigation, which can be directly fed from wells and which can raise agricultural productivity twenty fold, in favor of consumption from (more costly) tanker supplies driven in from elsewhere.

The wall's trajectory, as established thus far, does not coincide with the "green line", but extends in parts up to six kilometers into the West Bank in order to incorporate Israeli settlements. In doing so, it has already cut off some 12,000 Palestinians. Variants of the planned route, pushing deeper into the West Bank and designed to incorporate more Israeli settlements on the west side of the wall, would serve to effectively cut off a further 20,000 Palestinians. The World Bank, which has undertaken a study of the effects of the wall, estimates that, when completed, the wall could isolate as many as 250,000 to 300,000 people (including residents of suburbs to East Jerusalem). A further 140,000 people living on the east side of the wall will be effectively encircled within the wall's looping path, or by additional barriers. The wall could potentially affect 20 percent of the population of the West Bank. The resulting interruption of access to roads, water, agricultural lands, urban markets and public services, combined with the reduction of productive agricultural lands, will result in the exodus of farming communities along the wall and place a heavy and permanent burden on the economy of the West Bank. *(/4)*

1/ Data provided by the Palestinian Central Bureau of Statistics (PCBS).

2/ Detailed and up-to-date information on curfews and checkpoints is available from the *United Nations Humanitarian Information Centre for the occupied Palestinian territory,* http://www.reliefweb.int/hic-opt/

3/ For further discussion of the implications of closures, checkpoints and curfews see *The Impact of Closure and other Mobility Restrictions on Palestinian Productive Activities*, Office of the United Nations Special Co-ordinator, 2003; and *Twenty-Seven Months – Intifada, Closures and Palestinian Economic Crisis: An Assessment*, World Bank, May 2003.

4/ For more on the implications of the "separation wall", see *The Impact of Israel's Separation Barrier on Affected West Bank Communities*, Report of the Mission to the Humanitarian and Emergency Policy Group (HEPG) and of the Local Aid Coordination Committee, World Bank, 2003.

Finally, the effects of the closures in WBG were further aggravated by the severe recession in Israel. Israel's economy also suffered significant economic consequences following the onset of the violence, even though the decline in GDP has obviously been much lower than in WBG. Adding to the direct effects of the violence on the Israeli economy, such as the large contraction in tourism industry, were underlying problems related to difficulties in the high-tech sector and the slowdown of growth in the major industrial countries.

Figure 2.1 shows the relation between a measure of closures[9], the average number of Palestinian workers in Israel, and real GDP from 1994 to 2002. Throughout this period, there has been a very close relation between the level of closures and economic growth in the WBG. This was the case even before 2000. The declining growth rates of 1995 and 1996 are clearly related to increases in the days of closures and decreases in the number of Palestinian workers in Israel. Similarly, we see the same qualitative relation from 2000 to 2002.

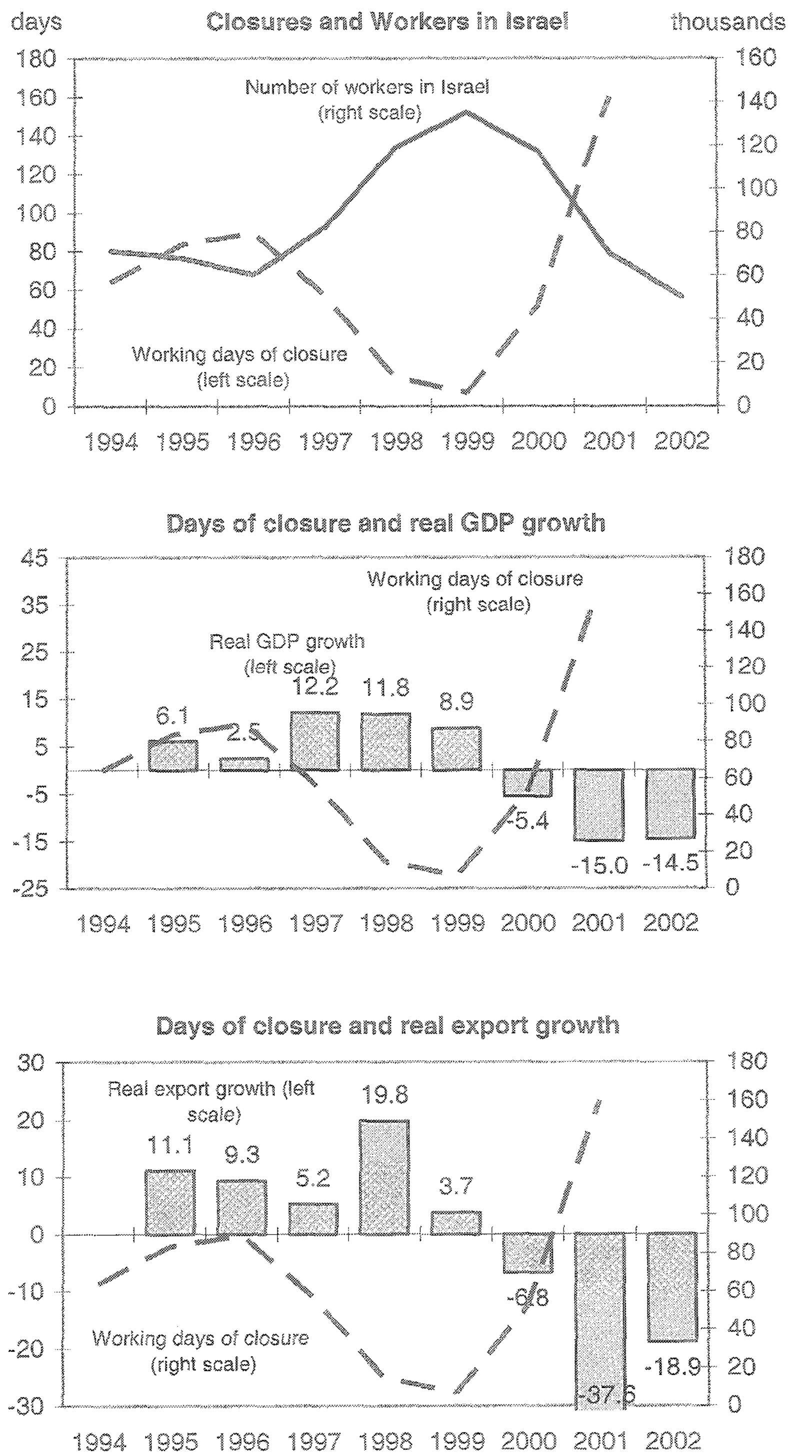
However, despite the similarities between those periods, there were also major differences. Although border closures in 1995 and 1996 were frequent, they applied mainly to the movement of people rather than goods. Thus, while there was a marked decline in the average number of Palestinian workers in Israel, the movement of goods was much less affected. Indeed, exports continued to increase during 1995–96. Internal restrictions on the movements of goods and people within the West Bank and within Gaza during this period were also much less extensive and curfews less widespread than during the Intifada. This explains why in 1995 and 1996 the Palestinian economy was still growing, although at a much lower rate and with declining per capita income, whereas in 2001 and 2002 GDP is estimated to have declined steeply.

Palestinian gross domestic product and gross national income (1994–2000)

Official national accounts statistics from the Palestinian Central Bureau of Statistics (PCBS) are currently available through 2000 (see Tables 2.2 and 2.3 and Box 2.3) with preliminary estimates for 2001. The figures shown for 2001–2002 are IMF staff estimates and are

[9] Closures are represented by the number of working days during which Palestinian workers were denied entry to Israel. The data were collected and published by UNSCO until 2001 (*Report on the Palestinian Economy*, Office of the United Nations Special Co-ordinator, Spring 2001). After 2001, UNSCO ceased to provide this data, because it was judged to be an imperfect proxy for closures during the Intifada. This is because it only measured external border closures, and did not reflect the other forms of closures, such as internal closures and curfews. The latter have been especially prevalent since the start of the Intifada. Moreover, external border closures have been in effect almost continuously since the onset of the Intifada, although with varying intensity and regional differences (for detailed information on various types of closures during 2001 see *The Impact on the Palestinian Economy of Confrontation, Border Closure and Mobility Restrictions*, UNSCO, 2002).

Figure 2.1: Closures and Macroeconomic Developments, 1994-2002



discussed in the next section. The PCBS data reveal the very high dependence of the Palestinian economy on imports. Total domestic expenditure surpassed domestic production by a large margin throughout 1994–2000, ranging between 150 to 165 percent of GDP. With exports typically equal to only 20 percent of GDP during this period, imports have been running between 70–85 percent of GDP. The high level of imports is explained, in part, by the high level of private consumption, which has remained close to 100 percent of GDP throughout the 1994–2000 period, fueled by worker's remittances and transfers from abroad. Public consumption also increased over these years, reflecting the growth of the Palestinian Authority (PA).

Box 2.3. Economic Growth in WBG 1994 to 1999: a Reinterpretation

The interpretation of economic developments during the years of the Oslo-process and before the Intifada (1994 to 1999) has changed somewhat since the last IMF review of economic developments was published in 2001.*(/1)* In June 2003, the Palestinian Central Bureau of Statistics (PCBS) published, for the first time, a set of annual national accounts statistics for the years 1994 to 2000, compiled with technical assistance from the IMF's Department of Statistics. Earlier staff estimates for this period had suggested that real GDP grew at an average annual rate of 2.3 percent between 1994 and 1999, implying a decline in per-capita GDP and thus deteriorating economic conditions and decreasing living standards (average real GNI growth was estimated at 3.3 percent). The official data now shows a different picture. It suggests that average standards of living improved between 1994 and 1999 with an average annual real GDP growth rate of 8.3 percent (and GNI growth of 9.2 percent), which is well above the population growth rate of about 5 percent during the same time.*(/2)* It is also more consistent with the general sense of optimism in the West Bank and Gaza that prevailed during these years. This optimism was reflected in the fact that investment almost doubled between 1995 and 1999, with an increasing share being invested in productive assets outside of the housing sector. Nonbuilding fixed investment increased by 150 percent during this time. The financial sector also grew rapidly with strong increases in banking activities and the creation of a Palestinian stock market.*(/3)* All these developments are suggestive of growing confidence that economic conditions in the West Bank and Gaza would continue to improve. The 1995–96 period therefore stands in stark contrast to 2001 and 2002, with the onset of the conflict, when investment all but disappeared and banking activity went into hibernation.

1/ "West Bank and Gaza, Economic Performance, Prospects, and Policies," IMF, 2001.
2/ It is difficult to assess the accuracy of the official national accounts statistics in the absence of alternative data sources. Nevertheless, the main result of positive per-capita GDP growth before the onset of the Intifada would still hold, even if the average growth rates were somewhat overstated in the official statistics.
3/ See Chapter III on financial sector developments

Domestic expenditure was also high on account of a high rate of investment. Fixed investment was over 30 percent of GDP in every year during 1994–2000, including the period of slow growth of 1995–96, and reached a high of 38 percent of GDP in 1999, before falling back in 2000 (reflecting, in part, the beginning of the Intifada). Most of the investment was undertaken by the private sector, although a large proportion of this was residential investment (buildings accounted for about 60 percent of total fixed investment in 2000) and as such does not necessarily expand the local production capacity or improve productivity.

Table 2.2: National Accounts
In percent of GDP

	1994	1995	1996	1997	1998	1999	2000	2001 est.	2002 est.
Gross domestic expenditure	157.5	152.1	158.1	156.4	157.1	164.5	157.1	171.3	179.1
Consumption	123.1	118.9	123.5	122.4	122.1	122.5	125.8	144.1	159.0
Private	104.4	100.7	101.8	100.8	99.7	99.4	99.4	114.5	124.7
Public	18.6	18.1	21.7	21.5	22.4	23.1	26.4	29.7	34.3
Gross Fixed Investment	33.1	31.3	32.9	31.9	32.8	38.7	30.4	26.1	20.0
Private /1	26.5	21.8	26.3	25.3	26.4	31.7	25.0	20.1	16.6
Public	6.6	9.5	6.6	6.5	6.4	7.0	5.4	6.1	3.5
Change in inventories	1.3	1.9	1.7	2.1	2.3	3.3	0.9	1.1	0.0
Net exports of goods and services	-57.5	-52.1	-58.1	-56.4	-57.1	-64.5	-57.1	-71.3	-79.1
Imports	75.8	71.1	78.3	75.5	78.0	84.2	76.6	85.6	93.0
Exports	18.2	19.0	20.2	19.1	20.8	19.7	19.5	14.2	13.9
Gross domestic product	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Net factor income	14.5	17.3	15.8	16.2	21.2	20.8	18.7	16.8	14.5
Gross national income	114.5	117.3	115.8	116.2	121.2	120.8	118.7	116.8	114.5
Net current transfers	15.1	12.4	13.9	11.7	9.6	8.8	13.2	31.1	59.0
Gross disposable income	129.7	129.6	129.6	128.0	130.8	129.6	131.9	148.0	173.4
Memorandum items:									
Nominal GDP (in millions of US$)	3,081	3,517	3,668	4,009	4,258	4,517	4,442	3,765	2,974
Exchange rate (NIS per US$) 2/	3.01	3.01	3.19	3.45	3.80	4.14	4.08	4.21	4.74

Source: PCBS and staff estimates.
1/ includes net errors and ommissions.
2/ period average.

The large deficit in the Palestinian trade balance, which ranged from 50–65 percent of GDP during 1994–2000, was offset to a considerable degree by net factor income and net current transfers. As noted earlier, employment in Israel and the settlements played a very important role as a source of income. Net factor income from abroad rose fairly steadily during 1996–99, after the dip that followed the closures of 1995–96, reaching 21 percent of GDP before subsiding in 2000, reflecting the beginning of the Intifada and renewed closures in the final quarter of 2000. That source of income was complemented by large current transfers, in form of aid flows as well as private remittances from the large Palestinian expatriate population.[10] To some extent, current transfers served as a buffer to offset changes in factor income. The two items together generated a fairly constant income flow equal to around 30 percent of

[10] Official aid flows that are included in *current transfers* are grants for current expenditures and aid-in-kind of noncapital goods.

GDP during 1994–2000. In 2001 and 2002, current transfers increased substantially, both in percent of GDP and in absolute terms. This was the consequence of increased emergency assistance, budget support, and private transfers.[11]

Table 2.3: Real National Accounts
Index: Real GDP in 1997=100

	1994	1995	1996	1997	1998	1999	2000	2001 est.	2002 est.
Gross domestic product	82.0	87.0	89.2	100.0	111.8	121.7	115.1	97.9	83.7
Gross domestic expenditure	132.0	134.4	141.5	156.3	174.7	200.0	180.7	169.5	148.9
Consumption	105.2	107.1	111.6	122.3	134.6	145.8	143.0	141.6	131.5
Private	89.8	90.9	92.0	100.8	110.2	119.3	114.0	113.5	104.1
Public	15.3	16.2	19.6	21.5	24.4	26.5	29.0	28.1	27.4
Gross Fixed Investment	25.8	25.6	28.4	31.9	37.8	50.4	36.8	27.0	17.4
Private /1	20.7	17.9	22.7	25.3	30.5	41.2	30.3	20.7	14.4
Public	5.1	7.7	5.7	6.5	7.3	9.2	6.5	6.3	3.0
Change in inventories	1.1	1.7	1.5	2.1	2.3	3.8	1.0	1.0	0.0
Net exports of goods and services	-49.8	-47.2	-52.1	-56.0	-62.5	-78.0	-65.4	-71.4	-65.0
Imports	64.8	63.8	70.2	75.1	85.4	101.7	87.6	85.2	76.2
Exports	15.0	16.6	18.2	19.1	22.9	23.8	22.2	13.8	11.2

Source: PCBS and staff estimates.
1/ includes net errors and ommissions.

Despite this high level of factor income and current transfers from abroad, the Palestinian economy has been running current account deficits in the order of 20 to 35 percent of GDP from 1994 to 2000. Donor assistance for capital projects to the WBG has generally been very high on a per capita basis and have played a crucial role toward financing the large current account deficits. Precise numbers, however, are difficult to come by, since the disbursements of donor assistance are currently not adequately monitored, either by the PA or by any international institution.[12] Nevertheless, the World Bank has compiled estimates based on

[11] The large increase in 2002 was caused by budget support from Arab donors which was given in form of a grant in 2002, but in form of loans in 2001. The latter was therefore not included under current transfers.

[12] The Ministry of Planning and International Cooperation (MOPIC) has in the past been collecting data on donor assistance to the WBG. But there were problems associated with double counting of certain aid flows due to inadequate reporting formats, and recently donors have not been providing the necessary data. The Ministry of Finance (MoF) with assistance from the IMF has established a new reporting system for donor assistance that avoids the previous problem and will provide more reliable data on current and estimated future donor aid disbursements.

informal surveys of donors and information from the PA fiscal accounts. These estimates show total disbursements of US$419 million in 1998, US$482 million in 1999, and US$549 million in 2000, almost all of which was directed toward infrastructure and technical assistance (or capacity-building) projects.

During the pre-Intifada period, therefore, donor assistance has probably financed around one half of the current account deficits recorded by the Palestinian economy. The remaining half was probably financed by a mixture of portfolio flows (in part into the nascent stock exchange in Nablus), inward direct investment and flows through the banking system. But it is not possible to verify this in the absence of reliable data on capital flows during 1994–2000.

Estimating GDP during the conflict (2001–2002)

In the absence of official data, an assessment of the behavior of GDP in 2001 and 2002 must rely on estimates. These estimates have been compiled by IMF staff using a simple income-expenditure model, and supplemented by a number of indicators. (See Box 5 for a brief description of the model).

Consistent with one's expectations based on the closures, Palestinian exports declined steeply by 38 percent in 2001 (preliminary Palestinian BOP data, measured in U.S. dollars). In 2002, exports declined further by 23 percent, proxied by imports of goods and services by Israel from the "Palestinian Authority" (Israeli Central Bureau of Statistics). Private investment, assumed to be mainly construction activity, is also estimated to have declined sharply, by 32 percent in 2001 and 31 percent again in 2002 (in real terms). This is based on PCBS data from cement imports, which declined by 32 percent in 2001 and 26 percent in 2002, and PCBS data on building permits, which showed a decline of 33 percent in 2001 and 37 percent in 2002. Public investment, proxied by donor project financing,[13] is also estimated to have declined as the composition of donor aid has shifted away from infrastructure projects toward emergency and direct budgetary assistance. The decline is estimated at 33 percent in both 2001 and 2002. Also consistent with the closures since the beginning of the Intifada, factor income, measured by income from workers in Israel, fell by 40 percent in 2001 and a further

[13] The component of public investment that is financed directly by the PA is very small relative to donor financed public investment. Data on the PA-financed component is available from the Ministry of Finance.

Box 2.4. Sectoral Developments in Production, 1994–2000

The sectoral composition of the Palestinian economy has been rather stable throughout the second half of the 1990s, although with a few exceptions (see Table 2.4). The financial sector grew very rapidly after the creation of the Palestinian Monetary Authority (PMA) in 1994 and the establishment of a payment clearing system. Between 1994 and 2000 the contribution of financial intermediation to GDP increased from 1.1 percent to 4.4 percent. The transportation and communication sector also gained importance and doubled its share of GDP from 4.4 percent to 8.7 percent during the same time. The shares of agriculture, manufacturing, and trade on the other hand declined, although the decline might be somewhat overstated since the statistics of those sectors do not include public enterprises that accounted for 3.9 percent of GDP in 2000 and did not exist in 1994. The most cyclical sector has been construction. It increased rapidly during the late 1990s, fueled by high demand from the fast growing population, improved access to financing by the developing banking sector, and the general sense of optimism about future economic conditions. By 1999 construction accounted for 14.3 percent of GDP (compared to only 7 percent in 1995), but since then it has contracted significantly.

Table 2.4: Sectoral Composition of GDP at Factor Cost

in percent of GDP (at constant 1997 prices)

	1994	1995	1996	1997	1998	1999	2000
Agriculture and fishing	12.2	12.8	15.0	12.2	12.2	10.5	9.1
Mining, manufacturing, electr. and water	21.8	21.7	18.8	17.4	17.0	15.7	16.8
of which: Manufacturing	19.3	19.2	16.3	14.8	14.2	13.3	13.7
Construction	8.4	7.0	8.9	8.7	10.2	14.3	7.0
Wholesale and retail trade	17.8	16.2	12.3	13.2	12.1	12.1	11.9
Transport, Storage and Communications	4.4	4.3	4.3	5.3	6.2	6.6	8.7
Financial intermediation	1.1	2.0	2.3	2.9	3.4	3.7	4.4
Other services	24.9	24.2	23.8	25.0	24.5	22.6	25.2
Public administration and defense	9.4	11.8	13.6	12.8	11.6	11.0	12.9
Public owned enterprises	0.0	0.0	1.0	2.5	3.0	3.4	3.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Palestinian Central Bureau of Statistics.

24 percent in 2002.[14] Private transfers from abroad have increased by 40 percent in 2001 (based on 2001 BOP) and are assumed to have increased by a further 25 percent in 2002 (based on partial data from two major banks).

[14] Measured in U.S. dollars. The figure for 2001 is based on preliminary BOP data, while 2002 is an estimate based on the PCBS's quarterly labor market survey.

Box 2.5. A simple Income-Expenditure Model to Estimate GDP Developments

The income-expenditure model starts with the identity *GDP equals Exports minus Imports plus Consumption plus Investment*. Information on exports in 2001 can be obtained from the preliminary balance of payments (BOP) prepared by the PCBS and the PMA. For 2002, Israeli BOP figures are available, that identify Israeli imports from the "Palestinian Authority", which is broadly equivalent to WBG excluding East Jerusalem in this context. According to trade statistics from the PCBS, about 90 percent of Palestinian exports go to Israel. Imports and private consumption are both assumed to be a linear function of private disposable income (PDI). PDI is equal to GNI less domestic taxes (available from ministry of finance data) plus transfers from abroad (for which some limited data is available from banks). GNI is equal to GDP plus net factor income from abroad, which is mostly labor income from Israel (estimates based on quarterly labor market survey). Public consumption is derived from the fiscal accounts (which are up to date). Investment is based on partial information on public investment from donors project financing and even more partial information on private investment in construction (based on indicators of cement imports and building permits).

The model provides estimates for GDP and certain components in nominal terms. In order to derive GDP in real terms, each demand component is deflated. The most important component of the deflators is the CPI which is complemented by several other price series, such as oil prices and prices in Israel. Historically, the GDP deflator and the CPI index have in fact been very similar.

The key parameters in the model are the average ratios of private consumption and imports to PDI, and deriving GDP estimates for 2001 and 2002 requires assumptions about these parameters. The propensity to import has remained relatively stable in 1995–2000 and the observed fluctuations do not appear to follow a systematic pattern. It therefore seems appropriate to use the historic average from 1995 to 2000 for the 2001 and 2002 estimates. The propensity to consume, on the other hand, shows more systematic variation. It increased in 1996 (from 82 percent to 85 percent), as economic growth slowed down, and then fell back to a level in 1998–2000 close to that observed in 1995. This suggest that the savings ratio adjusts to maintain some stability in consumption when there are variations in income. Since income by any measure must have fallen in 2001 and 2002, the GDP estimates for 2001 and 2002 are based on the higher consumption ratio (lower savings ratio) observed in 1996, the year of the last decline in per-capita income prior to the Intifada. Applying these parameter values implies a GDP decline of 15.0 percent in 2001 and 14.5 percent in 2002 (Tables 2.2 and 2.3).

The PCBS has recently compiled a preliminary estimate of GDP in 2001, which shows a decline in real GDP of only 8.3 percent. This estimate is based on incomplete data and may be revised as more data becomes available. But it suggests that the model's estimated decline in GDP for 2001 may be too large, and that the savings ratio may have fallen even further than assumed. Indeed, given that incomes must have fallen by more than they did in 1996, it seems likely that the savings ratio was also lower. On the other hand, a fall in GDP of only 8.3 percent seems rather small, in the circumstances, considering that domestic employment also fell by a similar amount (see below). This would imply no change in productivity, whereas productivity nearly always falls in a recession and seems especially likely to do so when workers remain on the roster but cannot get to work because of closures. The model's estimated decline in GDP is also more modest that that recently estimated by the World Bank (2003). The true fall may therefore lie somewhere between the PCBS preliminary estimate and the model estimate. The model's estimates are inevitably subject to a significant margin of error and will need to be reviewed as more information becomes available.[15] Nevertheless, as a guide to the possible broad orders of magnitude of changes in GDP, this simple model-based approach has merits, despite its shortcomings, in the absence of practical alternatives.[16]

According to the model's estimates, the decline in GDP, of 15.0 percent in 2001 and 14.5 percent in 2002, was associated with sharp declines in consumption (mainly on account of private consumption) and in investment. The trade deficit rose in 2001 and then fell in 2002, although in percent of GDP it increased in both years, because GDP fell so sharply. The decline in net factor income that also accompanied the closures under the Intifada was matched, as before, by a sharp increase in current transfers, reflecting a combination of higher private transfers and international aid. The increase in donor assistance partly reflected a switch from infrastructure (and thereby public investment) toward humanitarian assistance and budget support.[17] In 2002, nearly the whole of the trade deficit is believed to

---

[15] Major difficulties in deriving accurate GDP estimates using a model include the lack of sufficiently long and consistent historic time-series to estimate the model parameters, and more importantly the possible instability of these parameters following the onset of the Intifada. Additionally, only imperfect proxies are available for many exogenous variables.

[16] As a check on the model's accuracy, a forecast was made of GDP over the years 1997 through 2000, and compared with the actual outturn as compiled by the PCBS. The forecast used the same indicator data as used by the income-expenditure model (except for transfers, for earlier indicator data did not exist and actual data was used instead). The parameter values are the average realized values from 1995 to 2000. As the figures below indicate, the model succeeded is tracking the broad orders of magnitude in growth, although there are significant discrepancies in individual years, especially in 1998 and 2000.

(percent change)	1997	1998	1999	2000
Actual GDP (PCBS)	12.2	11.8	8.9	-5.3
Estimates GDP (Model)	12.6	6.9	10.6	-1.4

[17] At the beginning of 2001, Israel decided to suspend the monthly transfer of clearance tax revenues (VAT, customs and excise duties) that Israel collects on behalf of the PA. With steeply declining domestic tax revenues following the fall in economic activity, the PA faced

(continued)

have been financed from factor income and current transfers. This no doubt reflected a complete absence of inward direct portfolio or banking flows during this period, as well as the fact that most foreign aid was given in form of grants.

Three indicators are used as a check on the GDP calculations derived in the above method. The first is VAT revenue, which is available with a very short time lag. On the assumption of no change in tax rates or collection procedures, VAT revenue should track domestic spending closely. The second indicator is the number of bank checks presented for clearing, which should proxy the level of payment activity through the banking system. The third indicator is domestic employment. All these indicators are available with a two to three month delay.

The behavior of these indicators from the beginning of 2000 through the first quarter of 2003 is shown in Figure 2.2. All three indicators clearly show the effect of the beginning of the conflict, with strong declines in the fourth quarter of 2000. They also show the low point in the summer of 2002, with the escalation of the conflict, followed by a recovery toward the end of 2002.

Table 2.5 quantitatively compares the model results with the short-term indicators. The model estimates the decline in real GDP at 15.0 percent in 2001 and 14.5 percent in 2002. Domestic employment has declined by much less than this. But in a sharp economic downturn, employment is likely to fall by less than output, with a commensurate decline in labor productivity. The value of checks cleared, by contrast, fell by more than nominal GDP (see Table 2.5). This can also be explained. First, since the beginning of the Intifada, the number of bounced checks has increased, which may have discouraged people from accepting checks. Second, the fracturing of the economy brought about by the closures has resulted in a shift in economic activity to smaller scale operations, self employment and employment of family members, which has increased the use of cash at the expense of banks.

VAT receipts have also fallen by more than estimated GDP and by much more than estimated private domestic expenditure. This could possibly be explained by a shift in the consumption basket toward items which effectively escape VAT, such as food purchased from local vendors and from the informal economy, as well as a decline in tax collection rates. Overall, the average of the three indicators shows a growth rate not dissimilar to that produced by the income-expenditure model. The PCBS estimate for 2001, on the other hand, shows a decline in GDP roughly proportionate to the fall in domestic employment and much less than the decline in VAT collection and the fall in the value of checks cleared.

---

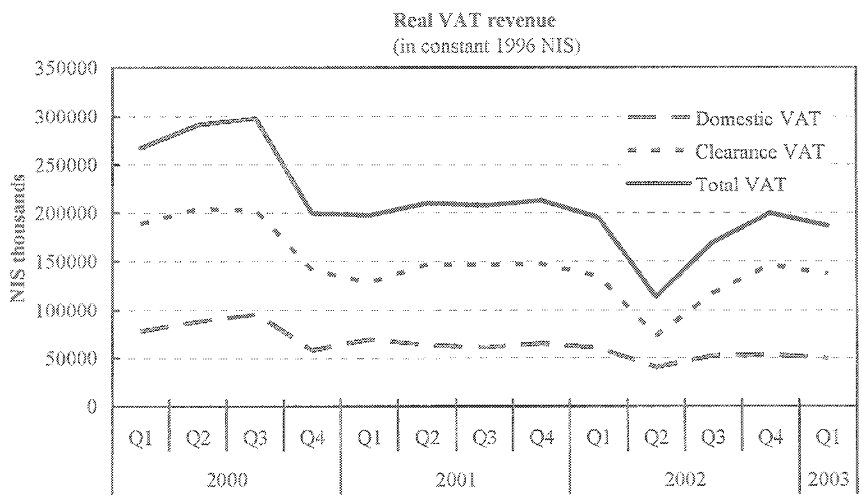
a severe budget crisis. Donors, in particular other Arab countries, responded by providing direct budget support to the PA (US$530 million in 2001 and US$463 million in 2002). As a result, estimates of total aid disbursements almost doubled to US$929 million in 2001 and US$1,026 million in 2002 (according to World Bank calculations).

C. Employment and Unemployment

The developments in the Palestinian labor market are clearly evidenced in the data compiled by the Palestinian Central Bureau of Statistics (PCBS) (see Table 2.6 and 2.7, and Figure 2.3 and 2.4). As a result of the increased closures in 1995 and 1996, the number of Palestinian workers in Israel and the settlements fell to an average of 62,000 during 1996. In the following years, access to the Israeli labor market steadily improved and in 1999, the last full year before the Intifada, a daily average of 135,000 Palestinians worked in Israel or the settlements. This number continued to increase through the third quarter of 2000, the eve of the Intifada, when it reached a peak of 146,000. Since then, access to the Israeli labor market has been severely restricted, reaching its lowest point in the second quarter of 2002 when the Israeli Defense Force (IDF) began "Operation Defensive Shield", reoccupying the main cities in the West Bank and imposing widespread curfews. In the second quarter of 2002, only 33,000 Palestinians worked in Israel, less than a quarter of the number working there nine months before.

These figures include workers without permits who managed to pass through the porous border between the West Bank and Israel despite the tight security measures. It also includes Palestinian workers from East Jerusalem who were not directly affected by the closures. The number of Palestinian workers from WBG outside East Jerusalem who were allowed to enter Israel legally is therefore likely to have declined by much more. Data for Gaza, where the border is much less porous than the West Bank, indicate a decline of 90 percent in the number employed in Israel in the second quarter of 2002, by comparison to the third quarter of 2001.

Figure 2.2: Short-term Economic Indicators, 2000-03



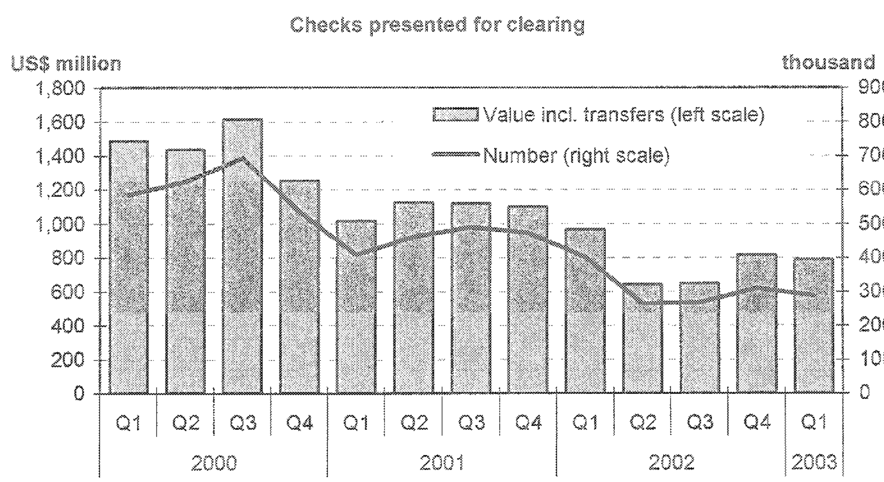


Table 2.5: Comparison of GDP estimates and short-term indicators

	2001	2002
(annual growth rates in percent)		
National Accounts estimates		
IMF model		
GDP (real)	-15.0	-14.5
GDP (nominal US$)	-15.2	-21.0
Private domestic expenditure (nominal US$)	-8.6	-17.1
PCBS estimate		
GDP (real)	-8.3	...
Short-term indicators		
Domestic employment (period average)	-8.7	-0.5
Value of checks cleared (nominal US$) /1	-24.8	-29.5
VAT revenue (nominal US$)	-23.2	-22.8
domestic	-20.5	-25.2
clearance	-24.4	-21.8

Source: MOF, PMA, PCBS, and staff estimates.
1/ includes transfers through clearinghouse

As noted above, labor income from Israel represented about 16 percent of GNI in 1999. Significant changes in the amount of labor income have therefore had major effects on the domestic economy by affecting domestic demand. This effect was visible during the closures of 1995–96. Table 2.6 suggests that the decline in the numbers of workers in Israel and the resulting decline in domestic demand served to depress employment and GDP, despite the fact that exports held up quite well (Figure 2.1). The only reason employment continued to grow in 1995–96 is because there was a strong growth in public sector employment.

During 1996–2000, as closures were relaxed, labor income from workers in Israel and exports both grew strongly. This combined with rapid growth in public sector employment to generate strong growth in GDP, which in turn led to strong growth in private sector employment in WBG. Table 2.6 shows that total annual average employment rose by 39 percent between 1996 and 2000. About a third of this increase related to employment in Israel, and a slightly larger proportion represented private sector employment, with the remaining quarter being public sector employment.

Table 2.6: Palestinian Labor Market Developments, 1995–2003

	1995	1996	1997	1998	1999	2000	2001	2002	2003 /1 Q1
					(In thousands)				
Labor force	513	561	602	640	667	695	682	707	745
Unemployment	96	132	121	92	79	98	174	226	226
in percent of labor force	18.7	23.5	20.1	14.4	11.8	14.1	25.5	32.0	30.4
in the West Bank	14.0	19.6	17.4	11.7	9.5	12.0	22.0	28.3	31.3
in Gaza	29.7	32.5	26.7	20.7	17.1	18.9	34.0	37.9	28.5
Total employment /2	417	429	481	548	588	597	508	486	519
Employment in Israel and the settlements	66	62	83	118	135	117	70	50	49
Employment in the West Bank and Gaza	351	367	398	430	453	480	438	436	470
PA employment /3	52	70	81	91	104	115	122	125	125
Private sector /4	299	298	317	339	349	365	316	311	345
Agriculture			54	54	63	71	57	69	73
Construction			43	53	55	54	39	33	37
Manufacturing			67	73	73	71	60	54	59
Commerce			81	85	82	86	86	88	97
Other services (excl. PA employment)			72	74	76	83	74	67	79
					(In percent of total employment)				
Employment in Israel and the settlements	16	14	17	22	23	20	14	10	9
Employment in the West Bank and Gaza	84	86	83	78	77	80	86	90	91
PA employment /3	12	16	17	17	18	19	24	26	24
Private sector /4	72	69	66	62	59	61	62	64	66
Agriculture			11	10	11	12	11	14	14
Construction			9	10	9	9	8	7	7
Manufacturing			14	13	12	12	12	11	11
Commerce			17	16	14	14	17	18	19
Other services (excl. PA employment)			15	14	13	14	15	14	15
					(Annual change in percent of previous year's total employment)				
Total employment /2		2.9	12.1	13.9	7.3	1.5	-14.9	-4.3	3.5
Employment in Israel and the settlements		-1.0	5.0	7.3	3.1	-3.1	-7.9	-3.9	-16.9
Employment in the West Bank and Gaza		3.9	7.1	6.7	4.2	4.6	-7.0	-0.4	6.3
PA employment /3		4.3	2.7	2.0	2.4	1.9	1.2	0.5	1.4
Private sector /4		-0.4	4.5	4.6	1.8	2.7	-8.2	-0.9	8.2
					(in NIS)				
Average daily wages									
West Bank	57	49	52	58	66	70	69	73	72
Gaza	45	42	44	48	51	53	54	55	54
Israel and settlements	82	86	92	100	106	110	107	117	122

Sources: Palestinian Central Bureau of Statistics, and IMF staff estimates.

1/ The change in percent is from Q1 2002.
2/ Includes employment in Israel and the settlements as well as those considered underemployed.
3/ Central government only.
4/ Includes employment in local authorities and public enterprises.

Table 2.7. Palestinian Labor Market Developments, 2000–2003

	2000 Q3	2000 Q4	2001 Q1	2001 Q2	2001 Q3	2001 Q4	2002 Q1	2002 Q2	2002 Q3	2002 Q4	2003 Q1
					(In thousands)						
Labor force	735	668	669	675	678	702	705	680	703	742	745
Unemployment	74	189	179	160	172	184	204	229	251	202	226
in percent of labor force	10.1	28.3	26.8	23.7	25.4	26.2	28.9	33.7	35.7	27.2	30.4
in the West Bank	7.5	26.3	23.8	19.1	22.7	22.2	25.6	29.6	31.1	26.9	31.3
in Gaza	15.7	33.5	33.8	34.8	32.0	35.5	36.4	41.7	46.4	28.0	28.5
Total employment /2	661	479	490	515	506	518	501	451	452	540	519
Employment in Israel and the settlements	146	43	72	74	63	68	59	33	53	56	49
Employment in the West Bank and Gaza	515	436	418	441	443	450	442	418	399	484	470
PA employment /3	113	115	117	119	119	122	123	124	123	125	125
Private sector /4	402	321	301	322	324	328	319	294	276	359	345
Agriculture	71	79	54	58	52	57	62	71	48	90	73
Construction	62	32	34	43	43	38	30	27	32	43	37
Manufacturing	78	54	60	59	58	63	63	50	47	59	59
Commerce	92	84	81	87	87	93	94	78	85	92	97
Other services (excl. PA employment)	99	72	72	75	84	77	70	68	64	75	79
					(In percent of total employment)						
Employment in Israel and the settlements	22	9	15	14	12	13	12	7	12	10	9
Employment in the West Bank and Gaza	78	91	85	86	88	87	88	93	88	90	91
PA employment /3	17	24	24	23	24	24	25	28	27	23	24
Private sector /4	61	67	61	63	64	63	64	65	61	67	66
Agriculture	11	17	11	11	10	11	12	16	11	17	14
Construction	9	7	7	8	8	7	6	6	7	8	7
Manufacturing	12	11	12	11	11	12	13	11	10	11	11
Commerce	14	18	17	17	17	18	19	17	19	17	19
Other services (excl. PA employment)	15	15	15	15	17	15	14	15	14	14	15
					(change from previous quarter, in thousands)						
Total employment /2	16	-182	11	25	-9	12	-17	-50	1	88	-21
Employment in Israel and the settlements	2	-103	29	2	-11	5	-9	-26	20	3	-7
Employment in the West Bank and Gaza	14	-79	-18	23	2	7	-8	-24	-19	85	-14
PA employment /3	3	2	2	2	0	3	1	1	-1	1	0
Private sector /4	11	-81	-20	21	2	4	-9	-25	-18	84	-15

Sources: Palestinian Central Bureau of Statistics, and IMF staff estimates.

2/ Includes employment in Israel and the settlements as well as those considered underemployed.

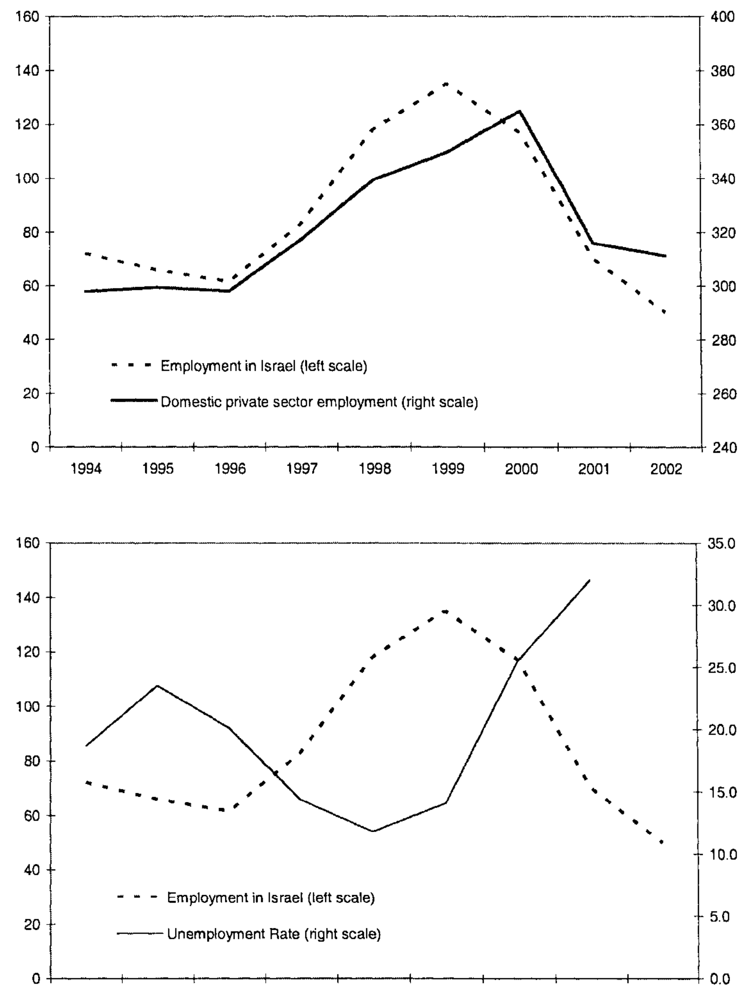
3/ Central government only.

4/ Includes employment in local authorities and public enterprises.

As noted above, the external closures associated with the conflict have affected the outflow of goods (exports) to the same extent as the outflow of people (workers in Israel), by contrast to the 1995–96 period, when closures affected mostly the latter. Closures during the Intifada period therefore compounded the effect on domestic employment by impacting on exports at the same time as on domestic demand. Total employment fell by 32 percent between the third quarter of 2000 and the third quarter of 2002. Less than half of this decline was due to lost jobs in Israel, while about 60 percent reflected jobs lost in the domestic private sector, swallowing up the small 5 percent increase that related to additional PA employment during this time.

These developments are clearly reflected in the behavior of unemployment. After rising during the closures associated with 1995–96 period, unemployment fell by more than half from 24 percent in 1996 to 10 percent in the third quarter of 2000 during the boom years that followed. Since then, the unemployment rate has increased dramatically, reaching 36 percent during the third quarter of 2002 before falling again to 30 percent by the first quarter of 2003.[18] Unemployment has traditionally been much higher in Gaza than in the West Bank, although both areas saw similarly marked increases in unemployment during the Intifada period.

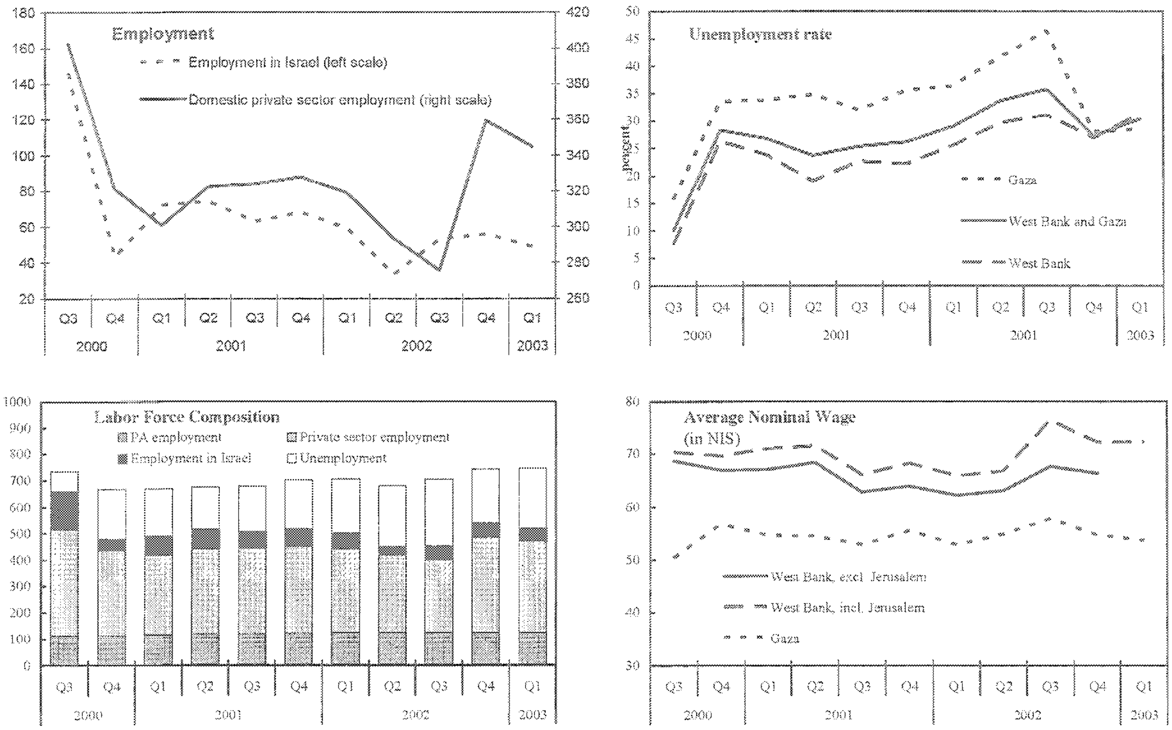
Figure 2.3: Palestinian employment in WBG and in Israel, 1994-2002



After a broad based increase across sectors during the recovery years of 1997–2000, the decline in private sector employment from the beginning of the Intifada through the third quarter of 2002 was also broad based, although the range of declines was quite wide. The steepest decline was recorded in employment in the construction industry, which fell by 49 percent. The most modest decline was in commerce (retail and wholesale trade, and hotels and restaurants) which fell by only 8 percent.

[18] These numbers are based on the ILO definition of unemployment, which excludes "discouraged workers" who no longer actively seek employment. Although the number of discouraged workers has risen since the beginning of the Intifada, they have not risen significantly as a proportion of the labor force. Nevertheless, unemployment measured inclusive of discouraged workers would be consistently some 9–11 percentage points higher than under the ILO definition during the period of the Intifada.

Figure 2.4: Labor Market Developments, 2000/Q3 - 2003/Q1



In the second half of 2002, there were signs of a recovery in employment. The number of workers in Israel recovered from the low point in the second quarter of 2002, although remained below the average recorded for 2001. More striking was the recovery in domestic employment, which reached levels not seen since before the Intifada. Some of this may have been related to the (modest) easing of closures relative to mid-2002, which may have improved the flow of goods. And the larger number of workers in Israel bringing home their wages may also have helped support domestic demand. But the increase in domestic employment may also have reflected supply considerations: there was an exceptionally good harvest, particularly of olives. Employment in agriculture nearly doubled in the fourth quarter (although many of the additional workers may have been unpaid family members), before easing again in the first quarter of 2003. Nevertheless, employment in the other sectors has also increased significantly (on average by 18 percent) in the fourth quarter of 2002 and it did not decline in the first quarter of 2003. Reflecting the major role played by agriculture, much of the recovery in employment seems to have been concentrated in Gaza (where agriculture is more important). Unemployment in Gaza fell to its lowest level since the beginning of the Intifada. By contrast, unemployment in the West Bank was little changed. As a result, the unemployment rates in Gaza and in the West Bank have converged (see Figure 2.4). Up until the last quarter of 2002, the unemployment rate has always been significantly higher in Gaza than in the West Bank.

D. Wages and Prices

Average wages have remained remarkably stable during the Intifada despite soaring unemployment rates. In Gaza, where the unemployment rate rose above 30 percent after the outbreak of the Intifada (and has been as high as 46 percent), nominal wages have been virtually constant. Because inflation has been very low in Gaza, real wages have also changed little. In the West Bank, where average wages are higher than in Gaza, the situation has been somewhat different. While nominal wages have also remained fairly stable, real wages declined by almost 10 percent as a result of higher inflation rates in the West Bank (relative to Gaza) during the period of the Intifada. Notwithstanding the adjustment to real wages in the West Bank, the much larger increases in unemployment suggest that even here, labor market adjustment was effected primarily through numbers in employment rather than a significant drop of real wages, suggesting a substantial degree of downward wage rigidity.[19]

Measured in terms of the New Israeli Shekel (NIS), the common currency for most retail transactions and wage payments, Palestinian and Israeli inflation rates are very closely related overall (Figure 2.5).[20] The behavior of both inflation rates closely follows the fortunes of the NIS against the U.S. dollar. But some differences have emerged between inflation in Gaza and in the West Bank during the Intifada period.

The close correlation between Israeli and Palestinian inflation is explained by the close trade relations between Israel and WBG. About 73 percent of all goods imported by WBG are imported from Israel.[21] While not all of these goods are produced in Israel (some are indirect imports from elsewhere in the world), the ratio of Israeli goods in Palestinian imports is

---

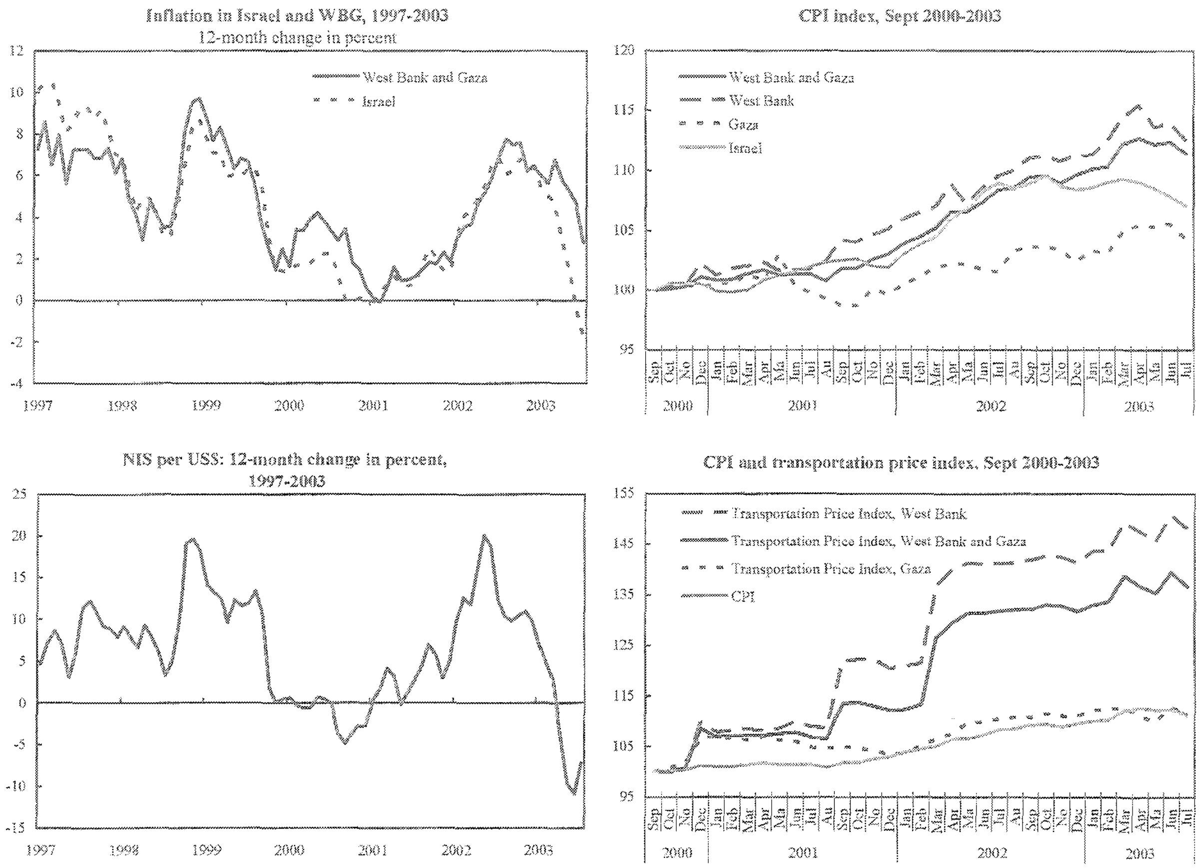
[19] One possible explanation for the relative stability of average real wages would be that employment in low-wage sectors has declined more than proportionately, which would bias the average wage upward. However, this does not seem to be the case. The construction sector, for example, which pays above average wages, has suffered the sharpest decline in employment. Overall, estimates of such sectoral composition effects suggest that they are quantitatively negligible. However, this does not rule out possible composition effects within sectors, e.g. due to a more than proportionate loss of low-wage jobs within each sector.

[20] The West Bank and Gaza does not have an independent currency. Instead, three different foreign currencies are used: the New Israeli Shekel (NIS), the U.S. dollar, and the Jordanian Dinar (JD). While the U.S. dollar is the most important currency for bank deposits and credit, most prices and wages are quoted in NIS and most transactions are also settled and paid for in NIS currency. Consequently, the NIS is the appropriate currency for calculating the consumer price index (CPI) and measuring inflation. (See Chapter III) for more information on monetary issues).

[21] Data from the PCBS for the year 2000.

believed to be very high. Imports are also very large in relation to GDP: in 2000, total imports were about 77 percent of GDP. Israeli imports therefore have a very high share in the Palestinian consumption basket. Any change in Israeli prices is directly transmitted to the West Bank and Gaza through this channel.

Figure 2.5: Prices and Exchange Rate, 1997-2003



Notwithstanding the influence of imported inflation, the relative strength of the Israeli economy versus the Palestinian economy might have been expected to play a greater role in influencing prices, especially on nontraded goods. For while the Israeli economy has contracted during the Intifada period, the depth of the recession in WBG has been much greater. The influence of the relative strength of the two economies becomes apparent when the experience of Gaza is separated from that of the West Bank. In Gaza, where the recession has hit harder, inflation has indeed been much lower than in Israel since the beginning of the Intifada (Figure 2.5). In the West Bank, by contrast, inflation has actually been higher than Israel. The reason why inflation has been higher in the West Bank relates to the effect the closures have had on transportation costs. Transportation costs in WBG have risen sharply since the beginning of the Intifada (Figure 2.5). While both Gaza and the West Bank have been subject to external closures for transport to and from Israel, internal closures have been far more extensive in the West Bank by comparison to Gaza. Accordingly, transportation costs in the West Bank have been pushed much higher than in Gaza. In the West Bank this has more than offset the depressing effect of lower economic activity.

Table 2. 8: Consumer Price Developments, 1997–2003

(12-month change in percent)

	1997 Dec.	1998 Dec.	1999 Dec.	2000 Dec.	2001 Dec.	2002 Mar.	2002 Jun.	2002 Sep.	2002 Dec.	2003 Mar.	2003 Jun.
CPI	6.1	9.7	2.5	0.6	1.8	3.7	5.9	7.5	6.4	6.7	4.7
Excluding food	7.5	6.5	4.1	2.7	1.8	6.3	9.0	8.9	8.8	6.8	3.2
Food	4.1	14.5	0.2	-2.7	1.9	-0.4	1.2	5.2	2.8	6.6	7.1
Beverages and tobacco	6.9	12.1	3.6	-0.1	2.4	2.6	12.4	13.3	13.6	11.7	2.4
Textiles, clothing and footwear	15.5	4.5	0.5	0.3	-1.4	2.1	4.1	7.4	4.7	1.6	1.0
Housing	5.2	7.1	6.4	6.0	6.8	8.7	8.5	6.3	6.5	8.7	-0.5
Furniture and household goods and services	10.1	7.6	2.7	-4.2	-4.6	-0.3	1.5	5.6	5.5	2.4	0.2
Transport and communication	5.1	2.7	10.2	11.2	3.2	18.1	21.8	16.3	17.4	9.6	6.2
Education	0.6	4.3	3.5	0.1	5.6	4.3	4.0	5.6	4.7	4.0	5.6
Medical care	7.9	6.8	4.2	0.8	2.6	1.1	2.0	1.7	1.3	6.4	6.8
Recreational and cultural goods and services	7.7	4.6	-12.8	-7.5	-0.2	-1.1	1.2	0.9	1.6	3.0	2.1
Miscellaneous goods and services	4.0	11.5	2.5	2.8	2.1	2.5	3.6	4.6	5.9	7.4	3.6
Memorandum item:											
Israel CPI (12-month change) percent	7.0	8.7	1.4	0.0	1.4	4.4	6.6	6.2	6.4	4.7	-0.4

Sources: Palestinian Central Bureau of Statistics, Israel Central Bureau of Statistics, and IMF staff calculations.

E. Resilience in the Face of Conflict

The Palestinian economy has faced extraordinary challenges over the past ten years, and, as laid out in this chapter, it showed vigorous growth until the onset of the Intifada in September 2000. The very close economic ties with Israel have proved a mixed blessing. On the one hand, the Israeli labor market offered employment opportunities at relatively high wages and thus provided a substantial stream of income to WBG. Israel also represents a large and geographically close market for Palestinian exports. But at the same time, these close economic ties, very beneficial during good times, also make WBG very vulnerable in circumstances of conflict, and to the resulting restrictions imposed by the GoI.

Box 2.6. Measures of Poverty and Malnutrition in West Bank and Gaza

The large decline in income levels following the onset of the conflict obviously had a significant impact on the living conditions of Palestinian households. However, there is some controversy regarding the quantitative measures of poverty rates. The World Bank estimates that before the start of the Intifada 21 percent of the population were living below the poverty line of US$2.1 per day. That number increased to 33 percent by December 2000, 46 percent by December 2001 and 60 percent by December 2002.*(/1)* These figures are based on estimates of households' distribution of consumption expenditures.

The Palestinian Central Bureau of Statistics (PCBS), on the other hand, provides measures of poverty rates based on households' reported income levels. They started periodic surveys of the economic condition of Palestinian households in early 2001.*(/2)* The most recent 5th round was conducted in April and May 2003 and indicates a poverty rate of 63 percent using a poverty line of about US$3 per day. While no poverty rates from this source are available prior to the Intifada, the survey indicates that almost 50 percent of households lost more than 50 percent of their usual income during the Intifada, which is a drastic decline by any measure. The measurement of poverty rates based on income, however, is problematic because it disregards households' ability to maintain higher consumption levels through the use of savings, the sale of assets, borrowing, but also support from extended family members, both from within the WBG and abroad. These factors are believed to have played a particularly important role since the beginning of the Intifada in the WBG. Unfortunately, no survey results based on actual consumption levels are currently available.

One of the gravest consequence of high poverty rates is malnutrition. The World Bank estimates that per capita real food consumption has declined by 25 percent between 1998 and end 2002. The PCBS's survey results also indicate that the majority of households have reduced the quantity and almost all households have reduced the quality of their food consumption. As a result of this, malnutrition rates have increased. The PCBS nutrition survey finds a significant increase in both acute and chronic malnutrition between 2000 and 2002, but the precise numbers are subject to some controversy. A study from Johns Hopkins University and Al Quds University (with support from USAID through CARE International) conducted in August 2002 finds alarmingly high rates of malnutrition, especially in Gaza, comparable to many African countries. The PCBS Nutrition Survey on the other hand shows much lower rates, with the largest discrepancy in Gaza. The exact source of the discrepancy is unclear but it is an important issue for assessing the need and effectiveness of food-aid and other humanitarian assistance.

1/ See World Bank (2003): "Twenty-Seven Months – Intifada, Closures and Palestinian Economic Crisis: An Assessment."

2/ See PCBS (2003): "Impact of the Israeli Measures on the Economic Conditions of Palestinian Households (5th Round: April-May, 2003)."

This vulnerability has been very evident since the onset of the Intifada: many Palestinians have lost access to their jobs in Israel, the export of goods has become increasingly difficult because of closures, the transfer of clearance revenues from Israel was suspended which led to a budgetary crisis and the accumulation of arrears to the private sector, and finally widespread curfews, severe restrictions on internal movement, and physical destruction further aggravated the economic situation.

It is not surprising that the Palestinian economy has experienced a major contraction (estimated at about 31 percent cumulatively since 1999). But given the circumstances, one might wonder why the contraction has not been even steeper. For despite all the pressures and difficulties, more than two thirds of the Palestinian labor force remain employed, the banking system is still operating, and the Palestinian Authority has continued to provide essential services in education and health and pay the wages of its civil servants. And even while the restrictions remain in place, there are signs that the economy has stabilized.

How has this resilience been possible? On an individual level, Palestinians have resorted to diverse coping mechanisms. This includes reducing consumption, selling assets (e.g. gold jewelry), the sharing of resources within extended families and local communities including credit within local communities and transfers from relatives abroad.[22] On a macroeconomic level, however, the resilience is primarily the result of the involvement of the international community and to the substantial external assistance provided to WBG. Donor aid is estimated to have doubled since the beginning of the Intifada, with much of that increase in form of direct budgetary assistance to the PA. This allowed the PA to continue its operations, pay wages, and limit the accumulation of arrears to the private sector. The salaries paid to PA employees certainly had a stabilizing effect on aggregate income and demand. Additionally, donors have provided substantial humanitarian assistance, and thus cushioned some of social impact of the crisis. Equally important, however, has been private external assistance, mostly in form of remittances from family members abroad, but also through NGOs and charities. These private flows have helped offset some of the loss of income from workers in Israel, while at the same time stabilizing the level of deposits in the banking system.

In this context, Israel's resumption of the transfer of clearance revenues owed to the PA at the end of 2002 has also thrown an important lifeline to the Palestinian economy, and at a crucial time, as they have coincided with an evident weakening of donor assistance in 2003. This action should be seen as an important milestone on the road to peace.

But notwithstanding all these factors, the Palestinian economy remains highly vulnerable. The conflict could intensify, donor assistance could weaken further and private transfers

[22] For a detailed account of various coping mechanisms of Palestinian households supported by anecdotal evidence see: Pål Sletten and Jon Pedersen, *Coping with Conflict: Palestinian Communities Two Years Into the Intifada*, FAFO report 408.

could dry up. Moreover, it is unclear how long businesses and the banking system will be able to endure the current conditions.

Much therefore depends on the achievement of a lasting peace. If progress can be made toward the implementation of the Roadmap, economic conditions in WBG can only improve. But the speed and the scale of the recovery will be very uncertain. It will depend primarily on the degree to which restrictions on the movement of people and goods are relaxed, progress in the reform of Palestinian institutions, confidence of investors that conditions will improve, and finally continued assistance from donors is also essential. But most importantly, it will depend on the speed at which the road map can be implemented and on many crucial decisions regarding the status of WBG and its relations with important neighbors, especially Israel.

III. The Palestinian Financial System: Withstanding the Recession[23]

A. Introduction

Over the past ten years, the Palestinian financial system has been subjected to the most extreme of stresses—with rapid economic growth and heady optimism in the mid to late 1990s followed by an abrupt and severe economic downturn in the wake of the onset of the Intifada at the end of September 2000. In such circumstances, one would have grounds for expecting the Palestinian financial system to have been strained to the limit, and possibly beyond. But despite the decline in the economy, despite the dire situation of resident depositors and borrowers, and despite the logistical difficulties faced by the regulatory and supervision authorities, the Palestinian financial system remains upright, functioning and liquid. This chapter seeks to shed some light on the reasons behind this impressive resilience. It explores the evolution and composition of available financial aggregates such as bank deposits, credit to the private sector, as well as other indicators of banking activity. It also considers changes in the regulatory environment. And it tracks the performance of the nascent Palestinian Securities Exchange during this turbulent period.

B. The Banking and Financial System

The banking system in the West Bank and Gaza (WBG) is comprised of 9 domestic banks and 13 resident branches of foreign banks (mostly headquartered in Jordan and Egypt). The branches of three Jordanian banks operating in WBG (Arab Bank, Cairo-Amman Bank and Bank of Jordan) accounted for more than 68 percent of total WBG deposits in June 2002. Banks take deposits and lend in three main currencies (sheqel, Jordanian dinar, and the U.S. dollar). The system is supervised and regulated by the Palestinian Monetary Authority (PMA), founded in 1994 for this purpose. In addition, there is a Palestinian Securities Exchange, based in Nablus, under which stocks and shares may be traded. This exchange is currently supervised by the Ministry of Finance, but will soon be supervised by a new Capital Markets Authority (pending legislation to put such an institution into being).

(i) Post Oslo—the years of growth: 1994–1999

The years following the Oslo accord were initially ones of rapid economic growth. Between 1994 and 1999, the economy grew every year and by a robust average of 8.3 percent per annum (see Chapter II). This growth was mirrored by an even more rapid expansion of the balance sheet of banks operating in the WBG. By September 2000, on the eve of the Intifada, the consolidated balance sheet of commercial banks in WBG was more than double the level of end–1996, after a compound growth rate of 23 percent per annum (Table 3.1) in the interim. During this same period, the stock of outstanding domestic bank loans trebled. Despite this increase in credit, however, the share of credit in the balance sheets of banks was

[23] Prepared by Samya Beidas and Adam Bennett.

still only 31 percent in September 2000. One third of the increase in credit, moreover, was in loans to the Palestinian Authority. It does not seem, therefore, that credit was the driving force behind the economy. Nor was it driving the balance sheet of banks.

Table 3.1 West Bank and Gaza: Consolidated Accounts of the Deposit Money Banks

In millions of U.S. dollars. Balances at the end of the period.

	1996 Dec	1997 Dec	1998 Dec	1999 Dec	2000 Sep	2000 Dec	2001 Dec	2002 Dec	2003 Mar	2003 Jun
Assets	2200	2907	3332	3853	4809	4581	4413	4260	4289	4636
Reserves (with the PMA)	177	248	271	336	398	384	346	357	362	452
Foreign Assets	1394	1641	1777	2161	2452	2347	2373	2516	2522	2548
Domestic Loans and Other Claims	436	632	822	1011	1504	1344	1229	1004	987	1029
Claims on Government 1/	19	58	82	92	404	329	306	138	159	160
Claims on Nonfin. Pub. Enterp.	9	10	7	6	26	88	63	7	29	21
Claims on Private Sector	409	563	733	913	1074	927	860	859	799	848
Loans	128	191	299	402	474	416	378	353	346	333
Overdraft	252	324	381	453	519	429	421	424	371	424
Other claims	29	48	54	57	82	82	61	82	82	90
Unclassified Assets	193	386	462	346	455	507	465	383	418	607
Liabilities	2200	2907	3332	3853	4809	4581	4413	4260	4289	4636
Total domestic deposits	1707	2066	2386	2828	3677	3457	3339	3269	3363	3512
Private sector deposits	1501	1815	2211	2611	3497	3261	3150	2974	3051	3204
Demand deposits	485	542	600	669	860	795	746	746	815	929
Savings deposits	241	281	311	375	466	462	494	532	524	562
Time deposits	775	992	1300	1567	2172	2004	1911	1696	1711	1714
PA Deposits	62	176	136	157	107	120	117	191	199	183
Other public sector 1/	144	75	38	60	72	76	72	104	113	124
Foreign Liabilities	105	266	290	373	349	310	303	222	130	112
PMA Deposits	100	125	98	143	129	119	88	105	91	90
Capital accounts	144	228	265	305	333	343	369	383	412	426
Unclassified liabilities	143	221	294	204	321	352	313	282	292	496

Source: Palestine Monetary Authority (PMA)
1/ Includes local government

Between 1996 and September 2000, private bank deposits grew by 133 percent, or by an absolute amount of nearly US$2 billion. This was double the absolute increase in bank loans during the same period. Where were these deposits coming from? An increase in deposits on this scale could not have resulted from the multiplier effect of the increase in bank lending alone. Instead it emanated from a large scale transfer of deposits held abroad to bank accounts in WBG, reflecting the new found confidence that followed the Oslo accord and the willingness of businessmen to repatriate monies to help finance their growing businesses. In addition, with growing confidence in the banking system, households may also have repatriated family money from abroad and banked cash holdings previously held in safes or under the mattress. The scale of the infusion of deposits was such that only one third could be deployed in new bank loans. The rest were re-deposited overseas by the banks. Banks' foreign assets increased by over US$1 billion between 1996 and September, reaching US$2.5 billion, or over half the balance sheet.

By September 2000, the WBG was, at least on the deposit side, well-banked: the ratio of private bank deposits to GDP in 1999 was 58 percent, one of the highest ratios in the region (Figure 3.1, Panels 1 and 2). The speed with which this had occurred was remarkable. In 1996, the ratio of deposits to GDP was only 41 percent and in 1994, one year after the process started, it was only 17 percent.[24] But this high ratio of deposits to GDP in 1999 greatly overstated the role of the banking system in the economy at the time: notwithstanding the rapid expansion of credit, the ratio of bank loans (claims) to GDP in 1999 remained comparatively low, at 20 percent.

Why was bank lending so low? Despite the improvement in confidence and the robust growth rates recorded during 1996–99, commercial lending in WBG was still a highly risky proposition. Peace was still not secure and businesses were still feeling their way around the new commercial opportunities post-Oslo. The legal and institutional environment was also very unsatisfactory: with limited land and real estate registration, there was little available for collateral, and the court system for supporting commercial claims was shaky at best. In these circumstances it was not surprising, and indeed creditable, that banks operated a fairly cautious lending policy.[25] The low rate of intermediation nonetheless attracted the attention of the newly established Palestinian Monetary Authority (PMA), which was concerned that they were insufficiently engaged in the new Palestinian economy. In 1998, the PMA introduced guidelines for banks stipulating that banks should on lend at least 30 percent of deposits and that foreign assets should not exceed 90 percent of total assets. In 1999, these ratios were adjusted further to 40 percent and 65 percent respectively. These ratios were not enforced by the PMA and it was not long before the conservative lending strategy of banks was to prove to have been justified.

(ii) The Intifada and the recession: 2000–2002

With the onset of the Intifada, GDP went into steep decline. As the closures and curfews went into effect, many businesses found their markets cut off, their labor unable to show up for work, and their supplies inaccessible. In such circumstances, it is not surprising that businesses in debt to banks found it difficult to service their loans. The proportion of nonperforming loans in the banks' total loan portfolio rose from some 8 percent just prior to the onset of the Intifada to 11 percent by the end of 2000. By the end of 2001, the ratio had climbed to 14 percent, and by the end of 2002, it had reached 29 percent. Banks reacted to

---

[24] See Alonso Gamo et al (1999) for a discussion of banking and monetary developments during the period 1994–1998.

[25] This caution was also reflected in the average maturity of bank loans—nearly half of all loans were in the form of callable overdrafts, and most other loans were very short term.

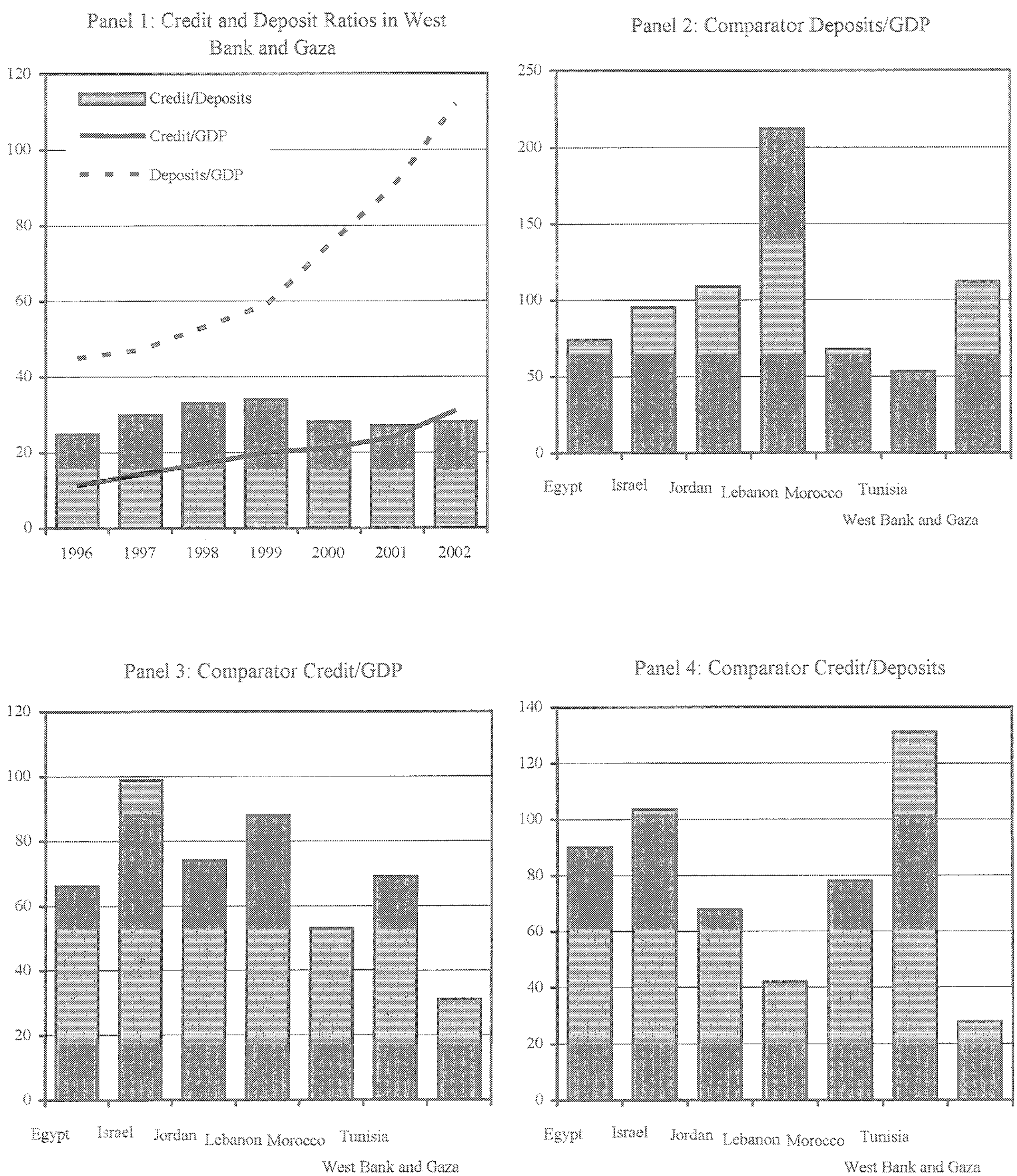
these developments by becoming even more cautious in their lending policy. Their outstanding bank loans shrank, as banks collected what they could and largely froze new lending. But with bank loans (and overdrafts) comprising only 31 percent of their balance sheet in September 2000, an increase in nonperforming loans to as high as 29 percent would have represented a proportion of nonperforming assets as a whole of only 9 percent. This was manageable. Furthermore, with half of the balance sheet in foreign assets, the banks were still highly liquid. This is not to say that banks were immune to the conflict—their income stream was adversely affected not only by provisioning requirements and nonperforming loans, but also by much higher transaction, transportation and insurance costs. The PMA required them to raise their vault cash holdings from 4 percent to 6 percent, which raise the opportunity cost of funds. Many banks also had to provide accommodation for their employees during closures and curfews.

On the deposit side, there was a fairly sharp drop immediately following the onset of the Intifada, mainly reflected in withdrawals from time deposits (Figure 3.2, panel 1). After that, although the total of deposits declined further, the rate of decline was modest, and by the end of 2002, total deposits were still 14 percent higher than the level prevailing at end-1999 (prior to the Intifada). Given the dire circumstances of many depositors (see Chapter II), the relative stability of deposits is both remarkable and surprising. To a large extent, it reflected the population's confidence in its banking system. This was helped by a proactive response to closures and curfews (spearheaded by Arab Bank): whenever curfews would be lifted, even if only for a few hours, the banks would open to provide ready customer access to deposits, even on holidays. Banks would also provide salary advances to employees of the Palestinian Authority or firms for which they managed the payroll, when salary transfers could not be readily effected.

It is notable, however, that there were some differences in the behavior of deposits in Gaza by comparison to the West Bank (Figure 3.2, panel 2). The whole of the decline in deposits since the onset of the Intifada is accounted for by residents of Gaza. In the West Bank, deposits actually increased slightly during this period. This may reflect the fact that residents of Gaza tend to be poorer than those of the West Bank (as the relative levels of deposits would indicate), with fewer alternative assets (real estate, jewelry) to sell to maintain their living standards. They also have fewer connections with the Palestinian expatriate community. The latter have been very important in supporting Palestinians, and especially in the West Bank, through financial transfers from abroad.

Residents of the West Bank have strong family ties with (often skilled) migrant labor abroad (Gulf countries, Jordan and some industrial countries) and thus have received significant remittances as a share of disposable income. This is likely to have been an important factor behind the strength of the West Bank deposit base. Migrant labor from Gaza, by contrast, has tended to be predominately unskilled workers going to Israeli (on a daily basis) bringing

Figure 3.1 Credit and Deposit Ratios
(End 2002; in percent)



Sources: Palestinian Monetary Authority; and IMF country desk data and staff estimates. Credit and deposit data refer to outstanding balances at the end of the period.

home relatively low wages and subject to border closures. There is little hard data on remittances, but two proxies are available: total net transfers to the private sector as reported in the balance of payments (prepared by the Palestinian Central Bureau for Statistics) and transfers to households recorded by the Arab Bank and the Bank of Jordan. According to the balance of payments data, net transfers to the private sector as a whole grew from US$114 million in 1997 to US$948 million in 2001. The data from both the Arab Bank and the Bank of Jordan also show a significant rise in transfers to households. These proxies are unavailable broken down for each of the West Bank and Gaza, but bankers confirm that transfers effected through the banks are mostly destined to the West Bank. This suggests that the expatriate community have sought to cushion the effect of the economic decline on residents by stepping up their transfers since the Intifada, and this in turn explains why the dire economic circumstances that Palestinians found themselves in did not lead to drastic withdrawals of savings from banks.

Another factor in explaining the strength of smaller deposits in the West Bank may have been an increase in the perceived risk of cash holdings in circumstances of frequent house to house searches and incursions by the Israeli Defense Force, which were more widespread in the West Bank than in Gaza. This may have induced residents to reduce their cash holdings to a minimum and place surplus cash into bank accounts during the Intifada. The typical size of deposit for most of the Palestinian banks and smaller foreign banks is quite small (in the region of US$1,500 according to informal estimates). Cash holdings ("under the mattress") could well have exceeded these amounts in some cases, so that their transfer to banks might explain the stability of such small deposits. This theory is less convincing for large deposits. The average size of deposit in the biggest foreign bank (Arab Bank) is very much larger than those of other banks.[26] These large deposits would usually be held by wealthy businessmen or individuals. For such depositors, cash holdings are unlikely to have been very large in the first place. But their experience of the economic hardships that accompanied the Intifada would also have been different from other Palestinians.

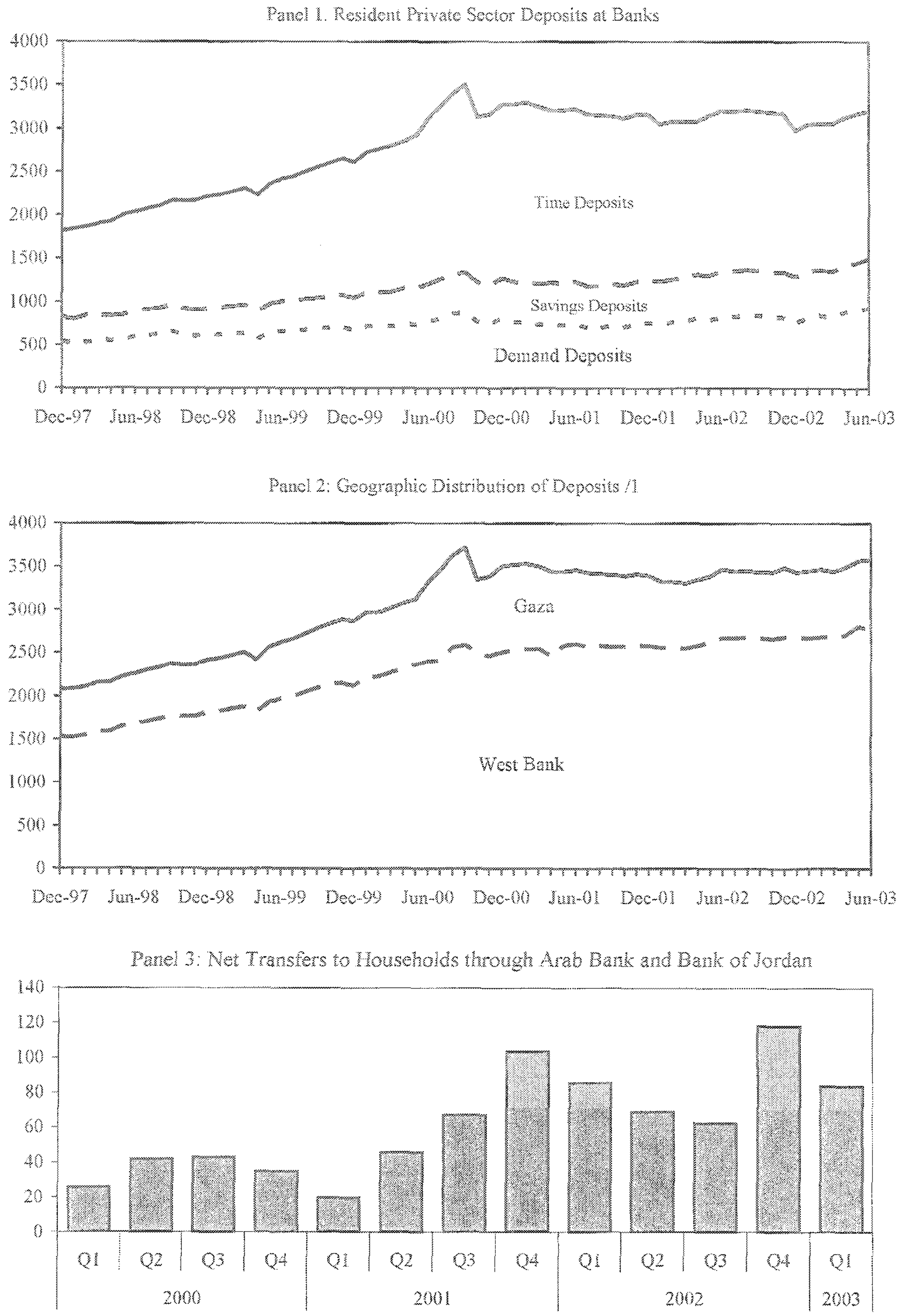
Although the banks operate in three main currencies, by far the largest share of currency denomination, in both deposits and lending, is in terms of U.S. dollars (Figure 3.3). The trend toward the dollar has been mostly at the expense of the Jordanian dinar and began soon after the Oslo accord[27]. By 1998, more than 60 percent of deposits were denominated in U.S. dollars, with about 24 percent in Jordanian dinars and 14 percent in Israeli sheqel. This ratio has since remained fairly stable, and seemingly unaffected by the onset of the Intifada. The

---

[26] Time deposits represent two thirds of Arab Bank's deposit base. These deposits have a minimum size of US$10,000. Half of its total time deposits, by value, is represented by individual deposits of more than US$50,000.

[27] The Jordanian dinar devaluations in 1989–1991 and subsequent perceived risk of further devaluations were cited as the main reason for this shift.

Figure 3.2 West Bank and Gaza: Deposits and Transfers, 1997–2003
(In millions of U.S. Dollars)



Source: Palestine Monetary Authority (PMA), Arab Bank, Bank of Jordan.
1/ includes all private sector, all public sector and non-resident deposits, but excludes domestic and foreign interbank deposits and deposits from the PMA.

share of dollars in bank loans, by contrast, has continued to increase. Such (limited) new borrowing that has taken place tends to be in U.S. dollars to take advantage of the low interest rates (which are much lower than those applicable for Jordanian dinar or Israeli sheqel). With the decline in business transactions with Israel following the Intifada, borrowing in sheqel has declined. While 68 percent of bank lending is now denominated in U.S. dollars, the ratio for loans is much higher than for overdrafts.

The dominance of the U.S. dollar in bank deposits and bank lending reflects its increasing importance as the currency of denomination for a wide range of transactions, not least international aid flows, as well as bank credit transactions for durable goods and rents. It also reflects its role as the growing currency of choice as a store of value. However, while U.S. dollar, Israeli sheqel and Jordanian dinar banknotes are all legal tender in WBG, the majority of cash transactions are conducted in Israeli sheqel. In the past the Jordanian dinar was the dominant currency for historical reasons, but this importance has declined in the last decade. The sheqel is used extensively for cash and check transactions because of the close interaction between the Palestinian and Israeli economies, whereby most imports come from Israel and most Palestinian exports go to Israel, and a significant proportion of the labor force works in Israel and receives wages in sheqalim. Moreover, most consumer products are priced in sheqalim. The Israeli sheqel is also the main currency for fiscal transactions: customs and value added taxes which clear from Israel, otherwise known as clearance revenues, are a quarter of budget revenue and are in sheqalim, as are all elements of the PA's budget (except international donor support).

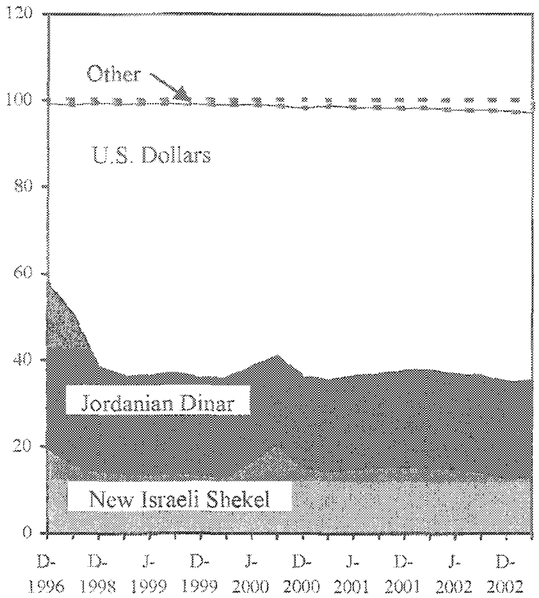
Although the banking system remains highly concentrated and dominated by the branches of foreign banks, there has been some decline in their share in the last five years. In 1998, the share of the three largest Jordanian banks in total deposits was 80 percent. By June 2002, this had declined to 58 percent. Similarly, these banks accounted for 80 percent of outstanding bank loans in 1998, but by mid-2002 this had fallen to only 42 percent. The picture was similar for overdrafts; again with these banks accounting for only 53 percent of total overdrafts at end June 2002. This no doubt reflects more attractive lending opportunities available to Jordanian banks outside WBG, as well as possibly a less conservative lending policy on the part of the small but growing Palestinian banks. It also may reflect more risk taking by Palestinian banks, and reported lower lending by Jordanian banks to the PA in 2002.

(iii) Signs of recovery: 2003

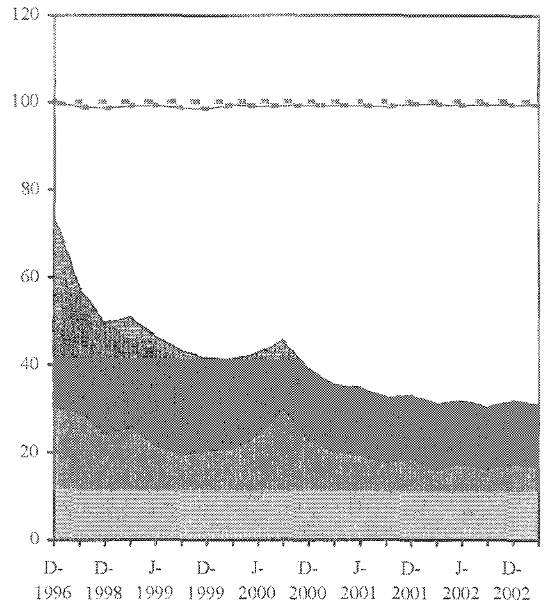
Although the decline in economic activity during 2001 and 2002 was steep, there were signs by the end of 2002 that the Palestinian economy was stabilizing (see Chapter II). The publication of the "Roadmap" toward a peace agreement between the Israelis and Palestinians in April 2003 (see Chapter VI) also served to restore a degree of confidence among Palestinians and in the business community—confidence that had been entirely lacking over the preceding two and a half years. Bankers and businessmen confirm that conditions have

Figure 3.3. West Bank and Gaza Currency Decomposition, 1998-2003
(In percent of total)

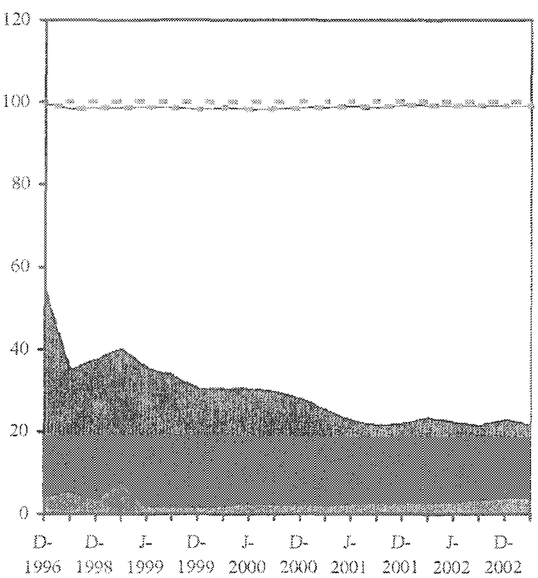
Panel 1: Currency Composition of Deposits with Commercial Banks 1/



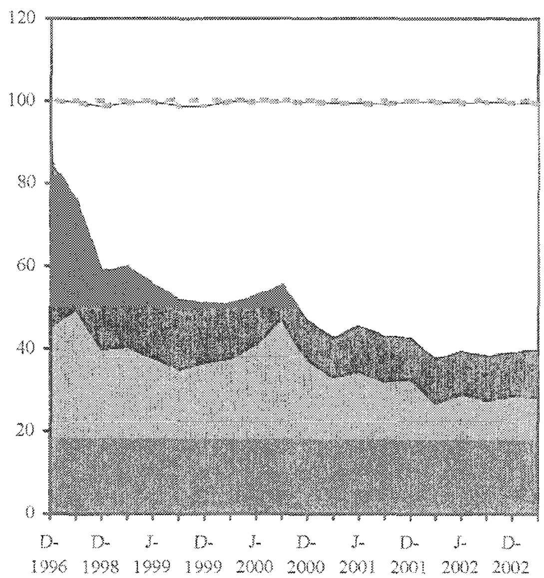
Panel 2: Currency Composition of Commercial Banks' Lending (Total loans and overdraft)



Panel 2a: Currency Composition of Commercial Banks' Loans



Panel 2b: Currency Composition of Commercial Banks' Overdraft



Source: PMA
1/ Residents Only

improved, but they also stress that the situation remains very fragile. Private sector deposits have risen steadily so far in 2003 from the low point reached at the end of the year, and are now at their highest level since December 2000. It is also notable that in the second quarter of 2003, there was a small but significant recovery in bank lending. This is all consistent with a rise in indirect tax revenues in 2003 confirming some degree of recovery. The rise in credit therefore appears to have been spontaneous, and unrelated to the PMA's rule requiring banks to on lend domestically a minimum of 35 percent of deposits (see above). This rule was introduced in 1998 but not enforced owing to the acknowledged riskiness of lending during the Intifada. With the apparently improved conditions during the spring of 2003, the PMA has felt emboldened to apply more pressure on the application of this rule. Nonperforming loans have also dropped slightly, suggesting that businesses have been able, at the margin, to resume servicing some of their debts.

C. The Palestinian Monetary Authority

The Palestinian Monetary Authority (PMA) was established in 1994, with its responsibilities and limitations delineated in the 1994 protocol on Economic Relations. These include licensing, regulating and supervising banks operating in the West Bank Gaza in accordance with "Basle Core Principles." The protocol provides that the sheqel should be one of the circulating currencies, and that required reserves on sheqel should be in line with those in Israel. The Banking Law of 1997 (and revision in 2002) provides the PMA broad authority over the means for achieving these objectives, and designates the PMA as an independent entity. Although the PMA has many of the powers and functions of a central bank, it does not issue its own currency. The control of inflation is therefore currently beyond its remit, and the PMA's existing monetary instruments (required reserves and quantitative guidelines on lending and foreign assets) offer limited scope for influencing monetary conditions in WBG.[28] Consequently, the PMA's main function is bank supervision, ensuring that the capital adequacy ratios are respected and protecting depositors. If there were to be a Palestinian state, the PMA would become the central bank, charged with monetary and exchange rate policy.

(i) Licensing, Regulation and Supervision

Since its inception, the PMA has made important progress in banking supervision arrangements. With the passage of the 1997 Banking Law, the PMA established prudential requirements for capital adequacy, liquidity, risk concentration, loan classification and provisioning, and foreign exchange exposure, which are generally consistent with the Basle

[28] See Zavadjil et al. (1998) for an analysis of the role of direct and indirect monetary instruments available to the PMA.

Box 3.1. The Palestinian Securities Exchange

The Palestinian Securities Exchange (PSE), located in Nablus in the West Bank, was set up in 1996 and conducted the first trading session in early 1997. The Exchange is a (quasi) private* stock company and is directed by an independent board with the consent of the Palestinian Authority. The ministry of finance regulates the Exchange, but this will transfer over to a Capital Markets Authority shortly. In June 2003 there were 23 companies listed, mostly in the services and light manufacturing sectors. Subscribed capital for an Exchange listing is a minimum of US$750,000 and the number of outstanding shares in excess of 100,000, with at least 250 shareholders with US$100 shares at par value, and at least 25 percent of common stock must be held by the public. All listed firms must submit annual audited reports.

Prior to the onset of violence and conflict in September 2000, the Exchange conducted two trading sessions a week. The Exchange continued to function with some limited intermissions during the height of the closures. They innovatively used local media coverage to announce trading sessions when closures where lifted for a few hours. As a result, during all but two months (April and July 2002) the exchange was able to open for at least a few trading sessions. Currently, the Exchange conducts one hour trading sessions five days a week. Trading statistics are reported continuous through the internet (www.p-s-e.com) and daily in the Jerusalem Times. Trading is fully computerized and driven by orders from licensed brokerage firms with clear rules and regulations governing their operations. Clearing and settlement occurs within three days of the trade.

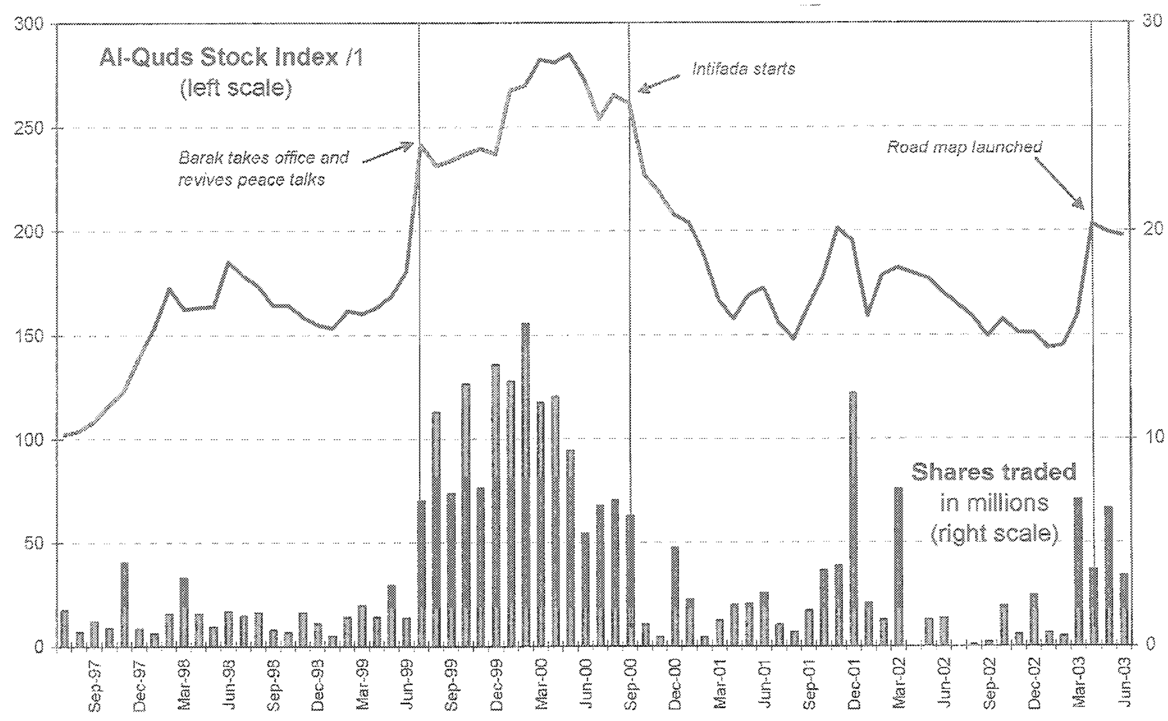
The total market capitalization is currently about US$717 million (end June 2003) after reaching a high point of US$1,011 million in May 2000 and a low of US$544 in January 2003. Market movements are reflected in the Exchanges' Al Quds index, a weighted average index of the top ten Palestinian companies, which make up 97 percent of the market.

The figure below shows the development of the index since July 1997. The index appears highly sensitive to political developments. There was a clear positive market reaction to the election of Ehud Barak as Israeli Prime Minister in May 1999 and the prospect of a resumption of peace talks. After that, the market continued to increase until the peace negotiations ended in deadlock in the summer of 2000. The onset of the Intifada on September 29, 2000 then marked the beginning of a severe decline in the market that continued for almost one year, as it became increasingly clear that the Intifada would last longer than initially anticipated. Effectively, the market remained depressed until April 2003 when, in anticipation of the road map peace initiative, stock prices rose sharply, reaching a high point when the road map was officially launched.

The trading volume of the PSE has varied significantly over the past years. The heaviest trading occurred during the 15 months prior to the Intifada. Since then, the volume was very low in the wake of the limited number of trading sessions. In March 2003, it has picked up again, but it has not yet reached the levels of 1999 and 2000. Currently, the monthly average trading volume is about US$6.9 million (March through June 2003). There is also an interesting relation between the trading volume and stock prices, as the volume has generally been high during times of high stock prices (which is clearly evident from figure below).

*Owned by PADICO, a private firm, and PalTel, a quasi-private firm.

(Box 3.1. continued)



1/ value on the last trading day of the month.

core principles for effective banking supervision. In 2002, the banking law was revised for closer alignment to Basle core principles, prepared with assistance from the IMF and approved by the Palestinian Legislative Council (parliament) in early 2003.

In the late 1990s, there was a rapid expansion in the number of banks and branches operating in the West Bank and Gaza. With its capacity to supervise these banks still limited, the PMA was initially forced to monitor regulatory compliance entirely through off-site inspections, using monthly statistics from these banks. Banks' compliance with the prudential requirements as set out in the 1997 Banking Law was fairly limited, and sanctions were not usually applied.[29] The situation improved at the end of the 1990s when the PMA hired some additional staff and began to conduct on-site inspections. The PMA has then started to more aggressively enforce its regulations in order to effectively discharge its supervisory responsibility (Box 3.2).

With the onset of the conflict in late 2000, supervision of the banking sector became very difficult. With a logistical standstill due to closures, bilateral assistance aimed at improving

[29] See Valdivieso, et al. (2001) and Alonso-Gamo, et al. (1999) for some background to the problems facing the nascent PMA and recommendations for reform in the 1990s.

on-site inspections was brought to a halt, as were the planned joint PMA-Jordanian inspection missions, with PMA inspectors limited to, at the best of times, desk off-site inspections. During this time many banks were hit by business inactivity and thus witnessed limited servicing of extended loans and overdrafts. Some smaller foreign and domestic banks suffered even further, given their nascent credit risk assessment skills, and failed to even provision. The full extent of the damage of the continuing conflict remains to be fully assessed. The PMA has recently resumed on-site inspections. The PMA has also revised the rules for provisioning and reissued the relevant circular (Box 3.3). These measures are in line with Basle standards. There has been an improvement in specific provisioning, which rose from 9.1 percent in Q2 2002 to 13.5 percent in Q1 2003.

With 22 banks and most deposits and credits concentrated within the largest five to six banks, the PMA has initiated a merger process of a number of undercapitalized smaller banks in consultation with cross border central banks and the IMF. This is expected to result in a reduction in the number of banks from 22 to 17 or 18. This consolidation should help smaller banks meet the new capital requirements imposed on foreign branches (see below) and should also help reduce the number of banks to a level more appropriate to WBG. Evidence from the region suggests that for the population size and GDP per capita, there are too many banks in WBG. The closest resemblance is Jordan, with a population of 5.5 million and GDP per capita of US$1,883, where there are 16 commercial and Islamic banks.[30] While in Egypt, with a population of 67.3 million and GDP per capita of US$1,297, there are 28 commercial banks.[31]

(ii) Treatment of foreign branches

A number of changes have been introduced in the regulations applying to domestic branches of foreign (regarding dotation capital and required reserves) banks since the promulgation of the 2002 banking law (Box 3.3). The PMA became concerned that circumstances could arise whereby a branch of a foreign bank could fail, but the parent might refuse to cover local losses to depositors, or that the parent might fail, but choose to favor depositors with the parent at the expense of those at the (local) branch. With banks having a high ratio of overseas assets, which might be beyond the reach of the PMA in circumstances such as these, the PMA might be unable to ensure adequate compensation for local depositors.

[30] Jordan also has an additional five investment banks.

[31] The Egyptian banking sector comprises 57 banks. This number includes 28 commercial banks, of which 4 are state-owned; 26 investment banks, of which 11 are joint-venture banks and 15 are branches of foreign banks.

Box 3.2. Prudential Regulations and the 2002 Banking Law

The PMA is the agency charged with, among other duties, licensing, regulating, and supervising banks operating in the West Bank and Gaza. The 1997 Banking Law stipulated that banks were required a minimum capital of US$10 million for all normal commercial banks and US$20 million for investment and Islamic banks. A foreign bank could open a branch in the West Bank and Gaza provided it had a comfort letter from its home supervisor and that the branch had a capital endowment (otherwise known as dotation capital) of US$5 million.

Locally incorporated banks were stipulated to observe all prudential ratios; a risk-weighted capital adequacy ratio of 10 percent (cash and loans with cash collateral carry a zero risk weight while all other assets carry a 100 percent risk weight). Further, all banks are subject to a 6 percent minimum cash ratio (and each branch subject to a 4 percent minimum) and a 25 percent liquid assets ratio. Regarding risk concentration, exposure to individual debtors cannot exceed the equivalent of 10 percent of their capital base. Finally, the foreign open positions are limited to 5 percent of the capital base for each of the three currencies in circulation, and 20 percent of the capital base for all other currencies in aggregate.

Following the conflict in 2000 and the deteriorating business environment, the PMA deliberated on tightening the regulatory framework so as to best respond to the changing environment and issued the 2002 Law. It stipulates that both locally incorporated banks and foreign branches must set aside 10 percent of net annual profits to a local reserve (until this accumulation equals the capital base). Foreign branches are not allowed to transfer these reserves abroad. In addition, these reserves could be increased at times of economic hardship at the PMA's request. Further, banks must not distribute dividends without prior approval of the PMA, unless they comply with all requirements. Prior PMA permission is also required for profits transferred from foreign branches. The Law stipulates that the PMA could further tighten these requirements during crises. The PMA has the authority to request that 1 to 2 percent of profits are to be used for research and development upon instruction of guidelines.

The 2002 Law also details guidelines for both internal and external auditing of banks, data obligations to the PMA, and sets out the guidelines of on- and off-site inspections, as well as penalties, liquidations and mergers.

In the first of these, foreign banks have been requested to increase the "dotation capital" of their branches operating in the West Bank and Gaza, from US$5 million to US$20 million by mid 2004. Dotation capital is usually held locally in the form of land, property or liquid assets. In the case of WBG, banks have been asked to hold half of their dotation capital at the PMA with remuneration at market rates less a ¼ percent for administrative charges. The PMA has also offered these banks to convert to local incorporation should they prefer.

Second, should foreign banks not comply with the above, differential required reserves on all deposits would be raised from the normal 8 and 9 percent to 20 percent. These reserves would be held at the PMA and remunerated at market rates, less the ¼ percent administrative fee. They would be deducted automatically from each banks' current account with the PMA. Penalties would be applied for nonobservance, although the exact format for the penalty is unspecified. Engaging the banks through a process of extensive consultation both in Ramallah as well as in Cairo and Amman, the PMA accommodated the banks in lengthening

Box 3.3. Recently Issued or Revised Regulatory Circulars

Circular 2003/57: Capital requirements for foreign banks
For foreign banks with branches operating in the West Bank and Gaza holding deposits less than US$30 million the capital requirement is $5 million. Those in excess of $30 million have a requirement of US$20 million. Half of this capital is to be deposited at the PMA. Each branch must submit a plan to PMA of compliance by May 2003 and should show compliance with requirement by end 2003. Should these banks wish to be licensed in West Bank Gaza, as Palestinian Banks, then Palestinian or nonforeign rules will be applied.

Circular 2003/68: Required reserves for foreign banks
All deposits (in all currencies) have a new required reserve ratio of 20 percent which will be applied in June 2003 from each bank's current account at PMA. This will be subject to review. The PMA will pay market interest rates on these reserves after deducting an administrative fee of 0.25 percent. There will be a (undisclosed) penalty for noncompliance.

Circular 2001/93 – re-issued: Provisioning and collateral
General provisioning is applied against direct and indirect losses on all instruments (loans and overdrafts) including those under monitoring for nonperformance (between 30—90 days). The requirement is a minimum of 1.5 percent of loans and 0.5 percent on other instruments, including standard instruments and those under scrutiny which have a lapse of performance between 30–90 days.

Current accounts will become inactive if the interest and commissions exceed 10 percent of the account for 90 days, and /or if the holder withdrawals in excess of 10 percent for 90 days. Then the account is to be frozen, and after 90 days of maturity, it becomes nonperforming with specific provisioning applied at 100 percent.

Overdrafts must be settled within 30 days. Excess is transformed into a frozen current account and if this is unsettled within a 90 days it becomes nonperforming with specific provisioning applied at 100 percent. For loans with nonperforming interest and commission payments over 90 days, banks are required to charge this as a loss their monthly income statements on a cash basis.

Specific provisioning is applied against losses for nonperforming defined to be beyond 90 days, broken down into three categories:
(i) nonstandard loans, with lapse of performance between 91–180 days requires 20 percent provisioning;
(ii) doubtful loans, with lapse of performance between 181–360 days requires 50 percent provisioning;
(iii) loss loans, with lapse of performance over 360 days requires 100 percent provisioning.*

*The following collateral instruments are accepted against this specific provisioning requirement (for principal only) at a specified percentage:**
(i) financial paper, valued at the lowest of purchase price or market price;
(ii) real estate (with first class mortgages only) valued at market price;
(iii) gold, gems and precious stones valued monthly and internationally;
(iv) bank guarantees (with a maturity of under two years), personal guarantees over US$25,000, checks, commercial paper are not acceptable. Bank guarantees (beyond two years) are only accepted if the capital adequacy of the issuer is over 12 percent.

*Rescheduling of loss loans: once a payment of over 10 percent of principal is made, the loan becomes performing again.
**See PMA table attached to circular.

the period for compliance and in its definition of dotation capital. By mid-2003, the PMA was able to report that all the banks (with one foreign exception) were complying with the new regulation which thereby precluded the imposition of the higher reserve requirement.

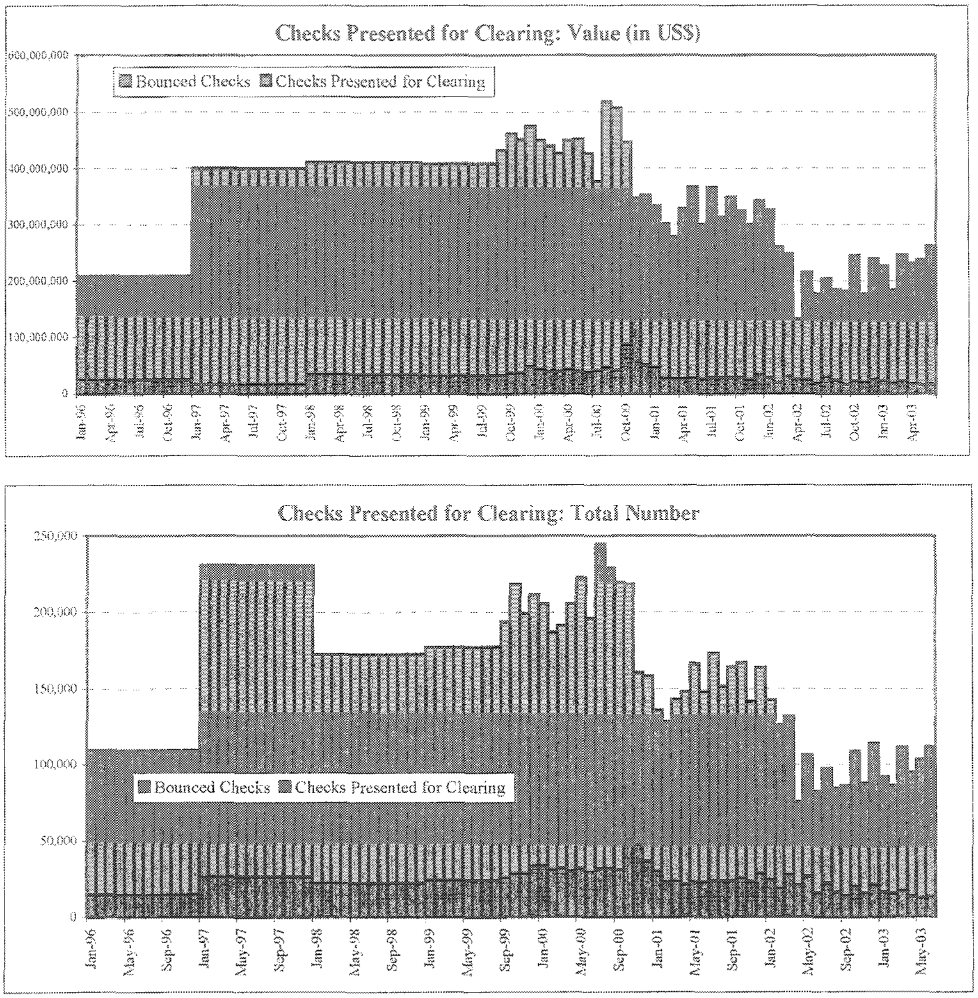
(iii) Payments system

The payment system in the West Bank and Gaza remains dominated by cash payments in shekel. Checks are the most important noncash form of payment, with the vast majority of transactions denominated in sheqalim followed by dollar and dinar. The PMA administers the clearing houses and supervises the organization of exchange of payment transactions among banks, determines the balance arising from the transactions, and settles the result. In this process, the PMA assumes the settlement risk (in interbank settlements). The unified check clearing system with Israel, established through the Paris Protocol, has so far survived the Intifada. An attempt was made by the PMA to establish a "Palestinian" check clearing system (which would entail sending Israeli checks back for collection), but it was strongly resisted by the business community.

The volume of check clearing at check clearing facilities in Ramallah and Gaza more than doubled from 109,000 checks per month (equivalent in value to US$207 million) in 1996 to 220,000 per month (US$509 million) by September 2000 and then fell back sharply following the onset of the Intifada to only 158,000 in December, 2000 (Figure 3.4). The number of checks presented reached a low point of 75,000 (US$132 million) in April 2002, coinciding with the intensification of the conflict in the West Bank at the time.

From that time on their has been a slow but steady recovery, and by June 2003, the number of checks presented for clearing had recovered to 111,000 per month (US$263 million). The proportion of bounced checks in the 1996–99 period averaged 13 percent, and then jumped immediately after the beginning of the Intifada to around 25 percent. The number of bounced checks fell back after this (although the proportion of bounced checks rose again briefly during the spring of 2002 with the drop of checks presented, reflecting the intensification of the conflict at that time). The jump in the numbers of bounced checks after the beginning of the conflict can perhaps be explained on the basis of checks being issued in good faith, but with check clearance (and positive cash flow) being severely interrupted by the unexpected effects of the Intifada. Once the Intifada became a fact of life, check issuance could be more carefully aligned with availability of funds, as before.

Figure 3.4 Evolution of check clearance



(iv) The PMA's Balance sheet

The PMA's balance sheet grew modestly overall, with more marked growth in foreign assets (Table 3.2). Apart from provisions and capital, the liabilities of the PMA comprise required reserves of the banking system, equivalent to US$370 million at end April 2003. These are 75 percent backed by foreign exchange reserves (US$284 million at end-April). The PMA's other assets mostly comprise deposits with domestic banks (or bank branches). The PMA has positive capital and reserves equivalent to 8 percent of the balance sheet.

Table 3.2. West Bank and Gaza: Balance Sheet of the PMA

(In millions of U.S. dollars. Balances at the end of the period.)

	1996 Dec	1997 Dec	1998 Dec	1999 Dec	2000 Dec	2001 Dec	2002 Dec	2003 Apr
Total assets	205	272	296	352	406	373	397	411
Balances with banks in WBG	117	139	96	146	112	97	104	108
Current accounts	2	0	4	9	6	9	3	17
Time deposits	0	139	92	138	106	88	101	91
Foreign assets	87	109	182	184	275	259	274	284
Balances with banks abroad	87	91	161	178	267	230	232	244
Current account and demand deposits	11	6	9	3	2	2	4	1
Time deposits	76	85	151	174	265	228	228	242
Foreign investments		18	21	7	8	29	42	40
Fixed assets	1	1	2	2	2	0	0	0
Other assets	1	2	2	3	2	1	1	1
Government loans and advances	0	21	14	16	14	16	18	18
Total liabilities	205	272	296	352	406	373	397	411
Deposits of banks and financial institutions	194	248	266	321	372	339	357	370
Required reserves	184	239	253	309	363	300	309	307
Other accounts	10	9	14	12	9	39	49	63
Provisions	1	1	1	1	2	0	3	3
Provision for depreciation	0	0	1	1	1	0	0	0
Other provisions	0	0	0	0	0	0	3	3
Capital and reserves	10	21	24	27	30	32	30	33
Paid-up capital	8	15	15	15	15	15	15	15
Reserves	2	6	9	12	15	17	15	18
Other liabilities	0	3	4	2	2	1	6	4

Source: Palestine Monetary Authority.

D. Conclusion

The Palestinian financial system has been subjected to major stress during the Intifada. But thanks partly to a relatively cautious lending strategy during the "good" years post-Oslo, the banking system has survived the severe recession that followed the onset of the Intifada and avoided a major collapse. Banks have continued to provide near-normal services for their customers and thereby helped Palestinians to carry on their daily lives, making deposits, withdrawing cash and even clearing checks. The Palestinian Securities Exchange has also continued to operate, notwithstanding the rather unreal circumstances of the conflict. And the Palestinian Monetary Authority is steadily building its capacity to supervise the banking system, as part of its gradual evolution toward a central bank.

IV. BUDGET UNDER CURFEW[32]

A. Introduction

After the creation of the Palestinian Authority (PA) in 1994, the most important task in the fiscal area was to secure a solid revenue base within the constraints imposed by the Oslo Accords and to establish mechanisms that would allocate resources efficiently to meet the needs of the Palestinian people, particularly for basic public services. The PA succeeded in steadily increasing revenue until 2000, largely as a result of efforts in strengthening tax administration and a well functioning revenue clearance system with Israel. It had more difficulties in managing and controlling public expenditure, especially with regard to the wage bill. The high and increasing wage bill began to crowd out other expenditures, and the PA had to rely on donors and NGOs to provide some public services and finance public investment. The PA nevertheless achieved an impressive turnaround in the current budget balance from a deficit of 4 percent of GDP in 1996 to a surplus of 1 percent in 1999.

The renewed violence, closures, and blockades at the end of September 2000 put an end to these favorable trends, and since then, the budget of the PA has been challenged by a collapse of revenues while expenditure needs have been growing due to the growing population, rising poverty and the destruction of essential infrastructure. After briefly reviewing fiscal developments prior to the Intifada, this chapter describes how the PA, assisted by the donor community, has been coping with this situation.

B. The Fiscal Situation Prior to September 2000

Revenue

In 1994, the newly constituted and recognized Palestinian Authority (PA) began for the first time to raise revenue in its own right. In the ensuing years, until the onset of the Intifada and the renewed conflict with the Israelis, the PA succeeded in steadily increasing revenue from about 8 percent of GDP in 1994 to around 21 percent by 1999, bringing the share of revenue to GDP in the West Bank and Gaza (WBG) substantially above the average for other Arab countries in the region (see Table 4.1). This was largely the result of the PA's efforts in strengthening its tax administration capabilities, the establishment of the revenue clearance system with Israel and the setting up of mechanisms to mobilize domestic tax revenue.

---

[32] Prepared by Joel Toujas-Bernaté with assistance from Christine Dieterich

Table 4.1: Bugetary Revenue of the Palestinian Authority, 1996–2002
(including revenue clearances withheld)

	1996	1997	1998	1999	2000	2001	2002
			(in millions of NIS)				
Total Revenue	2,059	2,784	3,300	3,898	3,829	2,896	2,640
Domestic Revenue	937	1,142	1,233	1,499	1,435	1,148	1,019
Tax revenue	663	734	865	1,027	982	759	640
Income tax	168	228	260	310	278	177	145
VAT	209	268	316	367	393	323	271
Customs duties	76	75	94	144	98	33	13
Property tax	3	2	2	6	6	7	4
Excises	207	162	193	199	207	219	207
Nontax revenue	274	408	368	472	452	389	378
Transportation fees	72	112	110	117	117	98	51
Health insurance	40	44	55	83	75	46	64
Health fees	30	35	39	38	40	33	27
Others	132	217	164	234	220	212	236
Revenue clearances 1/	1,122	1,642	2,067	2,400	2,395	1,749	1,621
Customs duties	226	476	780	1,030	1,013	736	740
VAT	543	709	777	844	907	708	620
Petroleum excises	303	371	406	415	371	305	260
Income tax	13	18	35	26	27	0	0
Health fees	20	28	35	36	27	0	0
Other clearances	19	40	33	49	50	0	0
			(in percent of revenue)				
Total Revenue	100	100	100	100	100	100	100
Domestic	46	41	37	38	37	40	39
Tax	32	26	26	26	26	26	24
Nontax	13	15	11	12	12	13	14
Clearances	54	59	63	62	63	60	61
Total Revenue	100	100	100	100	100	100	100
Tax	86	84	88	87	87	87	86
Direct	9	9	9	9	8	6	6
Indirect	77	75	79	78	79	80	80
VAT	37	35	33	31	34	36	34
Customs duties	15	20	26	30	29	27	29
Excises	25	19	18	16	15	18	18
Other	1	1	1	1	1	0	0
Nontax	14	16	12	13	13	13	14
			(in percent of GDP)				
Total Revenue	17.6	20.1	20.4	20.8	21.1	18.3	18.7
Tax	15.1	16.9	17.9	18.1	18.4	15.8	16.0
Direct	1.6	1.8	1.8	1.8	1.7	1.2	1.1
Indirect	13.5	15.1	16.1	16.2	16.7	14.7	15.0
VAT	6.4	7.1	6.8	6.5	7.2	6.5	6.3
Customs duties	2.6	4.0	5.4	6.3	6.1	4.9	5.3
Excises	4.4	3.8	3.7	3.3	3.2	3.3	3.3
Other	0.2	0.2	0.2	0.2	0.1	0.0	0.0
Nontax	2.5	3.2	2.5	2.8	2.8	2.5	2.7

Sources: Palestinian Authority; and IMF staff estimates.

1/ Taxes collected by the GoI on behalf of the PA minus taxes collected by the PA on behalf of the GoI.

From the first year of operation, the Government of Israel (GoI) and the PA jointly operated a unified invoice system and closely collaborated to ensure the smooth operation of the revenue clearance system[33]. This system provided a significant and stable source of revenue to the PA, equivalent to about 60 percent of the PA's total budgetary revenue, remitted on a monthly basis.[34] In parallel, early gains in domestic taxation stemmed from the implementation of a tax arrears settlement program, improvements in enforcement provisions in the legislation, recruitment of qualified staff, computerization of processing systems, and a campaign for taxpayer registration. Additional measures also enabled the PA to establish a well-functioning tax administration system within a short period of time, including the creation of a large taxpayer unit, a delinquent taxpayer unit, the implementation of a tax appeal system, the creation of an import reconciliation unit, and the establishment of a tax court. However, one factor on the revenue side that impaired the management of public finances during this period was the diversion of excise revenue on tobacco, liquor, and petroleum, as well as some nontax revenues, to off-budget activities outside the control of the Ministry of Finance, which contributed to liquidity problems and a buildup of expenditure arrears (see Chapter V). Part of it ended in April 2000 following the centralization of excise revenues at the Ministry of Finance in the context of measures taken under the medium-term Economic Policy Framework (EPF).

The structure of budgetary revenue remained broadly stable during 1996–2000 and was dominated by indirect taxes (see Figures 4.1 and 4.2). The VAT, together with customs duties and excise taxes on tobacco and petroleum, yielded almost all indirect taxation revenue, which represented about 80 percent of total revenue during the period. Within indirect taxes, however, the shares of VAT and excises declined between 1996 and 1999, while that of customs duties increased. This change in the composition of indirect taxes may have reflected improved customs administration and a shift from indirect to direct imports.[35]

---

[33] Under the Protocol on Economic Relations signed in 1994 by the PA and the Government of Israel, the two sides established a revenue clearance system to apportion an agreed pool of selected tax revenues which arise as a result of the de facto customs union and the unified VAT invoice system. The transfer of revenue from indirect taxes on Israeli-Palestinian transactions occurs after a reconciliation of accounts during monthly meetings between the two sides. On direct taxes (income taxes and health fees paid by Palestinian workers in Israel), 75–100 percent of revenues collected at source are to be transferred according to the agreement. Israel charges the PA a 3 percent service fee as the collecting agent. See Alonso-Gamo and others (1999), Box 3.1, for a more detailed description of the revenue clearance system.

[34] The only significant interruption in the settlement of revenue clearances prior to end-2000 occurred during the closures in the summer of 1997. The EU then made available to the PA a short-term credit facility aimed at preventing disruptions in its functioning.

[35] Under the revenue clearance system, Israel and the PA share customs duties on imports from third parties according to the final destination principle. For imports stated on the Israeli

(continued)

Since customs duties in WBG stem from Israeli tariffs (under the customs union) and collection, the level of customs revenue (6 percent of GDP) was, however, clearly unsustainable, as Israel has committed itself to a gradual reduction in tariffs under the WTO. This heavy reliance on indirect tax revenue is peculiar to the WBG when compared with other countries in the region (see Figure 4.3). It reflects the effectiveness of the revenue clearance system with the Government of Israel (through which most indirect taxes are collected), as well as the investment promotion law which undermined revenue collection from business profits. In addition, the present tax law includes widespread exemptions and a rather complex and inadequate system for calculating the tax base of businesses. In addition to taxes, the PA's budget has relied on a relatively large number of fees and other nontax instruments, which represented 12 percent of total revenue in 1999–2000, or about one third of revenues collected by the PA.[36] These revenue instruments mainly consist of fees levied on economic activities (e.g., transportation fees, fees collected by the ministry of supplies, stamp duties) and fees on social services (e.g., health fees and insurance, fees on housing and education).

Expenditure

Public expenditure management did not improve as much as tax administration during this period. Adequate procedures and mechanisms for expenditure control have been lacking until recently, especially with regard to the wage bill. Public sector employment increased by more than 50 percent between end-1996 and end-2000. The rise in the number of government employees that occurred in the years just after the PA was established could be justified on the basis of the PA's expanding responsibilities in providing public services and security. But the continued increase in later years went beyond this, and reflected more political pressure to alleviate unemployment and provide jobs to returning expatriates. The increase in public employment was also especially large in security services. By 1999, the share of the wage bill in total PA current expenditure had risen to about 55 percent, significantly higher than equivalent ratios in other countries in the region (see Chapter V).

---

customs declaration form as destined for the West Bank and Gaza (called direct imports), the PA receives the import tariff, VAT, and the purchase tax on imported goods. For imports that do not state the West Bank and Gaza as the final destination, the PA receives only the VAT. The PA encouraged traders to import directly, leading to an increase in the proportion of direct imports during the period.

[36] This does not include the so called solidarity tax. As noted above, some of these nontax revenues were not transferred to the budget before 2000, because line ministries collecting these fees were spending out of these collections.

Figure 4. 1
Structure of Revenues by type, 1996-2003
(including clearance revenues not transferred)
(quarterly, in million of NIS)

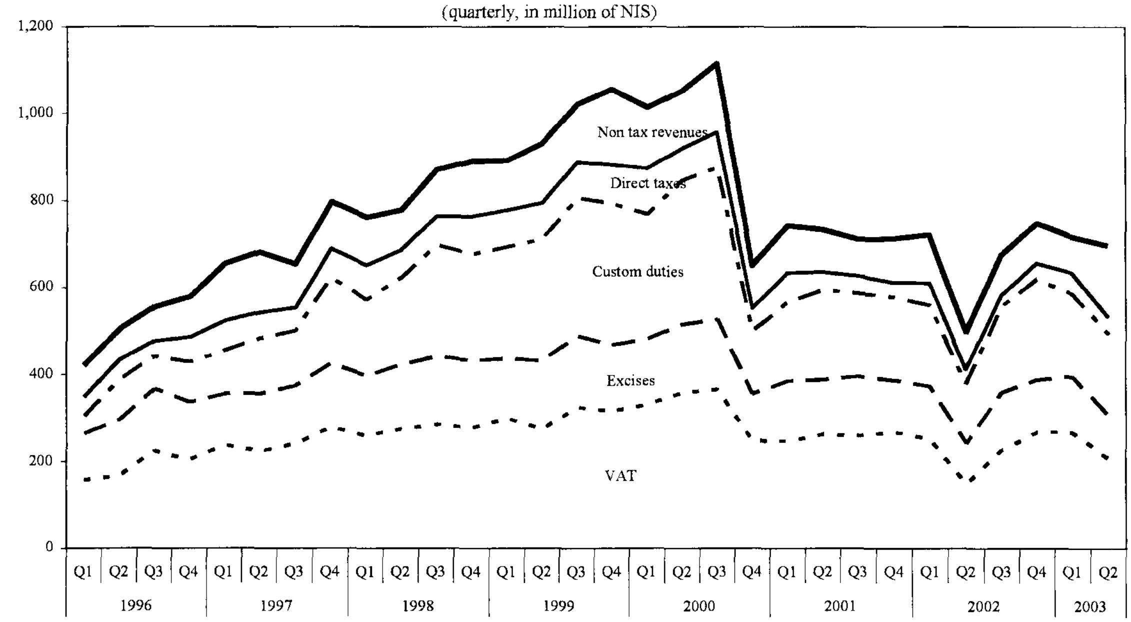


Figure 4.2
Structure of Revenue, 1996-2003
(in percent of total revenue)

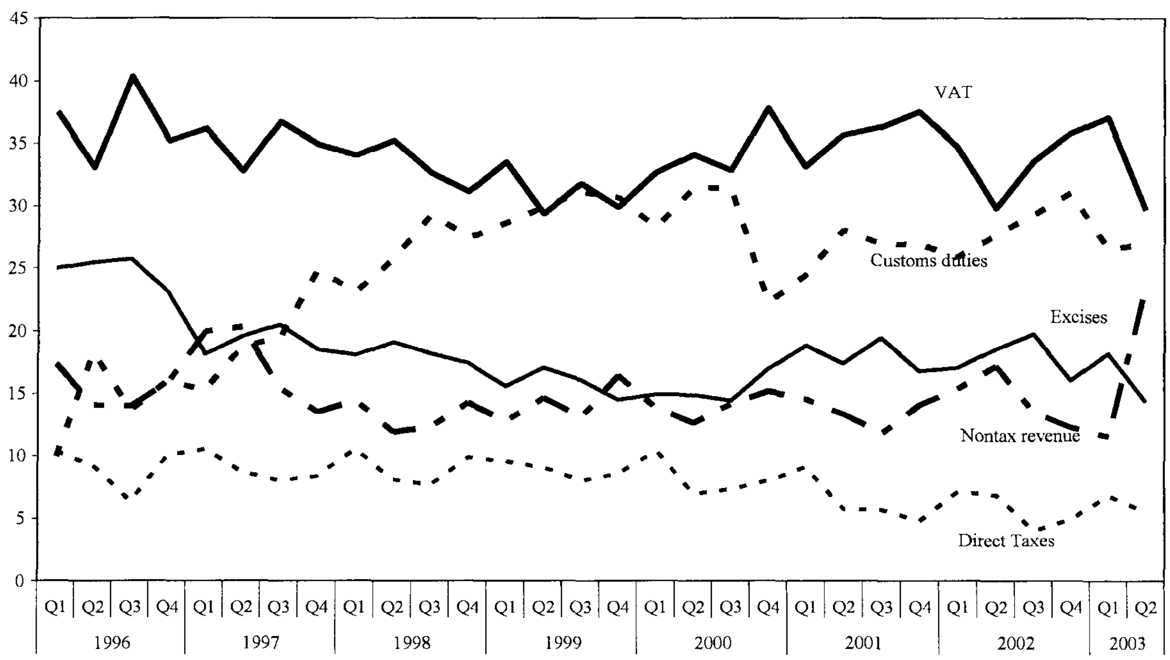
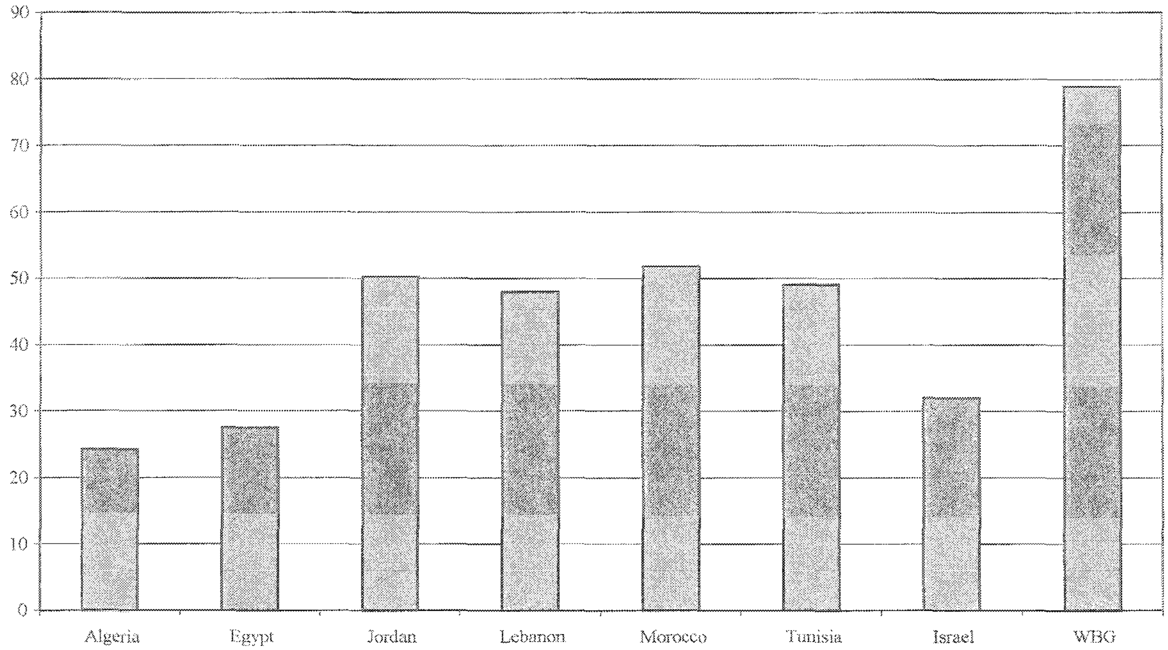


Figure 4.3
Share of Indirect Taxes in Total Revenue
(1999, in percent)



The high and increasing wage bill began to crowd out nonwage recurrent expenditure in social areas, and precluded the achievement of large current surpluses which would have enabled the PA to contribute its own resources to public investment. Nonwage expenditure increased by only 10 percent in dollar terms between 1996 and 1999. As a result, the PA had to rely on donors and NGOs to provide some public services. The health and (primary) education needs of the substantial refugee population of the WBG, for example, were (and are still) provided by UNWRA. An indication of the downward pressure on nonwage spending was provided in 2000, when the PA enjoyed a short-lived improvement in its liquidity situation (through the consolidation of tax revenue in April of that year and the transfer of an advance on purchase tax revenue from Israel in June) and recurrent nonwage expenditure jumped by 38 percent (in dollar terms).

Reflecting the squeeze on current surpluses, the entire public investment program was financed by donors until 2000. While the PA stated its intention on several occasion to start contributing its own resources to help finance capital expenditure, its first contribution was made only in 2000 and amounted to just US$13 million, compared to an estimated donor contribution of about US$255 million.[37] Despite this relatively large contribution from

---

[37] Estimates of donor-financed capital expenditure until 2000 had been based on data collected by MOPIC from donors. But these data had serious weaknesses, especially regarding the classification of disbursements from donors. MOPIC and other government

(continued)

donors, the estimated level of public investment remains too low to meet the infrastructure needs of the Palestinian economy.

Fiscal balance and financing

A major fiscal policy achievement by the PA during 1996–99 was the turnaround in the recurrent budget balance from a deficit of 4 percent of GDP in 1996 to a surplus of 1 percent of GDP in 1999 (see Table 4.2). As described above, this was made possible by enhancing revenue performance. It also prompted donors to phase-out direct budget support and redirect their aid to finance capital expenditures, until more recent events intervened. As a result, there was no external budget support in 1998 and 1999. In spite of the improvement in the financial position of the PA, however, the Ministry of Finance (MoF) continued to face a tight liquidity position because of the diversion of excise tax revenue to accounts outside its control.[38] In general, these resources were only partially transferred to the MoF on an ad hoc basis when the liquidity situation became untenable (see Chapter V). To cope with its liquidity problems, the MoF had to resort to domestic bank borrowing and arrears accumulation, mostly on nonwage expenditures. At end-1999, the stock of budgetary arrears stood at about US$80 million. At that point, the MoF had also accumulated liabilities to the banking system of an amount slightly larger than arrears, most of which was in the form of bank overdrafts.

In 2000, because of the very strong growth in recurrent expenditure and the decline in revenue in the fourth quarter, the recurrent fiscal balance is estimated to have shown a deficit equivalent to 6 percent of GDP. Despite the resumption of external budget support during the later part of the year and the centralization under MoF control of most of the previously diverted revenues in April, the scale of the deficit was such that the PA could not avoid accumulating budgetary arrears and borrowing heavily from the banking system. The sharp reversal in the financial situation of the PA in late 2000 following the Intifada and the suspension of tax revenue transfers from Israel was to plunge the PA into a financial crisis, whose worst potential consequences were only avoided by generous financial support for the PA budget from the international community.

---

agencies, together with the World Bank and the IMF, have been working to revise the donor questionnaire in order to address those weaknesses. In addition, for the purpose of integrating the current and capital budgets in the 2004 budget, the Ministry of Finance (with the assistance of the IMF) launched in July 2003 another more focused questionnaire to donors. Results of these questionnaires are not yet available.

[38] In Table 4.2 on the fiscal operations of the PA, these diverted revenues are included in total revenue, with the counterpart "diversion" shown as negative financing in the residual.

Table 4.2. West Bank and Gaza: Fiscal Operations of the Palestinian Authority
(In millions of NIS)

	1996	1997	1998	1999	2000	2001	2002
Revenue	2,059	2,784	3,300	3,898	3,829	1,148	1,361
Domestic	937	1,142	1,233	1,499	1,435	1,148	1,015
Tax	663	734	865	1,027	982	759	637
Nontax	274	408	368	472	452	389	378
Revenue clearance (excluding purchase tax advances)	1,122	1,642	2,067	2,400	2,395	0	346
o.w. withheld revenue released	0	0	0	0	0	0	210
regular transfers	1,122	1,642	2,067	2,400	2,395	0	135
Current expenditure (on a commitment basis)	2,647	2,994	3,188	3,902	4,891	4,621	4,936
Wage bill	1,286	1,622	1,774	2,147	2,537	2,862	3,124
Nonwage	1,204	1,352	1,412	1,732	2,354	1,759	1,725
Foreign financed current expenditure 1/	157	20	2	23	0	0	88
Current balance	-588	-211	111	-3	-1,062	-3,473	-3,575
Capital expenditure	773	905	896	991	55	93	43
PA financed (commitment)	0	0	0	0	55	93	43
Donor financed (commitment)	773	905	896	991	...	0	0
Overall balance (including capital expenditure)	-1,361	-1,116	-785	-994	-1,117	-3,567	-3,619
Financing	1,361	1,116	785	994	1,117	3,567	3,619
External Financing	1,197	1,043	907	1,014	221	2,238	2,214
Budget support	...	...	...	...	221	2,238	2,214
Multilateral assistance	...	...	...	...	221	2,090	2,158
Bilateral assistance	...	...	...	...	0	148	56
Project financing	...	...	...	...	...	...	...
Expenditure arrears	0	18	288	42	268	978	558
Net domestic bank financing and residual	164	55	-410	-62	627	351	846
	(in millions of US dollars)						
Revenue	645	807	868	942	939	273	287
Current expenditure	829	868	839	942	1200	1099	1042
Wages	403	470	467	519	622	681	659
Nonwages	377	392	372	418	577	418	364
Current balance	-184	-61	29	-1	-260	-826	-755
Capital expenditure	242	262	236	239	13	22	9
Overall balance	-426	-323	-207	-240	-274	-848	-764
External financing	375	302	239	245	54	532	467
	(In percent of GDP)						
Revenue	17.6	20.1	20.4	20.8	21.1	7.2	9.7
Current expenditure	22.6	21.7	19.7	20.9	27.0	29.2	35.0
Wages	11.0	11.7	11.0	11.5	14.0	18.1	22.2
Nonwages	10.3	9.8	8.7	9.3	13.0	11.1	12.2
Current balance	-5.0	-1.5	0.7	0.0	-5.9	-21.9	-25.4
Capital expenditure	6.6	6.5	5.5	5.3	0.3	0.6	0.3
Overall balance	-11.6	-8.1	-4.9	-5.3	-6.2	-22.5	-25.7
External financing	10.2	7.5	5.6	5.4	1.2	14.1	15.7
Memorandum items:							
Stock of arrears (end of period, in millions of US dollars, excl. arrears on VAT refunds)	0	5	74	84	152	361	415
PA employment (end of period, in thousands)	75,000	83,100	92,400	103,554	114,940	123,450	124,817
Nominal GDP (in millions of NIS)	11,707	13,830	16,180	18,698	18,110	15,834	14,096

Sources: Palestinian Authority; and IMF staff estimates.

1/ Refers to PA current expenditure directly financed by donors, including for job creation.

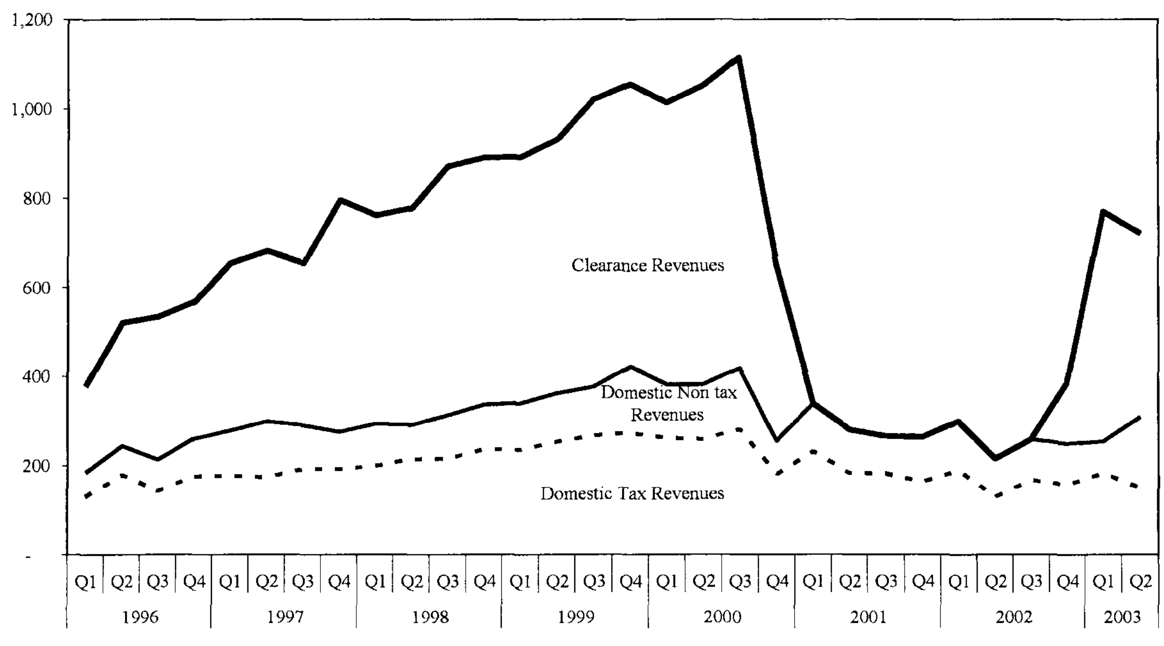
C. The Aftermath of Closures and Blockades

The closures and blockades that followed the renewed violence in the region at the end of September 2000 put an abrupt end to the generally favorable macroeconomic situation and atmosphere of relative optimism which had prevailed hitherto. As described in Chapter II, economic activity and employment declined significantly in 2001 and 2002. The consequences of the contraction of activity and incomes on the fiscal situation were very severe and were compounded by the suspension of transfers of revenue clearance by the GoI in January 2001.

Impact on revenues

The impact on fiscal revenues of the resumption of the conflict was twofold. First, underlying revenue collection declined significantly with the decrease in activity and incomes. Second, the GoI stopped transferring clearance revenues that it collected on behalf of the PA after December 2000. These two factors combined to depress the fiscal revenues actually received by the PA by 78 percent in 2001, by comparison to just prior to the Intifada (Figure 4.4).

Figure 4.4
Structure of Revenues by Origin, 1996–2003
(excluding clearance revenues withheld)
(quarterly, in million of NIS)



Tax revenue collected by both the PA and the GoI fell almost immediately after the conflict resumed. Total taxes collected in the last quarter of 2000 stood at about 38 percent lower than their pre-Intifada level, and remained broadly stable at this lower level throughout the period 2001 through 2003 (Figure 4.1). Tax revenue fell further during the second quarter of

2002 when incursions by the Israeli Defense Forces into Palestinian territories and curfews intensified. The decline in the collection of taxes was slightly greater than the estimated decrease in nominal GDP in 2001 and 2002 (Chapter II). The tax to GDP ratio stood at 16 percent in 2001–02, compared to 18 percent in 1999 and 2000. This points to a remarkable resilience of the PA tax administration in spite of all the difficulties encountered in collecting taxes, especially from the restrictions of movements for tax collectors.

Looking more closely at the developments of the various tax components, some interesting features emerge (see Table 4.3). First, taxes collected by the PA and those collected by the GoI declined on average in the same proportions in comparison with the pre-Intifada levels. However, while the decline in clearance revenue was initially more pronounced in the last quarter of 2000, their collection recovered somewhat toward the end of the period. On the other hand, tax collection by the PA has been slowly eroded over time. Second, excise taxes collected by the PA, levied mostly on tobacco, remained on average close to their pre-Intifada level, which explains why overall excises declined relatively less than other taxes.[39] Third, customs duties were the most depressed indirect taxes during the Intifada. Because of fears of likely security checks on Palestinian direct imports, Israeli importers have supplied their Palestinian counterparts from their own stock, rather than explicitly importing on their behalf. This would lead to underreporting at Israelis customs of products for which West Bank and Gaza was the final destination, therefore leading to a relatively larger leakage of customs duties from the PA's perspective. In addition, Palestinians businesses had to rely more or less wholly on Israeli intermediaries to bring products into Palestinian territories because of the restrictions of movements imposed on Palestinians. Because of the higher transaction costs, some business activity may have been discouraged beyond the effect of the weaker economy.

Income taxes sustained the most drastic decline (51 percent) reflecting lack of enforcement and inability to collect taxes because of closures, curfews and the collapse of the police force. Only 30 percent of registered taxpayers filed returns and tax arrears increased substantially.

Nontax revenue was overall slightly less affected than taxes and declined on average over the period by less than 30 percent compared with pre-Intifada levels. The composition within these revenues changed a little, with a declining share of fees levied on economic activities (e.g., transportation fees, fees collected by the ministry of supplies, stamp duties) and, in parallel, an increasing share of fees on social services. These fees on social services include health fees and insurance, and fees collected by the ministries of social affairs, housing and education. This indicates a rising burden on poorer people dependent on social services provided by the PA, which is clearly undesirable.[40]

---

[39] Excises collected by the GoI on petroleum products declined broadly in line with the reduced economic activity.

[40] Poorer people were also falling into arrears on their water and electricity bills, particularly in Gaza.

Table 4.3: Changes in Tax Collection from the pre-Intifada Levels 1/
(In percent)

	2000-Q4	2001	2002	Average
Total revenue collected	-39	-32	-38	-35
Domestic Taxes	-33	-29	-40	-35
Clearance Revenues	-40	-34	-38	-36
Direct Taxes	-41	-48	-57	-51
Indirect taxes	-37	-31	-37	-34
VAT	-28	-25	-35	-30
Customs duties	-55	-40	-42	-43
Excises	-29	-16	-25	-21
Nontax revenues	-44	-26	-28	-29

1/ Tax collection is measured in NIS. Pre-intifada levels are the averages for the period 1999Q4 - 2000Q3.

On top of the decline in underlying revenues due to depressed activity and incomes, the shortfall in revenues actually received was exacerbated by the GoI decision to stop the transfer of revenues collected by the GoI on behalf of the PA. These revenues were equivalent to almost two thirds of the PA's total revenue receipts in 1999 and 2000. They included VAT (based on a revenue clearance system) as well as customs and petroleum excises collected at the factory gate or at the time of importation at the Israeli border. In addition, health insurance and income tax deducted from the payroll of Palestinian workers in Israel were partly transferred to the PA. The last transfer effected by the GoI was on December 19, 2000, corresponding to the October clearance revenues. The GoI stopped these transfers notwithstanding its obligation to make the monthly transfers according to the Paris Protocol. The GoI justified this step on the grounds of suspicion that terrorist activities against Israel may have been supported out of the PA budget. The frozen monies were held in an account at the Bank of Israel. A total of about US$500 million in withheld clearance revenues had been accumulated by end-2002.[41] The GoI resumed the regular transfer of

[41] The gross amount was estimated to be US$734 million. But with US$45 million transfers made to the PA in the second half of 2002 and payments the GoI made out of the accumulated revenues on behalf of the PA (e.g., VAT refunds for USAID, utility bills owed to Israeli companies), the net amount was estimated to be US$535 million.

revenues in December 2002 following assurances from the PA to implement a comprehensive internal auditing reform plan for PA expenditures, as well as US political pressure.

Expenditure squeeze

Faced with such a large and sudden shortfall in revenue, and given that there was little room for increasing tax revenues through higher tax rates because of the economic slowdown and the risk of spreading poverty, the PA started reducing expenditures under an austerity plan. The initial objectives of the plan, developed in early 2001 with the assistance of IMF staff, were to prioritize expenditure to ensure that cuts were focused on less essential areas, and to secure adequate allocations to the social sectors. The PA also aimed at avoiding the accumulation of new arrears and further increases in net domestic bank borrowing. Even after this retrenchment, the budget would depend crucially on external financing for so long as the Israelis continued to withhold clearance revenues. The adjustment plan, together with measures to improve fiscal transparency, was very important for encouraging this external assistance. Satisfactory implementation of this plan became in effect a condition for the continued support from the European Union, which asked Fund staff to monitor and report on the implementation of the austerity plan.

Despite suggestions by donors, the PA precluded from the outset any cuts in the wage bill because of political constraints and the fact that wages had been subject to an additional 6½ percent solidarity tax since October 2000. The PA planned however to moderate the increase in public employment observed in previous years. In spite of a presidential order signed in August 2001 and informal instructions given by President Arafat, PA hiring did not decline to the rate envisaged in 2001, although it did slow down from the very high rate recorded the year before. Employment in the PA civil service and in the security forces in 2001 increased by some 4,000 and 3,000, respectively, bringing total PA employment to about 122,000 by the end of the year. As a result, the wage bill continued to grow by about 13 percent in New Israeli Sheqel (NIS) terms that year. The expansion of PA employment was somewhat better controlled in 2002 following the transfer of the Gaza payroll to the direct control of the MoF. This contributed to a somewhat slower growth in the wage bill of 9 percent (see Chapter V).

At the same time, nonwage expenditures were confined to strictly essential operations, and their amount was brought down in 2001 and 2002 to 1999 levels in NIS terms (a decline of 25 percent from the 2000 level). Detailed information on the composition of expenditure is limited—the budget is not available according to a functional classification—so it is difficult to assess how the nonwage expenditure cuts affected the priority sectors. To get a rough estimate about the priority sectors of spending, budget allocations of the different ministries have been sorted according to their main purpose (see Table 4.4). Budget allocations for social services have been particularly protected since 2000 with external financing and provide a fairly good picture of actual expenditures in these sectors. Based on this estimate, almost one third of the spending went into social services, including education and health. But the share of spending for transfers to the poorest household was limited. Although the

Ministry of Social Affairs succeeded in setting up a well targeted allocation mechanism for poor households[42], its budget allocation reached only 5 percent of the total budget spending. Beyond this, some support for social needs was also provided on a discretionary basis by the president's office, whose budget allocation was equivalent to 8 percent of the total budget.[43] Based on the above estimates of priority sector spending, there was a gradual shift in spending toward social services from 35 percent to 38 percent between 2001 and 2003 (particularly in the 2003 budget).

In an attempt to mitigate the impact of the crisis on the most vulnerable groups, the PA put in place several programs aimed at providing assistance to these groups, including through the provision of employment and the targeting of transfers. A number of these schemes were financed by two solidarity taxes,[44] and are specifically aimed at alleviating the impact of closures and blockade and violence. In particular, the "emergency fund solidarity tax" was earmarked to provide outlays to the unemployed (NIS 600 per person) and to job creation programs (see Box 4.1). An informal safety net also operates through the extended family networks that characterize Palestinian society, and it is widely considered that the timely payments of wages and salaries has played an important role in facilitating burden sharing among extended family members.

Because project financing by donors is not yet channeled through the PA budget, there is no comprehensive or accurate data available on public capital expenditure. It is therefore not clear how capital expenditures evolved during the Intifada. It seems, nevertheless, that project financing declined due to the escalation of the conflict and the destruction of donor financed infrastructure projects by the Israeli Defense Force (IDF). Spending was mostly limited to urgent repairs of destroyed infrastructure, particularly at the municipality level. Due to the destruction and delays in the execution of most capital projects, public infrastructure has deteriorated substantially. The World Bank estimates that around 35 percent of total infrastructure has been damaged between September 2000 and August 2002.[45]

---

[42] See "Twenty Seven Months—Intifada, Closures and Palestinian Economic Crisis, an assessment", World Bank, May 2003.

[43] This is an area where further scrutiny is warranted, see Chapter V.

[44] There were two solidarity taxes applied to PA wages until June 2003: (i) the so-called "5 percent solidarity tax," applied since 1994 on all PA workers' salaries after an exemption of 1,500 NIS; (ii) The "emergency fund solidarity tax", applied since October 2000 on all PA workers' salaries at a rate of either 7 percent (for employees whose monthly salary is less than NIS 1,500) or 10 percent (for other employees).

[45] "Twenty Seven Months—Intifada, Closures and Palestinian Economic Crisis, an assessment," World Bank, May 2003.

Table 4.4: Budget Allocations by Main Purpose, 2001–03
(in million of NIS)

	2001				2002				2003			
	Non-wage and capital expenditures	Wages and salaries	Total	*in percent* of budget total	Non-wage and capital expenditures	Wages and salaries	Total	*in percent* of budget total	Non-wage and capital expenditures	Wages and salaries	Total	*in percent* of budget total
Administration	367	160	527	12	365	172	537	12	416	178	594	11
o/w President's office	334	30	364	8	331	32	363	8	373	32	405	8
Security	293	1,160	1,453	34	279	1,313	1,592	35	299	1,385	1,684	32
o/w Police	262	1,043	1,305	30	248	1,190	1,438	31	194	1,240	1,434	27
Financial administration	363	52	415	10	360	50	410	9	613	54	667	13
Foreign affairs	16	30	46	1	14	31	45	1	31	37	68	1
Economy	37	150	187	4	33	155	188	4	43	156	199	4
Social services	457	1,026	1,483	35	523	1,113	1,636	36	765	1,127	1,892	36
Media	29	97	126	3	29	98	127	3	33	100	133	3
Other	11	41	52	1	9	41	50	1	15	42	57	1
Total	1,571	2,718	4,289	100	1,613	2,975	4,588	100	2,207	3,088	5,295	100
	1,573	2,716	4,289		1,612	2,973	4,585		2,215	3,079	5,294	

Source: Palestinian Authority.

Seeking other sources of financing

Faced with a continuous large shortfall in revenue, the PA had been actively seeking to attract external financial support in order to keep its spending budget in operation. External donors assisted the PA by providing budget support as well as technical assistance for the PA's reform process. The major donors have been the Arab countries followed by the European Union (EU).

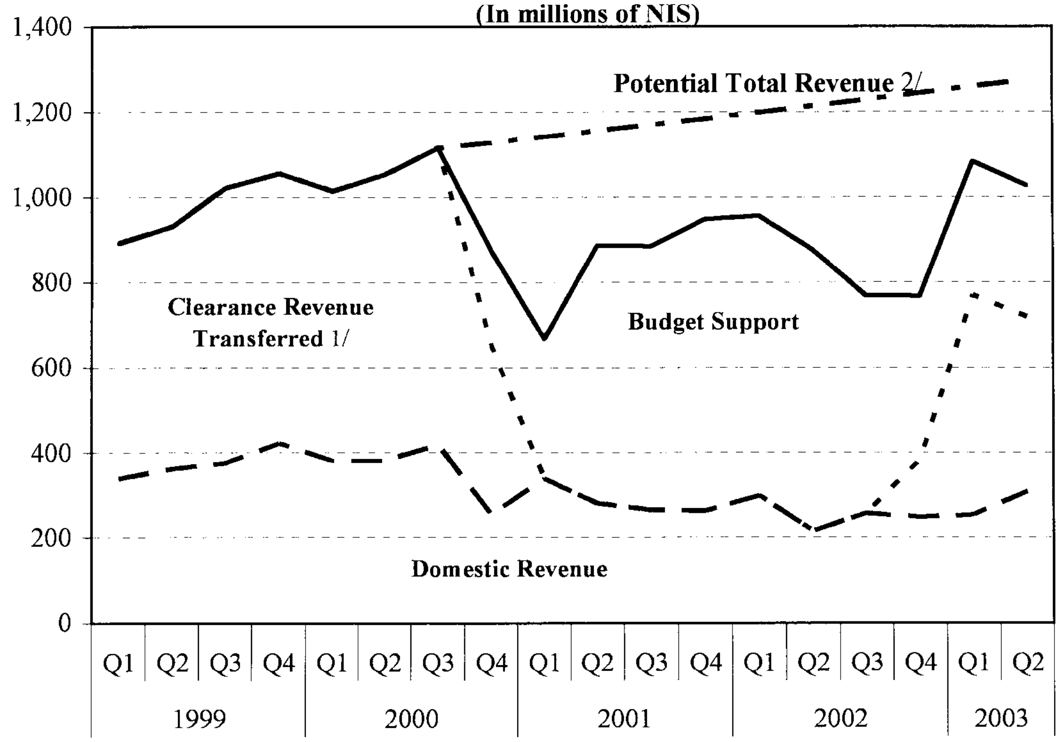
The Arab countries provided most of their support up to March 2002 in the form of loans through the Islamic Development Bank, partly by redirecting funds previously committed for project financing. Their commitment at the Cairo summit in early 2001 was for US$45 million per month, which were disbursed without any shortfall and on time. Other grants were provided by the Aqsa Fund to Palestinian communities to ensure the provision of basic services. However, Arab countries in the GCC which contributed 75 percent of the budget support funds felt that other Arab countries should contribute more. Consequently, in March 2002, at the Arab Summit in Beirut, the Arab League made a new commitment for monthly payments of US$55 million to be made directly by the donor countries. The total amount to be disbursed was distributed among the Arab League member countries in line with their shares in the Arab League budget. This, in effect, lowered the share of Gulf countries in total ex-ante contributions to be made to the PA budget from 75 percent under the IsDB mechanism to 43 percent under the new Arab League formula. Other relatively poorer members of the Arab League, which are themselves in a difficult economic position, were therefore expected to contribute significantly. However, many of these countries did not meet their target. As a result, actual monthly payments fell short of commitments by half between April and December 2002 (at US$24 million per month). Although the commitment to provide US$55 million per month was renewed in March 2003, actual disbursements from Arab donors in the first half of 2003 declined further to less than US$15 million per month.

The EU began to provide budget support right after the beginning of the closures and blockades in the last quarter of 2000. About €10 million were disbursed monthly from the (First) Special Cash Facility during October 2000-December 2001. In December 2001, a new agreement was signed between the European Commission and the PA to establish the Second Cash Facility whose purpose was to continue to help offset the revenue shortfall. Disbursements from this second cash facility amounted also to €10 million per month from January to October 2002, and were linked to conditionality on the evolution of budget expenditures, in particular employment, and several reform measures mostly related to fiscal transparency. The last two disbursements related to November and December 2002 were delayed and made only in May 2003, reflecting political pressures within the European Union parliament related to (unsubstantiated) allegations that these funds were being diverted toward financing terrorists activities.

The World Bank also set up and administered an account (ESSP) to which the Netherlands, United Kingdom, Finland, Denmark, EU and IDA have contributed. The objective of the facility is to provide sufficient nonwage spending in social areas (education, health, and transfers to the poor by the Ministry of Social Affairs). These sectors have been particularly hard hit by the accumulation of arrears. Total spending under the ESSP amounted to US$38 million through June 2003. In addition, projects were supported at the municipal level to ensure basic services like water and electricity.[46]

In sum, there was a strong response by foreign donors to the withholding of revenue transfers by the GoI. Budget support amounted to US$532 million in 2001 and US$467 million in 2002. While significant, this support was however not sufficient to fully offset the shortfall in revenue (Figure 4.5). Even if the PA had received all indirect taxes collected by the GoI in

Figure 4.5 Total Revenue and Budget Support, 1999–2003
(In millions of NIS)



1/ Excludes transfers from the accumulated stock that are earmarked for the repayment of domestic payment arrears
2/ Potential total revenue is based on an annual increase by 5 percent over the 2000 level, assuming a situation with no conflict.

2001–02, there would have been a substantial gap during this period, because of the impact of the depressed activity on revenue, which would have required budget support. To illustrate this

[46] Donor support also increased through channels outside the PA budget. In particular, UNRWA extended its support for the refugees among the Palestinian population, providing education and health services. UNRWA also supports the poorest households in the form of cash allowances and food aid.

point, one could think of the level that total revenue (including clearance revenue) would have reached if there was no Intifada and no regime of closures and blockages. Under such a scenario, total revenue would have assumed normal growth of at least 5 percent a year. As shown on Figure 4.5, the sum of revenue collected and budget support has been far below the level of potential revenue, even after transfers of clearance revenue resumed in end-2002. Therefore, the PA had to rely on additional domestic sources of financing.

The PA's primary domestic source of financing was the banking system. The PA started to rely more heavily on bank financing in late 2000 with the outbreak of the Intifada, letting the stock of bank loans rise to around US$128 million by end-2000. It continued to increase with some fluctuations until the end of 2002, when the GoI resumed its revenue transfers. By the end of 2002, net PA liabilities to the banking system had declined to US$121.0 million, mainly in the form of overdrafts. This reliance on banking sector financing has been quite expensive due to market interest rates being charged,[47] causing an increase in the interest burden for the budget (US$9 million in 2002). Public sector bank borrowing could not, however, be blamed for crowding out private credit—private credit demand was already very weak due to the difficult economic circumstances and banks were in any case extremely risk averse and thereby very liquid (see Chapter III). Far from crowding out the private sector, PA bank borrowing helped avoid an even larger accumulation of budgetary arrears to the private sector, which would have further tightened the liquidity situation of private operators who were already short of cash. Beside borrowing from the private banks, the PA also received advances from the PMA (against expected profits) of US$37 million, which were paid down to US$18 million by end-2002. The 2003 budget law now prevents the PA from further borrowing from the PMA. Because the decline in revenues was only partly offset by additional donor support and domestic bank financing, and the adjustment on the expenditure side was limited, significant arrears accumulation was inevitable. The accounting of these arrears had been complicated because the PA's treasury system defines expenditures as checks issued, but due to the MoF cash crunch, a significant number of these checks were not cashable. These obligations therefore remained unpaid, but the expenditure reporting was not able to differentiate consistently between cashed and uncashed checks. Arrears reporting to the MoF was instead generally confined to obligations due to suppliers for which no checks were issued. Following a review initiated by the MoF in mid-2002 of all line ministries unpaid obligations, the MoF estimated that arrears equivalent to US$415 million were outstanding at end-2002, including arrears to the private sector and to pension funds (see Chapter V).

D. The 2003 Budget and its Implementation

The 2003 budget was approved by the PLC on December 31, 2002. The submission of the budget was delayed until agreement was reached with the GoI that monthly tax revenues and the stock of withheld tax revenue would be transferred during the year. These assurances

[47] Banks charged around 10 percent per annum on U.S. dollars and more than 15 percent on NIS in end-2002.

provided the necessary financial viability for the budget. The 2003 budget tries to bring the fiscal situation under control by using revenues accumulated in the past for the clearance of arrears and limiting new commitments. To understand the logic behind this budget, it is useful to split the budget into two parts for illustrative reasons. The first part deals with revenues and expenditure commitments which originate in 2003, which can be called the "core budget." The second part deals with the stock of revenues collected in 2001 and 2002 but withheld by the GoI and expenditure arrears accumulated in the past.

The objective for the "core budget" is for the government to finance its new commitments without accumulating new arrears or borrowing from domestic banks, but only with regular budgetary revenues (including regular transfers of clearance revenues from the GoI) and a continuing high level of donor assistance. In that regard, the 2003 budget had the following features:

- Revenues collected by the PA were projected to decline slightly in line with conservative GDP assumptions. Regular revenue transfers from Israel were projected to resume but at only around half of the amount collected prior to the Intifada due to the effect of the economic depression.

- Expenditure commitments for wages and salaries were below the 2002 level, while nonwage commitments were increased to offset at least partly the drop in previous years.

- Compared to 2002, the composition of expenditure shifted in the 2003 budget in favor of social services (reaching 36 percent of total spending) while the share of security expenditures declined (reaching 32 percent of total spending). The shifts in the composition of the budget focused on nonwage expenditure. Given the high share of wages and salaries in current expenditure, the flexibility in budget allocations between sectors remained limited.

- Donor support was expected to reach the 2001 level which was above the 2002 outcome.

Despite these conservative assumptions, there remained major risks due to the uncertainty of the availability of donor financing. The main and optimistic assumption in the budget was that donors would transfer US$535 million in budget support, expecting that Arab League countries would transfer US$30 million per month (as opposed to their US$55 million commitment) and that the EU would maintain its monthly support of €10 million per month.. In addition, the PA's payroll bill was projected to decline due to a hiring freeze for nonpriority sectors. Overall, the deficit of the "core budget" was to be limited to around 2 percent of GDP, including capital expenditures of around 1 percent of GDP.

Beyond this core budget for 2003, the budget included a plan for return of the stock of withheld clearance revenues not yet transferred to the PA by the GoI. These revenues (the equivalent of US$480 million) were to be used entirely for clearing arrears and reducing debt with the following provisions:

- All transfers out of the stock of withheld revenues would first be used to clear domestic arrears (estimated by the Ministry of Finance at US$415 million)

- The remaining money would be used to repay US$65 million of the PA's debt with domestic banks.

The first key assumption of the 2003 budget—that Israel would resume transfers of clearance revenues—was sound. Starting in December 2002, the Israelis resumed regular monthly revenue transfers. In fact, the outcome was even better than expected: regular clearance revenue transfers during the first five months of 2003 were about US$6 million higher than forecast. Domestic revenues collected by the PA was lower than the budget expectation by US$1.5 million a month, but domestic receipts benefited from a one-time transfer to the budget from the PA's commercial activities (PIF) of US$16 million in April. Overall, therefore, revenue collection was better than budgeted in the first five months of 2003.

The second key assumption, that external budget support would come through on the scale envisaged, proved too optimistic. Budget support from Arab donors amounted to less than US$15 million per month compared to the expected US$30 million. The European Union, originally assumed to continue contributing €10 million a month, had to temporarily cut its support due to pressure from its parliament related to (unsubstantiated) concerns that PA budget resources may have been involved in financing terrorism. In the event, only €18 million, held over from the previous year, was paid in the first half of 2003. Budget support from the ESSP, of the order of US$3.5 million a month, continued as planned.

Notwithstanding the better than expected revenues, these shortfalls in external financing necessitated a significant retrenchment in spending. Nevertheless, thanks to enhanced and more efficient expenditure management compared with a couple of years ago, all necessary expenditures could be covered and budgetary arrears were reduced. This is in stark contrast with developments in 1999, when the level of total expenditures was higher and arrears were accumulated. Timely payment of wages was seen as crucial to ensure the smooth functioning of government as well as being important in helping to stabilize the economy: personal consumption out of civil service wages was considered a mainstay for the domestic economy.[48] With wage payments continuing at broadly the level envisaged in the budget, the

[48] Gross wages were slightly below budget appropriations despite a further increase in PA employment. Civil service employment increased from year end 2002 to end May 2003 by 2,595 employees. The increase in the first half of the year was only slightly below the amended budget allocation for 2,772 additional positions in the civil service for the year as a whole. Security employment also increased by 1,622 during the same period, payments for which exceeded the budget allocation.

full brunt of the adjustment to the shortfall in financing fell on nonwage expenditures. These were squeezed dramatically by a monthly average of US$11 million below budget. This was most pronounced in the first quarter, in anticipation of a shortfall in revenues and financing. The squeeze was somewhat eased in April and May, but nonetheless nonwage expenditures remained below the budgeted monthly average of US$34 million. Thanks to the reduction in nonwage expenditure, the overall monthly deficit amounted to US$27 million during January to May—some US$18 million lower than envisaged in the budget and broadly in line with the shortfall in foreign financing.

Regarding the "noncore budget," the monthly repayment by the GoI out of accumulated clearance revenues reached around US$20 million in the first five months compared to US$40 million projected in the budget.[49] The lower transfer is partly explained by the freezing of NIS832 million (equivalent to around US$180 million) by court order pending resolution of court cases for private Israeli claims against the PA. These claims are being challenged by the PA in Israeli courts. There have also been deductions on account of municipalities arrears on utility services provided by Israeli companies.

In spite of the financing shortfalls, the PA succeeded in reducing its arrears to the private sector by US$107 million during the first half of the year. Priority was given to the clearance of small bills to providers of goods and services and to arrears in the education and health sector. The PA also started to pay the 10 percent employee contribution to the Gaza pension fund in January 2003, but the payment of the 12.5 percent employer contribution only began in July thus resulting in additional arrears to the pension fund of US$8 million during the first half of the year.[50] With attention focused on the clearance of arrears, no progress was made in reducing bank borrowing (as hoped for in the budget). Instead bank borrowing increased by a further US$50 million during the first half of the year.

The severe compression on nonwage expenditures during the first half of the year, necessitated by the shortfall in foreign financing, is a less than ideal reaction to underfinancing. Such expenditures are important if the PA is to be able to deliver on its commitments on public services and continue the reform of public administration. Room must therefore be made for these expenditures. In the first instance, efforts must be made to resist the further expansion of the wage bill. But a significant restoration of nonwage spending toward the budget's ambitions will require a renewed commitment on the part of the international community to external budgetary support. There have been some promising signs in this regard. Following the interruption in EU support during the first half of 2003, negotiations in June between the PA and the EU resulted in a new agreement for €80 million

[49] Beginning in June 2003, Israel increased transfers from the stock of withheld revenues to US$30 million a month.

[50] There are plans to reform the pension fund toward a fully funded system encompassing the security forces with a retirement age of 60 years.

for 2003, with a first tranche of €40 million that was disbursed in July 2003, and the second tranche of the same amount expected to be disbursed during the last quarter of the year.[51] The United States also provided, for the first time, direct budgetary support to the PA, in an amount of US$20 million. This is an important start. But much more financing will need to be forthcoming from these and other donors if the remaining budget for 2003 is to implemented along the lines intended.

E. Future Budget Trends

A review of performance under the 2003 budget makes it clear that the current budget situation is not sustainable without continued and expanded donor budget support, unless and until there is a strong economic recovery. Such a recovery should one day materialize if the "Roadmap" is implemented and there is a lasting peace.[52] In these circumstances, domestic and clearance revenues should recover to, and go beyond, the levels recorded in 1999. With domestic and clearance revenues at this level, a budget of the order of US$1 billion could be financed without exceptional financial support from international donors. This will be the peace dividend for the international community. And while the investment budget will continue to need donor financing for some time to come, even after peace has been established, this process too will be finite. When the reconstruction and repair of damaged and destroyed infrastructure is complete, the PA can be expected to become a fully self sufficient administration within the context of a future independent Palestinian state.

But we are not there yet. Progress along the Roadmap is still in its early stages and its future implementation is uncertain. Peace is not yet secure, or even visibly on the horizon. A significant economic recovery on a scale to close the budgetary gap is therefore unlikely to materialize very soon. Substantial support from international donors, broadly equal to about half of the budget, will therefore continue to be required. Without this support, the PA will have little choice but to resume running into arrears, to borrow unsustainably from banks, or to cut back on the basic social services that the Palestinians desperately need. This can only compromise the chances for stability and peace.

Even with peace, much will depend on the ability of the PA to continue with the reform momentum, not least in the area of its fiscal responsibilities. The stable and strong revenue base that the PA needs will not materialize without progress in tax reform. As discussed in Chapter V, this would include a reform of the income tax and as well as a restructuring of tax administration. The PA will also need to regain flexibility on the expenditure side of the budget, chiefly by bringing the wage bill under control and achieving a meaningful reform of

---

[51] The second tranche was subject to some conditionality regarding progress in reforms.

[52] The roadmap, drawn up by the Quartet (United States, United Nations, the EU and Russia), was published on April 30, 2003. See Chapter VI for a discussion of its implications for economic reform.

the civil service. Choices will need to be made about what services the PA should provide, what services should be discontinued, and what should be devolved to the private sector. These choices will also concern some of the state owned enterprises.

A more efficient tax system and increased flexibility in budget management will be necessary not only for the budget to be able to meet it current objectives over the medium term, but also for it to be able to meet new challenges. These new challenges will include the need to meet the additional outlays that are likely to arise from pension reform, from the assumption of responsibility for refugees, and for contributions to the rehabilitation of infrastructure:

- Pension reform: the Gaza pension system for civil servants is facing financial problems duc to generous pension packages (see Chapter V). The World Bank estimates that by 2010 the pension funds' deficit will reach 1 percent of GDP (assuming that all government arrears to the pensions funds accumulated over the past years will be fully paid).

- Expenditures for the refugees: under the current arrangement, the United Nations Relief and Work Agency (UNRWA) provides services for the 1.5 million refugees in the West Bank and Gaza. At least over the medium-term, the Palestinian state will have to take over some of UNRWA's responsibilities, which would lead to increases in spending for education and health.

- Infrastructure rehabilitation: the repair of damaged or destroyed infrastructure will require substantial investment once a peace deal has been reached. Following the Oslo accord, donors provided a significant share of funds necessary for infrastructure reconstruction. It can be expected that donors will again contribute to the costs of reconstruction if there is a new peace agreement. But the PA will also need to be ready to pull its weight, and increasingly so as the investment budget evolves away from reconstruction and toward development.

- Debt service: while most of the financial support for reconstruction in the 1990s was given as grants, a significant part was provided in the form of loans (a total of some US$872 million is outstanding). Most of these loans have a generous grace period, long repayment periods and low interest rates. A significant share could be expected to be converted into grants in due course. But a share may also remain which will one day have to be serviced.

Box 4.1. Emergency Welfare Programs

An "emergency fund" was established shortly after the beginning of the Intifada in an effort to mitigate the impact of the crisis on some vulnerable groups. Expenditures from the "emergency fund" have been used to finance six separate welfare programs: (i) the disbursement of the Palestine Association of Workers' Unions (PAWU) of welfare transfers of NIS 600 to workers that the PAWU has designated as "Unemployed due to the post-September 2000 events," with the number of beneficiaries and the frequency of transfers varying markedly from one month to the next, depending o the amount transferred from the emergency fund to the PAWU (which varies depending on the requirements of the five other schemes); (ii) payments to 3,500 workers, designated as "temporarily unemployed," in various ministries and agencies; (iii) payments to 1,400 workers, designated as "unemployed due to the Al-Aqsa Intifada," in the ministry of health; (iv) payments to workers in the town of Beni Zeid (near Ramallah) to perform various tasks, including cleaning of streets and garbage collection; (v) payments to fishermen in Gaza, for various tasks (including cleanup of beaches), to compensate for the restrictions placed by Israel on fishing; and (vi) transfers to those whose property has been damaged or destroyed by Israeli actions. These expenditures were financed until June 2003 by the "emergency fund solidarity tax", applied since October 2000 on all PA workers' salaries at a rate of either 7 percent (for employees whose monthly salary is less than NIS 1,500) or 10 percent (for other employees).

V. Getting a Grip on Public Finance[53]

A. Introduction

Prior to the 1994 Oslo Accord, the WBG was administered by the Civil Administration of the Occupied Territories. With the government empowerment of the Palestinian Authority, some administrative functions were taken over by Palestinian officials, as was the case with all the municipal services, but in other cases they had to be established from scratch. In particular, a ministry of finance was established, including a VAT, customs and excise department, and an income tax department. These were established in concert with other building blocs of an economic and financial administration, including the Central Bureau of Statistics (PCBS) and the Palestinian Monetary Authority (PMA). While the institutions were established on sound principles, mostly with the assistance of the IMF, and followed best practice, they were inadequately staffed and controlled, with the result that various cracks began to appear. This led to a number of reforms in the Spring of 2000, which were designed to address these issues. However, this reform episode highlights the difference between agreement in principle and issuance of a Presidential decree, and actual execution of reforms. The failure to execute major reforms, coupled with internal and external pressures, led to a second and far more comprehensive wave of reforms. This chapter describes the various weaknesses which appeared in public finance and which reached crisis proportions, particularly with the donors, resulting in a reform package under the Economic Policy Framework, unveiled in Lisbon in June 2000. It then explains the circumstances which led to the second wave of reforms, and to the pursuit of solutions to the various weaknesses and loopholes in public finance which were not addressed in the Spring of 2000.

B. The Genesis of Reform

Taxes and revenues

In the area of public finance, the Palestinian tax system took off on a strong footing. Despite calls for Palestinian sovereignty in establishing an independent tax system, the Palestinian Authority (PA) agreed to adopt Israel's VAT by opting for the same single rate (17 percent) and by introducing a unified invoice system with Israel in January 1995. Under the de facto customs union established with Israel, the PA also adopted Israel's customs tariff and petroleum excises which were included in the clearance system.[54] While international taxes were to be collected at source (e.g. Israeli ports for customs), they were to be distributed according to the destination principle, i.e. where final consumption takes place. And while most VAT paid by Palestinians derive from goods purchased in Israel and are collected by

---

[53] Prepared by Karim Nashashibi

[54] Seventy five percent of income taxes and all health fees paid by Palestinian workers who are employed in Israel were also transferred.

Israeli authorities – thereby injecting some vulnerability—this system greatly facilitated a tax revenue clearing mechanism with Israel whereby all invoices were being vetted in monthly meetings. This determined net VAT revenues owed to the PA as well as VAT refunds.[55] This system was supported by the introduction of automated reporting for large traders and a computerized revenue management system operated by the Israeli Ministry of Finance computing agency (SHAAM).[56] A single check clearing mechanism for both WBG and Israel was the second pillar of financial cooperation with Israel to facilitate banking transactions between Israel and the WBG.

Under the operation of the unified invoice system, the ratio of tax revenue to GDP rose from 7 percent in 1994 to 18 percent by 2000.[57] This put revenue performance in the West Bank and Gaza (WBG) above all other countries in the southern Mediterranean area with the exception of Israel and Morocco, (at 28 percent and 21 percent of GDP, respectively, Table 5.1). Taking into account per capita income and the age dependency ratio, the WBG lies well above the trend of 62 developed and developing countries in its tax performance.[58] The PA also achieved small recurrent budget surpluses in both 1998 and 1999. With this stellar performance, why was there a need for reform?

From the outset, several weaknesses appeared in tax administration, revenue management, and expenditure control. These weaknesses reached crisis proportion by 1999, and resulted in a first wave of reforms associated with the issuance by the PA of the "Economic Policy Framework" at an international conference of donors held in Lisbon by the Ad Hoc Liaison Committee (AHLC) in June 2000.

Tax administration

Revenue leakage from indirect imports and purchase tax

The high revenue GDP ratio achieved by 1999 was mostly driven by indirect taxes, primarily VAT (7.2 percent of GDP), customs (6.7 percent of GDP) and excises (3.3 percent of GDP). Once an efficient indirect tax system is set up (i.e., a single VAT rate and unified invoice system), international experience has shown that such taxes can be highly revenue productive.

---

[55] Sales by Israeli merchants to Palestinian buyers are accompanied by an invoice coded I and sales by Palestinians merchants to Israeli buyers are accompanied by an invoice coded P.

[56] SHAAM was cut off from Gaza in 1994 and replaced by a private company (AL-BAHAR).

[57] Direct and indirect taxes, excluding social security and mineral rents.

[58] World Bank development indicator data base.

Table 5.1. Tax Revenue in the Southern Mediterranean Region and comparator countries in 2001 1/ (As percent of GDP)

	Tax Revenue	Indirect Taxes Total	Sales Tax (VAT)	Excises	Customs Duty	Income Tax Total	Corporate	Individual
West Bank and Gaza 2/	18.2	16.5	7.2	3.2	6.1	1.7	0.3	1.4
Algeria	9.0	6.7	2.5	1.7	2.5	2.3	1.2	1.1
Egypt	14.1	8.2	4.3	1.4	2.5	5.9	4.2	1.7
Israel	27.7	12.1	10.4	1.4	0.3	15.6	3.7	11.9
Jordan	15.9	12.8	8.2	0.8	3.8	3.1	2.1	1.0
Lebanon	9.9	7.4	0.0	3.7	3.7	2.5	...	...
Morocco	20.9	13.8	6.0	4.1	3.7	7.1	3.1	4.0
Syria	8.4	3.9	0.2	1.2	1.3	4.5	...	...
Tunisia	16.7	10.3	7.3	0.0	3.0	6.4	2.4	4.0
Turkey	16.3	7.3	6.7	0.4	0.2	9.0	2.5	6.5
Indonesia 2/	14.3	4.9	3.6	0.8	0.5	9.4	4.9	4.5
Malaysia 2/	15.6	6.9	2.1	2.3	2.5	8.7	6.2	2.5
Philippines 2/	13.1	7.9	1.8	2.2	3.9	5.2	2.7	2.5
Thailand 2/	14.8	9.5	3.7	3.6	2.2	5.3	3.0	2.3
Argentina	8.0	5.5	3.3	1.7	0.6	2.5	1.7	0.8
Bolivia	10.4	9.2	4.4	3.9	0.9	1.2	1.2	0.0
Chile	16.3	11.7	8.1	2.4	1.2	4.6	...	...
Peru	12.9	9.5	6.2	1.9	1.4	3.4	1.8	1.6
Venezuela	10.7	6.5	4.1	1.0	1.5	4.2	...	...

Source: IMF estimates
Note: Data represents what is available for the central government.
1/ Excluding social security taxes and mineral rents.
2/ Data is for 2000.

For the WBG, much of the strong performance can be attributed to the collection efficiency of the Israeli tax administration. Even then, there was a substantial leakage of tax revenue from the Palestinian Authority which was not addressed by the Paris Protocol. This leakage pertains to "indirect" Palestinian imports through Israel and Palestinian purchases of local Israeli products. Many Palestinian importers prefer to source their imports indirectly from Israeli wholesalers to avoid onerous Israeli security checks on imports destined to PA territories and also to utilize established business relationships. While VAT collected by Israel on indirect imports was transferred to the PA, related customs duty and purchase tax were not. Similarly, while Palestinians paid purchase tax on their purchases of local Israeli products, these revenues were not transferred to the PA. Estimates of the combined revenue leakage on indirect imports and purchase taxes on local products range between 3 to

5 percent of GDP.[59] The Palestinian authorities raised this issue with their Israeli counterparts and offered a sound estimation methodology for measuring the shortfall on purchase taxes on Palestinian purchases of local Israeli products, which the Israelis accepted as a basis for transferring such tax receipts to the PA.[60] In June 2000 the Government of Israel (GoI) transferred NIS 200 million to the PA in purchase tax clearance revenue (although in December 2000 some of this was transferred back due to overestimation).[61] With respect to customs duties and purchase taxes on indirect imports, on the other hand, the Israeli authorities did not accept a methodology based on indirect import projections, and with renewed conflict in September 2000, negotiations were interrupted.

Income tax yield

Another weakness of the WBG tax system was the low yield of income tax. At 1.8 percent of GDP in 1999, this yield was among the lowest in the region (4.5 percent of GDP) and even more so among middle income countries (5.6 percent of GDP). This weakness can be partly attributed to the lack of a substantial corporate structure in the business community of the WBG. Under the Israeli occupation between 1967 and 1994, there was very little scope for Palestinian businesses to expand, let alone establish modern corporate structures. During the Oslo period (1994–2000), a number of modern enterprises were established, particularly in telecommunications, beverages, and tourism; but the gestation period toward developing a consistent flow of income was too short. Moreover, under the investment promotion law, most investments benefited from an income tax exemption during the first 10 years of operation. Consequently, 83 percent of income tax receipts stemmed from individuals. Even then, while WBG's individual income tax revenue exceeds those of Lebanon, Syria and Jordan, it is still about half the yield in middle income countries and well below its potential. Income taxes in the West Bank are assessed in line with the 1964 Jordanian Law and in Gaza with the 1947 Egyptian Law. This fragmentation and archaic structure meant that the tax system lacked a modern and simple legal basis. An attempt was made in 1997 to unify the tax law, but the reform was stuck in the legislation. Weakness in the judiciary and in legal enforcement, as well as the lack of cross checking between VAT and income tax returns,[62] further undermined the efforts of the nascent tax administration to improve income tax yield.

---

[59] Jean-Pierre Dumas: Fiscal leakage in the WBG European Commission June 1999.

[60] Recommendation of the Ad Hoc Economic committee pursuant to the Wye River Memorandum 6/6/2000.

[61] In August 2000, Israel eliminated purchase taxes on many products and reduced them on others. While purchase taxes on locally produced products continue to be transferred by GoI, they are now very small.

[62] The income tax law allows checking VAT returns but VAT administration does not have this power.

Fragmentation of tax administration

Lack of control over revenues was exacerbated by the absence of coordination between West Bank and Gaza treasuries and tax administration. Different computer and accounting systems, ineffective telecommunications and de facto autonomy of departmental directors resulted in essentially two different tax systems. For instance, selection criteria for large taxpayers were different in the West Bank and in Gaza. Agricultural income was exempt in the West Bank but taxed in Gaza. Payroll checks were automated in Gaza but manually generated in the West Bank. The links among taxing departments were largely informal at the operational level and the sharing of information regarding taxpayers occurred on an ad hoc basis. The lack of an integrated, functionally based tax administration as well as inadequate internal audit procedures undermined effective control over revenues.

Revenue management

From the onset of the Oslo peace process and the early empowerment of the PA in Gaza and Jericho, clearance revenues did not fully accrue to the PA. While VAT and customs revenue were transferred to the Ministry of Finance (MoF), petroleum excises were transferred to a special account in an Israeli bank[63] under the control of President Arafat and his financial advisor Mohammad Rachid. In addition, tobacco and alcohol excises domestically collected by the PA as well as revenues from PA monopolies and other commercial activities were channeled to accounts outside the MoF. Yet in the context of the Tripartite Action Plan agreed to by the PA, Israel and donors (April 27, 1995), there was a strong directive to "consolidate" all income and expenditure under the direct control of MoF. Later on, the Minister of Finance committed himself in the first quarterly report to the AHLC to "consolidate" all accounts at the Single Treasury Account (STA) by August 31, 1996. None of these commitments were implemented and this diversion of tax revenues lasted for six years until April 2000 when consolidation of revenue finally took place, under the implementation of the Economic Policy Framework (EPF) (See Box 5.1).

Diversion of excise tax revenue

Yearly excise revenue diversions are shown in Table 5.2. In 1997, revenue diverted outside the MoF reached US$164 million. In 1998 and 1999, the PA experienced liquidity crises as a result of these diversions, which combined with rapid increases in payroll and other expenditures. Moreover, the budgets for these years were predicated on accrued (rather than cash) revenues. Faced with severe liquidity problems and rising indebtedness from the banking system, the MoF managed to recover about US$119 million of diverted revenues over these two years. But all in all, a net US$591 million of excise tax revenues were diverted from the MoF during 1995–2000.

---

[63] Bank Leumi, Hashmounim branch in Tel Aviv.

Diversion of profits from PA commercial activities

Most of the diverted tax revenue was used for investment in PA commercial operations through the PCSC. Together with the lucrative monopolies on cement and petroleum acquired early on, these commercial activities started generating substantial profits which were also being diverted away from the budget. Because of lack of transparency and accountability for these activities (no balance sheets or annual reports were published), it is difficult to estimate the profits which they generated between 1995 and 2000. However, an audit conducted on PCSC operations in 1999 by Saba company (a subsidiary of Deloitte, Touche and Tohmatsu), in the context of the EPF, revealed that the PCSC made net profits of US$77 million of which US$18 million came from the sale of cement. Since PCSC assets were evaluated at that time at US$345 million, this would be a hefty rate of return on equity of 22.4 percent. Extrapolating these profits back to 1995 and forward to 2000, it is possible to reach a rough but conservative estimate of about US$300 million in profits channeled outside the budget over this period. All in all, excise tax revenue and profits from commercial activities diverted away from the budget may have exceeded US$898 million.

Lack of control over fees and charges

Fees and charges are levied by about fifteen PA ministries and constitute 12–15 percent of all PA revenues. In addition to education and health fees, there are transportation fees (automobile licensing and fines) as well as agricultural and judicial fees. These fees were remitted to the ministries' bank accounts and remained under the ministries control and discretion until very recently. Ministries would typically spend out of the revenues they would collect instead of remitting the entire amount to the Treasury. This resulted in loss of control by the Treasury over both revenues and expenditures.

Expenditure management

The high level of revenue collected by 1999 of close to US$1 billion was not deliberately planned. Nor was there an "optimum" revenue level and trend established as a function of PA government needs for the provision of basic services and security to the population. The revenue level attained emanated from the Israeli tax system, under the customs union, particularly from the relatively high VAT rate, customs and excises. With small recurrent surpluses attained in 1998 and 1999 and the financing of public investment by donors, the PA felt that there was nothing to worry about. This loosened the budget constraint and may have provided incentives for revenue diversion and excessive PA employment and spending.

Box 5.1. The First Wave of Reforms: The Economic Policy Framework June 2000

Three major issues continued to plague the PA in public finance: (i) diversion of tax revenue to special accounts, (ii) excessive hiring in the civil service and security apparatus, and (iii) PA commercial operations and monopolies with no transparency or accountability. These three issues were raised at various AHLC meetings beginning in 1996 with growing dissatisfaction among donors and little more than a lip service response on the part of the PA. As these issues were reaching crisis proportions in 1999, threatening a major dispute with the donor community, the IMF Resident Representative (Dr. Salam Fayyad) initiated a major reform initiative with President Arafat: the establishment of an Economic Policy Framework (EPF) under which (a) all PA revenues would be consolidated into a Single Treasury Account (STA), (b) the Gaza payroll unit would be transferred to the MoF to ensure control over hiring, and (c) there would be an international audit of all PA commercial assets, with the transfer of profits to the MoF. At the AHLC meeting in Tokyo in October 1999, President Arafat requested IMF assistance in developing this policy framework and in June 2000 launched it at the AHLC meeting in Lisbon.

To ensure its full implementation, the President constituted an economic policy committee comprised of four members: the Ministers of Finance, Economy and Trade, Planning and International Cooperation as well as Mohammad Rachid, economic advisor to the President, all of whom signed on to the document.

This reform initiative resulted in two major achievements: (i) the consolidation of petroleum, tobacco and alcohol excise revenues with other tax revenues in MoF, and (ii) the auditing of the assets of the Palestinian Commercial Services Corporation (PCSC). Nevertheless, while the EPF pledged the transfer of the Gaza payroll to MoF, and the establishment of a Palestinian Investment Fund, these were not implemented. Nor was the issue of diversion of profits from PA commercial activities addressed. These outstanding matters had to await the second wave of reforms in June 2002.

Table 5.2. Diversion of Revenues Outside the MoF
(In millions of U.S. dollars)

	1995	1996	1997	1998	1999	2000 (to end April)	1995–2000
Accrued revenue	424.9	684.9	825.5	863.1	988.6	924.0	4711.0
Diverted revenue							
- petroleum excises	33.5	100.4	111.3	106.8	100.2	33.8	486.0
- tobacco and alcohol	15.0	42.2	52.4	50.6	47.8	15.6	223.6
Revenue transferred back to MoF	0.0	0.0	0.0	49.0	70.0	0.0	119.0
Net diversion of excise revenue	48.5	142.6	163.7	108.4	78.0	49.4	590.6
Profits from PCSC	20.0	30.0	50.0	70.0	77.0	60.0	307.0
Total revenue diversion	**68.5**	**152.6**	**213.7**	**178.4**	**155.0**	**109.4**	**897.6**
Exchange rate NIS/US$	3.01	3.19	3.45	3.80	4.14	4.08	-

Excessive PA employment

In mid 2003 (end June), civil service employment in the WBG stood at 73,933, while security personnel amounted to 56,128 (Table 5.3). Given the difficult and unique security situation of the WBG, it is difficult to judge whether the numbers of security personnel are excessive or not. For the civil service, the World Bank has concluded that there is some modest overemployment (about 5 percent). But there are indicators which would suggest that civil service overemployment is rather more substantial. The PA does not yet provide all the services the population requires. For example, health and education services are provided by UNRWA, with 14,000 employees, to the refugee population, which accounts for 42 percent of WBG population. When the refugee population is excluded, the proportion of WBG civil service to employment on a per capita basis (4 percent) exceeds that of most countries in the region as well as comparator countries.[64]

While yearly increases in civil service employment would be appropriate for a rapidly growing and very young population, actual increases in civil service employment up to 2002 greatly exceeded what would have been warranted. Increases in employment during 1998 through 2000 exceeded 11,000 each year, with the civil service increasing at a rate more than double what would have been needed to keep up with the population's growing needs. The wage bill quickly exceeded all comparator countries (Table 5.4) and introduced a major rigidity in budget management, which was revealed during the recent conflict: as revenues dried up, wages squeezed out other expenditures. While in 1999 the wage bill accounted for 15 percent of GDP and 55 percent of current expenditures, by 2002 it absorbed 70 percent of current expenditures, leaving inadequate resource for nonwage expenditures and resulting in accumulation of unpaid bills and arrears to the private sector.

[64] Civil Service Pay and Employment in West Bank and Gaza, B. Nunberg, World Bank, February 18, 2003

Table 5.3. PA Employment and Wage Bill

	1995	1996	1997	1998	1999	2000	2001	2002	2003[1/]
Employment (in thousands)	57.00	75.40	83.10	92.30	98.50	114.90	122.10	124.80	130.61[/]
Civil Service	32.60	42.00	46.20	51.40	54.10	65.60	69.70	71.20	73.93
Security	24.40	33.40	36.90	40.90	44.40	49.30	52.40	53.60	56.13
Wage bill (in US$ million)	304.30	402.50	470.90	466.90	522.60	618.80	678.20	676.10	693.00
Civil service	193.80	246.50	273.40	286.00	319.70	377.80	414.10	412.80	--
Security	110.50	156.00	197.50	180.90	202.90	241.00	264.10	263.30	--
Exchange rate	3.01	3.19	3.45	3.80	4.14	4.08	4.21	4.73	4.62

Source: Ministry of Finance

[1/] End-June 2003, wage bill is projected based on the first six months

Table 5.4. Central Government Wage Bill (2001)
(ratios in percent)

	Ratio of GDP	Ratio of current Expenditure	Ratio of total Expenditure
West Bank and Gaza (2000)	15.2	57.6	49.3
		...	...
Algeria	7.5	...	...
Egypt	7.0	31.2	26.2
Israel	8.7	23.9	21.0
Jordan	6.3	21.2	18.0
Lebanon	8.6	25.2	22.6
Morocco	12.5	...	...
Syria	9.0	54.0	30.8
Tunisia	12.0	49.6	37.6

One of the weakest aspects of expenditure management was the empowerment of the General Personnel Council (GPC) in Gaza outside the control of the Ministry of Finance. This resulted in excessive hiring without regard to the budget constraint. The excessive hiring and control over promotion by the (GPC) went beyond the MoF budget constraints and appropriations creating an unsustainable fiscal structure.[65] It also created strong vested interests in maintaining the independence of the GPC from the MoF. While President Arafat signed a decree on January 10, 2000 moving the GPC to the MoF, in the context of the EPF, the measure was not executed. Indeed, recruitment in 2000 continued at the same rate, with

[65] "The expansion of the PA payroll represents the largest deviation from the budget and is now by far the most serious fiscal problem" paragraph 20 Economic Policy Framework, June 2000

11,400 additional positions, exceeding the 11,187 added in 1999. The resulting budgetary impact forced a freeze on wages and delays in reviewing civil service remuneration, generally considered to be too low. It also increased future pension liabilities. The issue was not resolved: as with the PIF, it had to await the second wave of reforms in June 2002.

Weak expenditure controls

By 1998, the MoF had established the major building blocs of budget execution and expenditure control within a sound legal framework. In particular, in accordance with the budget law, line ministries were now receiving monthly advances according to budgetary appropriations. The Budget Directorate in Gaza performed controls to make sure that expenditure requests are matched by an equivalent appropriation. Government purchases had to abide by procurement regulations, and an internal audit department conducted some post expenditure checks. Nevertheless, several weaknesses appeared in expenditure management and control:

- There was a multiplicity of spending centers in both the West Bank an Gaza. Treasury checks were issued and transfers effected without the approval of the Minister. Cash management could not be undertaken without full control by the Minister over all revenues and expenditures.

- Ministries were allowed to maintain positive bank balances (instead of a zero balance at the end of each day) and to obtain bank overdrafts. This provided ministries with much greater spending discretion, going beyond budgetary appropriations.

- While the Budget Directorate in Gaza ensured that appropriations cover expenditure requests, expenditures in the West Bank often took place without appropriations.

- Security personnel were paid in cash instead of through bank transfers. While the Financial Administration of the security apparatus controlled these payments, the system often led to abuse. For instance, pay deductions for absentees did not revert back to the Treasury.

- The Internal Audit Department (IAD) of the MoF only performed very limited tasks: pre-payment controls conducted in Gaza in the MoF, and post payment checks for all other ministries. Payments controls were particularly weak, resulting in the build-up of substantial arrears. Financial records of ministries were not audited, nor was the cash position of various ministries as received by the Budget Department on a monthly basis. The payroll processed in Gaza and Ramallah, which accounted for 70 percent of expenditures in 2001 and 2002, was not audited at all, and there was no attempt by auditors to safeguard PA assets. The weakness of the IAD was compounded by weakness of the external auditors, the General Control Institute (GCI). There was only one report made public in 1996, which raised a lot of criticism, and there were also major issues concerned with the GCI independence and mandate.[66]

- There are two departments of supplies and tenders for government purchases (one in Gaza and one in the West Bank), instead of one independent department. Supplies to the security organizations were monopolized by a separate agency (Al-Sakhra).

Financing Public Investment outside the PA budget

With the gradual empowerment of the PA in the WBG under the Oslo process, the donor community mobilized external financing to assist in establishing a basic infrastructure in the occupied territories. Before a Ministry of Finance was even established, the donor community, spearheaded by World Bank studies and its' Holst Fund, began executing infrastructure projects. The PA established an implementing agency – the Palestinian Economic Council for Development and Construction (PECDAR) – which quickly proved that it could undertake a wide range of projects. Consequently, it became the recipient of most donor assistance, although UNDP and UNRWA retained a substantial share of projects. But over the following years, donors increasingly went directly to line ministries, municipalities or to the PA agencies, such as the Water Authority or the Ministry of Energy, to discuss projects and infrastructure development. While the Ministry of Planning (MOPIC) had to co-sign all loan and grant agreements with donors (with the MoF), MOPIC was not involved in the selection of projects or in the design of an indicative development framework. Projects were also not adequately assessed in terms of their future recurrent costs. A case in point was the European Hospital in Gaza, (funded by the EU) which had to be entirely staffed (244 employees in 2003) and supplied with high cost utilities (it had to develop its own energy source) from recurrent PA budgetary resources. Infrastructure development was being carried out on an ad hoc basis with little if any coordination, either among donors or with the authorities.

At a macroeconomic level, these projects should have been incorporated in a development framework which took into account actual and projected infrastructure needs, with a clear understanding of future recurrent costs and debt servicing capabilities. The process also lacked transparency, since information on public investment financed from abroad was fragmented and incomplete without the benefit of a single information center which would monitor project costs, disbursements and execution. As a result, the PA budget could not incorporate donor financed public investment.

[66] For example, the annual report was only provided to the President who was also empowered to exclude certain sectors from auditing (e.g. security).

Emergence of arrears

The diversion of excise revenue as well as PCSC profits from the budget, coupled with the rapid expansion in PA employment resulted in substantial Treasury cash deficits in both 1998 and 1999, notwithstanding the realization of surpluses on a commitment basis in the current budget in both years. While these deficits were partly financed by bank loans and overdrafts, such financing was limited by banks' prudential regulations on their exposure to the PA. These limits, coupled with the growing wage bill, which could not be compressed, resulted in the emergence of arrears in late 1997, accumulating to about US$370 million by March 2000. Most of these arrears were in the form of unpaid bills to suppliers. However, the Ministry of Finance also resorted to the issuing checks without cover to suppliers and to various ministries covering the difference between budgetary appropriation and actual cash transfers received. In addition to the loss of all Treasury credibility, this system also lent itself to abuse and corruption. Check holders were not treated equally and eventual payment was negotiated or executed on a preferential basis.

With the suspension of Israeli transfers of tax revenue beginning in January 2001, the fiscal crisis deepened and financing through accumulation of arrears became a major feature of fiscal management. By the end of 2002, the stock of payment arrears exceeded 10 percent of GDP and was estimated under two definitions:

(i) US$531 million under a broad definition which included, not only unpaid bills to suppliers but also differences between budgetary appropriations to various ministries and actual cash transfers to ministries.

(ii) US$415 million under a narrower definition which sums up:
- Unpaid bills (US$63 million)
- Uncashed checks (US$187 million) including pension contributions
- Payroll deductions not transferred to government institutions (US$155 million, including pension deductions for security personnel)
- Funds withheld in trust for third parties (US$10 million— e.g. to municipalities)

The logic behind the narrower definition was that full budgetary appropriations could not be claimed by various ministries under a tightening budget constraint. Even under this narrow definition, some of the uncashed checks held by ministries would not be viewed as arrears and would be cancelled by a certain cut-off date in 2003.

By mid 2002, arrears accumulation by the PA had run out of steam as it essentially relied on forced credit from the private sector, which was itself facing a major drop in demand and inability to service its own bank loans. Suppliers only provided goods and services against cash as the financial credibility of the PA collapsed. With no other source of financing the incoming minister of finance had only one course of action: to restore tax revenue transfers from Israel, and financial credibility for the PA.

C. The Second Wave of reforms: June 2002-July 2003

A political crisis occurred in May 2002 in the wake of the Israeli incursions in PA controlled territories. Intense discussion within the cabinet, political factions and the Palestinian legislative branch, coupled with external pressures, prompted President Arafat to take immediate action toward a broad based effort at institutional reform. A new "reform" cabinet was appointed on June 9, 2002, and a ministerial committee prepared a 100 day reform plan on June 23, 2002 covering several reform areas, including financial transparency and accountability (Box 5.2). The appointment of Salam Fayyad as Minister of Finance had a particular advantage in view of his involvement in the first wave of financial reforms while he was the IMF representative, which made him very aware of the weaknesses and distortions in the financial sphere. Nevertheless, upon the assumption of his duties, the new minister faced an acute financial crisis precipitated by the suspension of transfers to the PA of the bulk of its tax revenue which Israel collects on behalf of the PA. Arab League budget support had fallen to a monthly average of US$26 million, less than half the amount committed. With an additional US$10 million provided by the EU and about US$16 million collected by the PA in tax and nontax revenue, there was barely sufficient financing to pay monthly salaries, let alone the full budgetary appropriations of about US$80 million per month. The wage bill had risen from US$44 million per month in 2000 to US$56 million per month in 2002. Indeed, May and June salaries could not be paid till the end of the following month and ministries were accumulating payment arrears for their supplies and maintenance expenses. Political pressures where building up to finance salaries by borrowing from the PMA or by raiding the pension fund (GPIC). The minister viewed these recourses as potentially disastrous and they were strongly resisted.

Coping with the financial crisis

Given the declining external assistance, there was only one way out of the crisis: a resumption of tax revenue transfers from Israel. With strong US support and the credibility of a renewed financial reform process following the appointment of the new government, the minister of finance was able to convince the GoI, as a good will gesture, to release NIS 210 million (US$45 million) in three equal tranches.[67] These transfers took place in July, September and October 2002 and provided some temporary relief. However, they needed to be supplemented by predictable monthly transfers of tax revenue collected by Israeli authorities, greater controls over revenue and expenditure generally, and a determination to stop the accumulation of payment arrears. Only then could a credible 2003 budget be formulated which would be fully financed and even provide for the repayment of past arrears. An agreement with GoI was reached in November 2002 for monthly transfers of revenue (which started in December 2002) and the unwinding of the accumulated tax revenue in monthly installments during 2003. This paved the way for the design of a fully financed and credible budget for 2003 and the pursuit of further reforms.

[67] These transfers were drawn from the accumulated tax revenue collected by GoI during 2001 and 2002 which at the time were estimated at about NIS 2.8 billion.

Strengthening controls in the Ministry of Finance

On the revenue side, ministries and PA agencies were instructed to transfer all revenues which they held in bank accounts into the STA. To ensure that this measure was executed, banks were instructed to effect these transfers, and not honor any checks drawn on revenues. A new revenue department was established in the Ministry of Finance to trace all sources of revenue and perform a reconciliation with banking records. Such a reconciliation did not exist before. On the expenditure side, banks were instructed not to provide advances or overdrafts to line ministries, which were in turn subjected to tighter controls on spending. The Treasury itself stopped issuing checks without sufficient cash provisions.

Controlling employment

Since the rapid expansion of PA employment became a major drain on the budget, an institutional breakthrough was needed to control employment. This took place in August 2002 when, after a showdown with the GPC, payroll management was physically transported to the MoF, leaving the GPC only with the tasks of personnel management, promotions and appointments (the last of which now required the approval of the minister of finance). While these measures raised expectations on a stabilization and perhaps even a reduction in PA employment, they proved to be a pyrrhic victory. Between December 2002 and May 2003, the civil service expanded (on a net basis) by 2,595 positions. This was already very close to the 2,772 net increase allowed for in the (revised) 2003 budget for the full year.[68] While the level may go down during the remainder of the year through natural retirements and separations (which usually number some 1,500 a year), the opportunity to eliminate vacant positions was not taken, when these arose during the first half of 2003. Moreover, security services, over which the MoF has very little control, separately expanded by 1,822 positions, which exceeded their budgetary appropriation. PA employment pressures therefore remain a concern in budgetary execution.

Realizing the difficulty in controlling civil service employment expansion, the Minister passed a resolution in the Council of Ministers in May 2003 to enforce retirement at age 60. Extensions would not be granted except by the approval of the Council of Ministers. In addition, those civil servants who lacked the minimum fifteen years of service to qualify for a pension—mostly older PLO veterans—would get 75 percent of their base salary.[69] This

---

[68] In the 2003 budget presented to the PLC, the Ministry of Finance requested 3,118 additional civil service positions, including 2,100 for the Ministry of Education and 600 for the Ministry of Health, with the expectation that not all vacant positions in other ministries would be filled so as to stabilize the level of PA employment. The PLC reduced the number of new positions to 2,772 in the approved budget.

[69] At the end of 2000, 408 civil service members over age 61 remained in active government employment. Nearly all lacked the minimum 15 years of service to qualify for a pension.

would free up high ranking positions to younger civil servants and provide the opportunity to eliminate some of the vacant positions in a civil service reform. Another measure meant to control employment of security personnel, was to switch the payroll away from cash to direct deposits in bank accounts. By end-August 2003, four security organizations numbering 25,000 people had accepted this scheme. When it becomes fully operational, this system will provide a full data base for security personnel, allowing for a payroll audit and cross checking with the civil service to exclude dual positions.

Implementing a modern internal audit system

The weaknesses in expenditure control and leakage of revenue prompted the MoF to establish a modern and effective internal audit system. The following steps were taken in this regard:

- Establishment of an Internal Audit Department (IAD) in the MoF and appointment of a senior audit advisor. The internal auditors who are engaged in pre-audit work for their respective ministries would be transferred to MoF and become part of the IAD. About seventy MoF auditors would be trained and deployed to various ministries and agencies to conduct post payment audits.

- Obtaining technical assistance from USAID and the EU to address auditing inadequacies and training needs.

- Establishing auditing system for PA revenues, payroll and purchasing.

The IAD would also aim to verify the financial records of all ministries and agencies. Treasury operations of the MoF and other ministries would be audited, with associated financial statements and bank reconciliation. A draft charter of internal auditing has been prepared to clarify the relationship between the external audit (General Control Institute) and the IAD and to specify the work plan and responsibilities of the IAD. While the establishment of an effective and comprehensive audit system would take some time, two problem areas have already emerged.

- Auditing of the payroll can only be effective if there is access to all personnel records. This is not yet the case, given the lack of cooperation between the personnel authority GPC and IAD.

- The external audit requires a new law to ensure its independence and ability to conduct audits of all the PA agencies, including security organizations. It should also produce an annual report available to the PLC and other PA institutions. The PLC is in the process of drafting a new law.

Both these issues are being addressed. The building blocs of a modern and more effective IAD have now been established.

Budget reform

In preparing the 2003 budget, the Minister of Finance had four objectives:

(i) to have a fully financed budget to preempt any accumulation of arrears or costly bank lending.

(ii) to integrate public investment financed by donors into the budget.

(iii) to meet the budget calendar by respecting various deadline and by issuing it before the beginning of the budget year.

(iv) to achieve full transparency by producing a comprehensive document which would be published.

With large shortfalls in external financing, the major challenge was to obtain an assurance from the GoI that monthly tax revenue transfers would take place and that withheld tax revenue accumulated in 2001 and 2002 would be transferred to the PA in 2003. While the draft budget was ready for the PLC by November 15, thereby meeting the budget calendar, these assurances were not obtained till late November. Consequently, the budget was sent to the PLC in early December and approved by the PLC on December 31, 2002. It included external budget support of US$528 million, in line with such assistance during the preceding year, US$324 million in monthly tax transfers from Israel and US$480 million in tax revenues withheld by Israel in 2001 and 2002. This amount would be entirely used to repay PA arrears, (US$415 million), mostly owed to the private sector, and to reduce costly borrowings from the banking system (US$65 million). To the extent that these flows would materialize, there would be no fiscal gap, no accumulation of new arrears nor unsustainable public borrowing from the banking sector. However, should external budget support fall short of expectation the pace of arrears liquidation would become slower. Hence some degree of realism was built into the budget.

The budget also included a provision which would make it illegal for the Ministry of Finance to borrow from the Palestinian Monetary Authority or from any other PA institution or agency. There was also a major effort to enhance transparency:

- A summary of the budget speech and all budget data were posted on a web site when it was presented to the PLC. This openness and transparency is quite exceptional in the Southern Mediterranean Region.

- The budget is comprehensive in its content, including macroeconomic parameters, exchange rate assumptions, balance of payment, monetary statistics and details on external public debt. It also provides comparisons to actual performance in 2001 and 2002

- For the first time, the budget is presented in NIS as well as in U.S. dollars. Previous budgets were only presented in U.S. dollars, even though virtually all revenues and expenditures with the exception of foreign assistance are effected in NIS.

- The budget includes a line item on profits from public enterprises managed by the Palestinian Investment Fund. It also includes borrowing from the banking system and interest charges. This was not the case in previous budgets.

- For the first time, the budget includes comprehensive data on employment (both full time and part time) by ministries and agencies. It sets a limit on civil service employment increase, distributing the increase by ministry and agency. Hiring by security organization was to be limited by the budgetary appropriation.

- With the establishment of the STA in 2001, there was a new impetus to channel donor project assistance through the MoF. A number of major donors (EU, WB, Norway) started opening sub accounts dedicated to specific projects within the STA. In the 2003 budget, a first step was taken by incorporating public investment expenditures of US$212 million. This was essentially a rough estimate because of the absence of a solid data base on project disbursements. Generating a comprehensive data base on project spending and implementation became a priority in the preparation the 2004 budget. The MoF issued a circular to all PA ministries and agencies as well as a questionnaire to all donors, requesting information on donor project financing. This would provide a much more detailed and accurate budgeting of development expenditures for the 2004 budget. This information will also allow the new Ministry of Planning (MoP) to evaluate project execution and assess gross capital formation needs in the WBG. At the same time, it will enable the MoP in elaborating a developmental framework consistent with the direction projected for the Palestinian economy.

- With the unification of West Bank and Gaza accounting systems and computer networks, monthly budget execution is appearing on the MoF web site—By September 10, 2003 data for the month of August 2003 was published. These are of the shortest lags in public finance disclosure.

In its debate with the MoF prior to its budget approval, the PLC obtained two modifications. The first was a reduction in the net increase in the civil service from 3,118 in the draft budget to 2,772 in the approved version. The second was the implementation of the 1998 law on civil service reform. Since this reform would include a substantial increase in salaries, NIS 85 million were allocated for this purpose. However, the Ministry insisted on equivalent cuts in other budgetary appropriations. This constructive dialogue with the PLC marked a new era of cooperation between the two institutions.

The Palestinian Investment Fund

A major commitment in the Presidential decree of January 10, 2000 in the context of the EPF was the establishment of a Palestinian Investment Fund (PIF). This was charged with "managing all of the PA's assets and commercial activities in the WBG as well as abroad and also with executing the PA's privatization strategy once it has been finalized."[70] International auditors (SABA) evaluated all the (PCSC) assets for 1999 and published them as part of the Economic Framework. Nevertheless, no action was taken to establish the Fund and PCSC profits continued to be channeled outside the budget. It was only after the appointment of the reform cabinet in June 2002 that the new minister of finance made it a priority to establish the Fund with the assistance of Standard and Poor's. Articles of Associations were drafted in August 2002 and the Fund was formally established in October 2002 with the appointment of a board of directors chaired by the Minister of Finance and managed by Mohammad Rachid. The decree establishing the PIF made it illegal for the PA to conduct any commercial activity or any hold assets outside of the PIF.

The new board of the PIF ordered a full valuation of PA assets and assigned the Democracy Council to conduct a transparency assessment. The valuation of assets as of January 1, 2003 amounted to US$633 million, including 67 commercial entities and liquid assets.[71] This is almost double the US$345 million valuation of PCSC assets as of end-1999, suggesting that the coverage of PA assets in 1999 was incomplete. The range of activities reported not only covered part ownership of various Palestinian enterprises but also many investments abroad including venture capital, most notably in ORASCOM Telecommunication which has established itself as a major telecommunications conglomerate in emerging markets.

The question immediately arises as to the wisdom of investing taxpayer money in all these commercial activities and risk ventures. Since there was neither transparency nor accountability surrounding these investments, one may surmise that the only strategy was to build up equity with little regard to risk. Some of the commercial activities such as the Cement company failed the transparency test because of "anti competitive behavior, unfair or preferential relationship with the Palestinian authority and corruption"[72] which would disqualify it from being included in the PIF under its current structure. Hence, the on-going

[70] Economic Policy Framework—PA in collaboration with IMF, Progress Report, May 2000.

[71] The initial report issued on February 25, 2003 made a full valuation and transparency assessment of the 10 largest PA holdings. Evaluation of remaining assets was almost completed by mid-July 2003.

[72] Palestine Investment Fund. Initial Report on valuation and transparency as of January 1, 2003 Standard and Poor's, p71.

Box 5.2. The Second Wave of Reforms in Financial Accountability and Transparency: June 2002 – July 2003

1. **Revenue Consolidation**
   - Consolidation of all PA revenue into the Single Treasury Account (STA)
   - Transfer of income from PA commercial activities into the STA – First, profit transfer as of January 1, 2003 in April 2003 (US$ 15 million)
   - Consolidation of all PA commercial activities into the Palestinian Investment Fund (PIF), valuation of its assets and a transparency assessment.

2. **Tax Administration**
   - Steps toward unification of tax administration and computer systems in the West Bank and Gaza. Technical assistance provided by the IMF and EU.
   - Revising the income tax law based on international best practices – effective with 2004 budget.

3. **Strengthening expenditure controls**
   - Consolidation of expenditure management in Gaza and the West Bank: unifying the accounting system, treasury operations, submitting West Bank expenditures to budgetary approval
   - Establishing a modern Internal Auditing Department: a) issuance of internal audit procedures b) training of internal auditors c) establishing a system for auditing PA payroll purchasing and revenue
   - Prohibiting ministries from incurring advances from commercial banks.
   - Shift to direct deposits into bank accounts of security personnel salaries instead of cash payments. Four security agencies have joined this program with 20,000 members. Four other with 33,000 have not yet joined.
   - Strengthening external auditing procedures through the drafting of a new external auditing law by the PLC to ensure full independence of the office, submission of regular reports to the PLC and comprehensive coverage of all PA institutions.
   - Establishing an independent procurement agency within the Ministry of Finance

4. **Limits on PA employment expansion**
   - Strict adherence to additional civil service positions as specified in the budget
   - Enforcement of budgetary appropriation limits on increase in security personnel
   - Enforcing retirement of civil service at age 60

5. **Budget Reform**
   - Design of fully financed 2003 budget based on realistic assumptions and without resort to public indebtedness
   - Repayment of arrears to private sector (US$117 million as of end-May 2003)
   - In preparing for the 2003 and 2004 budgets, steps toward the integration of the public investment budget financed by donors into the PA budget
   - Enhancing transparency by meeting the budget calendar and publishing all budgetary accounts

6. **Pension Reform**
   - Steps taken toward unifying pension system and inclusion of security personnel under pension coverage
   - Closing the West Bank pension scheme to new entrants as of May 2001
   - Resumption of transfers of employee and government contributions in 2003
   - Expected agreement on parameters of unified pension system in the fall of 2003

7. **Restructuring monopolies**
   - Takeover of Petroleum Authority by MoF to ensure greater transparency and accountability and to restore market share and tax revenues
   - Restructuring prices policy for cement and petroleum products in favor of consumers by eliminating monopolistic rents

reorganization of the Cement Company (see below) was necessary prior to its inclusion in the PIF or privatization. The PIF board will now be reviewing all of its holdings and formulating a privatization strategy.

Grappling with monopolies

Prior to the empowerment of the PA, cement sales in the territories were monopolized by the Israeli Nesher Cement company, which also controlled the Israeli market. Petroleum product sales were also monopolized by the Israeli petroleum company DOR. With the establishment of a Palestinian authority over the territories under the Oslo process, the PA seized the opportunity of transferring these lucrative monopolies under its own authority. Ostensibly, the objective was to reap a quick source of quasi-fiscal revenues for the PA, given the uncertainty surrounding the establishment of a taxation department and the difficulties surrounding the Oslo peace process.

The Cement Company

The Cement Company became wholly owned by the PCSC and had an exclusive contractual relation and buying agreement with the Israeli producer Nesher. In addition, the Cement Company became the sole distributor for the Jordanian Cement Company. Beginning in 1999, the Ministry of Economy and Trade started issuing licenses to importers, but the market share of the cement company remained at around 90 percent until 2000. Since then, its market share declined to below 70 percent. Its pricing policy attempted to maximize monopoly profits. Thus, the price of cement in Gaza was set at NIS 295 per ton, while the price in the West Bank was set at NIS 245 per ton. Because Gaza is surrounded with a fence, which effectively prevents smuggling, a relatively high price can be enforced. On the other hand, sales of cement in the West Bank were subject to some competitive forces. When the cement company became part of the PIF, the Minister of Finance, as chairman of the board, found this pricing policy objectionable on two grounds: it extracted a quasi-fiscal and regressive monopoly tax on Gaza, the poorest region among the occupied territories, and it would complicate future efforts at privatizing the company. Consequently, he ordered the cement price in Gaza to be lowered to NIS 255 per ton, including a small transportation margin. He also dissolved the exclusive contractual relation with the Jordanian Cement Company, which now can sell to any Palestinian importer.

The Petroleum Commission

The Petroleum Commission took over the monopoly of selling petroleum products in the WBG from DOR in 1996. It is a regulatory agency but it is also engaged in channeling and selling petroleum products to the WBG with an exclusive contractual agreement with DOR. In this capacity, it should have been incorporated into the PIF. The Petroleum Commission was able to exercise its monopoly power prior to the Intifada but with the onset of the conflict and the closure of major West Bank cities, its market share fell substantially.[73] While pricing of petroleum products in the West Bank was roughly at the same level as in Israel, there were reports of fraud, extortion, and widespread smuggling of products at lower prices either through product mixing or from sources which did not bear full taxation. This deteriorating situation prompted the Minister of Finance to take over the Commission, change its management and conduct a full audit of its financial transactions. Petroleum product prices were reduced to the price levels of smuggled products, partly by scaling back the agency's profit margin and partly by renegotiating pricing with DOR. The MoF expectation is that by regaining market share, the increase in tax revenue on higher volume might offset some of the lost profit margin. By August 2003, sales of petroleum products rebounded dramatically with proportional increases in excise and VAT revenues (see Figure 5.1). The Commission had also imposed on gas stations sales of lubricants which it supplied from a manufacturer in Hebron. MoF dissolved this noncompetitive relation and took the Commission out of the lubricant business.

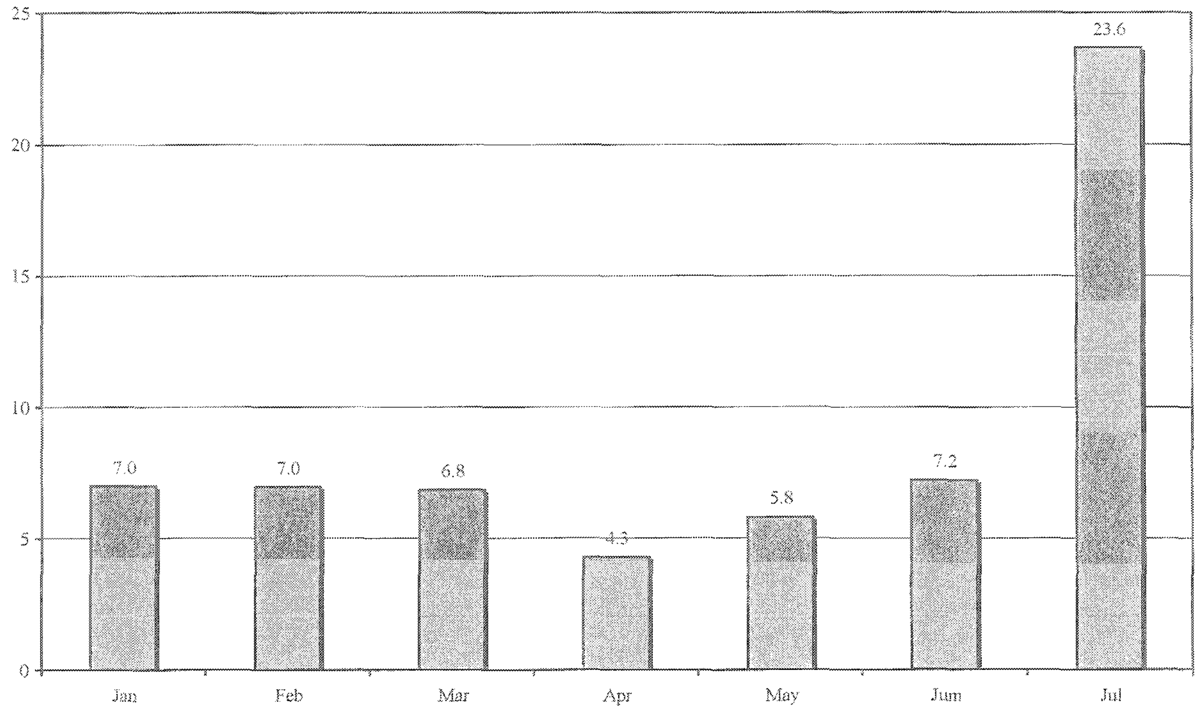
Once the West Bank market stabilizes, the ministry's intentions are to eventually privatize the commercial activities of the Commission—as in the case of cement—while maintaining its regulatory functions within the PA. For now, the ministry is refraining from collecting monopoly rents from cement and petroleum products by keeping prices closer to competitive levels and, while in the process, it may lose some budgetary revenues, it is nevertheless laying the ground for the establishment of a competitive market and privatization.

Pension reform

A major impediment to civil service and security organizations reform and personnel has been the lack of unified, fully funded and sustainable pension system. The security agencies do not have a pension system at all even though their employees have been contributing 10 percent of their salaries since 1995. The West Bank and Gaza systems are fundamentally different and both are unsustainable. The West Bank system is a "pay as you go" system with a low employee contribution (2 percent of salary) resulting in yearly expenditures on retirees exceeding contributions (NIS 50 million in 2000), with a resulting drain on the budget. The Gaza scheme, on the other hand, is a funded scheme with a high employee contribution (10 percent of salary) and a current surplus. However, partly because its benefits are too generous, it will start running deficits beginning in 2010 which will accelerate thereafter.

[73] For instance, diesel fuel was sold at an average of 10 million liters per month in early 2002 but only 5 million liters in May-June 2003.

Figure 5.1 Monthly Diesel Fuel Sales in the West Bank in 2003
(In millions of litres)



In addition to its structural unsustainability, the Gaza pension fund (GPIC) did not realize any gains on its original assets (US$170 million) transferred by Israel in 1994. It has not published annual reports nor has it been audited. Moreover, under the financial crisis experienced by the PA during the Intifada, the government fell into payment arrears on both its own and the employee contribution to the GPIC. By end-May 2003, these arrears amounted to about US$100 million. Another US$150 million would have to be provided to cover the security services contributions. These issues have been studied extensively by both the IMF (1997) and the World Bank (2001).[74] The World Bank proposal has received broad support and preparations are moving ahead toward quick implementation. The MoF is seeking to implement a unified and viable pension system, possibly starting with the 2004 budget. Three steps have already been taken:

- Beginning May 2001, all new West Bank employees started contributing in line with the Gaza scheme at 10 percent. In effect, the West Bank scheme has been closed to new entrants.

---

[74] IMF Pension Reform, Peter Heller and all, Technical Assistance Report. World Bank. West Bank an Gaza: Pensions in Palestine: Reform in a context of unrest, Feb 28, 2003.

- Beginning January 2003, employee contributions to the Gaza scheme have been transferred to the GPIC. Starting in August 2003, both the employee and the employer's share have been remitted to the GPIC.

- The GPIC is being fully audited and an evaluation of its assets is being conducted.

During the second half of 2003, additional steps are envisaged under pension reform. These will include:

- Defining the parameters of a new, unified pension scheme, such as retirement age, transition period for unification, years of service for eligibility and inflation adjustment formula.

- The appointment of an investment committee for the GPIC with formal investment guidelines, and full transparency of its activities.

- Passing legislation for a new pension law, incorporating both civil service and security agencies.

- Establishing a minimum universal social security scheme for the elderly. This system should benefit from a substantial transfer from Israel on account of estimated contributions it has collected since 1967 from Palestinian workers in the Israeli private sectors (fluctuating between 50,000 and 120,000).[75]

Once the necessary financing is mobilized and a pension scheme is established, the immediate benefits will be felt by security employees who are eligible to retire and who will have the opportunity to do so. It will also facilitate civil service reform and make it more acceptable. While the funding of a unified pension scheme may be substantial, the budgetary benefits will also be significant as it may reduce the wage bill by providing more attractive retirement opportunities. At the same time, it will result in budgetary savings with the shift of the West Bank retirement cost to the pension fund.

The President's budget

Presidential budgets (or for heads of State) are sensitive issues in all Middle East countries and most developing countries. In most cases, information is quite opaque if at all available.

---

[75] Contributions made to Israel's Ministry of Finance and the Employment Service of the Ministry of Labor. These contributions include those for national insurance (6 percent) and social security contribution (11.5 percent, with a further 12.5 percent paid by the employer). Palestinian estimates of these cumulated benefits range around US$2 billion, but these are rejected by Israeli authorities. Peter Heller op cit (Chapter 5).

In the case of the PA, actual expenditures of the President's office are published on a monthly basis, broken down by wages, operating expenses and transfer. The 2003 budget appropriated US$74 million to the President's office (8 percent of the total budget), of which US$34 million is dedicated to "transfers." The President assumes the prerogative of providing aid to various organizations and individuals. Some of them have legitimate claims but have fallen through the safety net and have no recourse other than appealing to the President. These include students seeking scholarships abroad, patients seeking specialized medical care abroad, people who have lost all their assets and livelihood during the conflict. However other claimants and organizations are part of politically favored networks who should not be getting such grants under any criterion. This inevitably raises questions and suspicions which are inconsistent with accountable and transparent public finance systems (unless all transfers and beneficiaries are published). The solution is simple—the President's budget should only cover the President's staff and operational expenses. All transfers should be spun off to the respective ministries for education, health and social affairs. With the strengthening of these ministries under the reform program, the legitimate claimants should prevail.

D. Conclusion

The reforms carried out in public finance since June 2002 have been highly significant in improving both accountability and transparency. With the strong support of the banking system, revenue mobilization and expenditure controls were effectively implemented. In depth reforms such as the establishment of the Palestinian Investment Fund, which fully accounted for PA's assets, and the tackling of major public monopolies were also pursued. This was accompanied by a major effort at transparency with the publication of the first quarterly report by the Ministry of Finance, followed by monthly reports, and the establishment of a data system which will provide up to date information with only a few days lag. When fully operational this system will rival best practices in the region.

Other reforms will take time to unfold because of their complexity and scope, as well as the need for new legislation. Among these one can mention the redrafting of a new income tax law, the unification of the pension system, civil service reform, the achievement of a fully operational internal and external audit system, and the reform of the transfer component of the President's budget. Some of these reforms will not only require persistence in execution, but also a change in the mind-set of officials and accountants, consistent with these new directions. This will require training, but also in some cases changes in management and personnel. All this will inevitably take time, but at the end of the day the financial system will be sound, transparent and user friendly.

Looking forward, as the Palestinian fiscal responsibilities evolve from an interim arrangement toward those of an independent state, the PA will need to review its role in raising revenue and providing services. It will need to consider, inter alia, the question as to what would be the appropriate level of taxation for a Palestinian state, given a realistic assessment of external support, and of the basic services which need to be provided to the population consistent with its level of income and expectations.[76] Income tax reforms, the level of customs tariffs excises and VAT can then all be calibrated to respond both to the basic needs of the population and the desired direction of the Palestinian economy. The PA will also need to review its financial relations and sharing of responsibilities with local government (see Chapter VI). The tax base of local governments should be expanded, consistent with some devolution of responsibilities to municipalities. A system of transfer in favor of poorer municipalities should also be addressed.

[76] For instance, schools in Gaza were forced to operate on two shifts of four hours each for lack of school buildings and teachers. While this is understandable, in emergencies it falls below minimum standards and is not sustainable.

VI. Staying on the Path of Reform[77]

A. Introduction

The Palestinian Authority (PA) was created in 1994 under the 1993 Oslo agreement between Israel and the Palestine Liberation Organization (PLO) as an interim administrative body that would assume responsibility for education, health, social welfare, direct taxation and tourism in the West Bank and Gaza. In certain sectors, it was also to be responsible for security. Also provided for under the Oslo accord, the Palestinian Legislative Council (PLC) was elected for the first time on January 20, 1996. Together, these two bodies, with President Arafat and his cabinet of ministers, began to work toward building the institutional foundations for a future Palestinian state.

Notwithstanding the failure of the Oslo peace process, much was achieved in the early years of the new Palestinian government. First, the Basic Law for the Palestinian Authority, with elements of a constitution for a future Palestinian state, was passed by the Legislative Council in 1997. Laws were also passed toward establishing an impartial and independent judiciary. And the PA's financial arrangements were put on sound footing with the agreement between the Government of Israel and the PA regarding the sharing of clearance revenues (VAT and customs collected by Israel but due to the PA).

But then the momentum was lost. Tensions emerged between the PLC and the President. Most of the laws passed by the PLC sat on the desk of President Arafat, and remained there for many years unsigned and therefore ineffective. Progress toward designing a new constitution stalled. The judicial process remained arbitrary and politically motivated. The fiscal process was perceived as extremely opaque, and liable to corruption. Under pressure from the international donor community, efforts were renewed in June 2000 to reform public finance in order to secure diverted revenue and improve transparency (see Chapter V). But in other areas reforms ground to a halt. And then in September 2000, the second Intifada broke out. These were hardly the circumstances under which one could expect a renewed effort toward reform on a broad front. And yet this is what happened. This chapter explains the circumstances that led to the resumption of reform, and describes the progress—rapid in some areas, slow in others—that has been made so far.

B. The Impetus for Renewed Reform

The origins of the renewed Palestinians reform effort can be found in the darkest days of the second "Intifada", during the Spring of 2002. Following U.S. President Bush's speech calling for an end to the Arab-Israeli conflict on April 4, 2002, U.S. Secretary of State Colin Powell visited the Middle East and Europe. In Madrid he met with representatives from the European Union (EU), the United Nations, and Russia. With the United States, these formed

---

[77] Prepared by Adam Bennett

what is known as the "Quartet", charged with overseeing the resumption of the peace process between the Israelis and Palestinians. In its "Madrid Declaration" of April 10, the Quartet endorsed the principle of the "two-state" solution to the conflict according to which Israel and a viable independent Palestinian state would coexist side-by-side and in peace.

Meanwhile, on May 16, 2002, the Palestinian Legislative Council (PLC) met with President Arafat and his cabinet (after the April siege of President Arafat's compound in Ramallah had ended) to propose sweeping reforms in a number of areas, and to call for the appointment of a new and smaller government in 45 days and for elections within six months. Some legislators also argued for the appointment of a prime minister. President Arafat agreed to hold elections within six months. He also reduced the size of the cabinet from 45 to 21 members on June 12, 2002, appointing key reformers as minister of finance and minister of economy & trade, but made no commitments regarding the position of prime minister.

Urged on by President Bush in a speech on June 24, 2002, the newly convened Palestinian government responded to the PLC's request for reform by announcing a "100 day reform program" on June 26, 2002 covering five "domains" (see Box 6.1). Highlights of the program included (i) presidential and legislative elections to be held by January 2003, (ii) the reorganization of the Palestinian security forces under a single authority (Ministry of Interior), (iii) the appointment of judges in the context of an independent judiciary and the adoption of measures and passage of laws consistent with the Judiciary Law and the Basic Law, (iv) the consolidation of all Palestinian Authority (PA) incomes into a single Treasury Account at the Ministry of Finance, the management of all commercial and investment activities through a transparent Palestinian Investment Fund, and the strict auditing of government operations, (v) the reorganization of relations between the Ministry of Finance and the municipalities and local authorities, (vi) the modernization of government institutions, (vii) the development of institutions and promulgation of laws that encourage investment and the market economy, and (viii) the engagement of Palestinian civil society in the development of democracy and in the reform program.

In support of this program and to help broaden the reforms, the Quartet established the International Task Force on Palestinian Reform ("Task Force") to develop and implement a comprehensive action plan drawing on the Palestinian program and to assist the Palestinian authorities in implementing it. The Task Force comprises representatives of the Quartet, Japan, Norway, the World Bank and the International Monetary Fund (IMF). The role of the Task Force is to monitor and support the implementation of Palestinian civil reforms, and to guide the international donor community in support of the Palestinian reform agenda.[78] At its

[78] The Task Force works with and reports to the Ad Hoc Liaison Committee (AHLC) which was first established in 1994 to help coordinate international donor assistance while also working, on a practical level, with both Israel and the Palestinian Authority to facilitate donor projects. The AHLC grew out of the "Oslo" multilateral Middle East peace process, with Norway as Chair and the World Bank as Secretariat, and comprises representatives of the

(continued)

inaugural meeting on July 10, 2002, the Task Force put forward a "Reform Action Plan" including specific Palestinian commitments covering seven areas: (i) financial accountability (discussed in Chapter V), (ii) the market economy, (iii) local government, (iv) ministerial and civil service reform, (v) the judiciary, (vi) elections, and (vii) civil society.[79] The development of benchmarks and monitoring of progress relating to each of the seven areas of reform was delegated to seven "Reform Support Groups" drawn from the Task Force membership. The IMF co-chairs with the EU the Support Group on Financial Accountability.

The Task Force was organized to function at both the capital level (periodic meetings at various international venues) and the local level (more frequent meetings in WBG between field representatives). Since its formation, the Task Force has worked with Palestinians to develop in greater detail the seven areas of reform, highlighting Palestinian commitments, establishing benchmarks, and identifying obstacles to reform and areas for donor assistance. The Task Force has done this by consulting directly with Palestinian executive and legislative officials, with Palestinian civil society, with the Israeli government, and with the donor community.

The Quartet also stressed in its July 16 statement the need for the Israeli government to facilitate the reform program by (i) easing internal closures and withdrawal of forces to pre-September 2000 positions, as the security situation permitted, and (ii) resuming the transfer to the PA of clearance revenues collected by the Israelis on behalf of the Palestinians, which had been stopped following the onset of the conflict. While there was no significant progress toward easing closures and withdrawing forces, the Israelis responded fairly rapidly in resuming transfers of withheld revenues, the first of which occurred in July 2002 (see Chapter IV).

Continued dissatisfaction regarding the composition of the cabinet resulted in the PLC again forcing President Arafat to disband his 21-member cabinet on September 12, 2002. A new cabinet of 19 members (including four new appointees) was approved by the PLC on October 29, 2002. Key reformers appointed in June, 2002, remained in place. In December, President Arafat announced that elections planned for January would have to be delayed until progress had been made toward lifting Israeli enforced closures. On February 14, 2003, under renewed pressure from both within the PLC and from international mediators, President Arafat agreed

---

United States, the United Nations, the European Union, Russia, Norway, Canada, Japan, the Arab League, the World Bank and the International Monetary Fund. The Joint Liaison Committee (JLC), a smaller body, was established in the field to focus on key economic issues relevant to donor implementation. The Local Aid Coordination Committee (LACC), a donor inclusive group, was set up to deal with planning and aid coordination issues in the field.

[79] Although one of the domains in the PA 100 day reform program included public security, the Task force did not assume a role in monitoring progress in this area.

to appoint a prime minister. After two months of negotiations, the PLC approved the appointment of prime minister Abbas and a new cabinet on April 29, 2003. With key financial and economic portfolios remaining with reformers, the most important (and contentious) change was to the ministry of interior which came under the direct control of the new prime minister, with a reformer selected under him as junior minister in charge of security.

In the meantime, and toward the broader objective of a two-state solution and a peaceful settlement, the Quartet proposed, on September 17, 2002, the draft outline of a three-phase "road map." The final version of the road map was supposed to be published in December 2002, but the concerns expressed by the government of the United States regarding the political leadership of the Palestinian Authority and the intervention of the Iraq war resulted in its publication being delayed until April 30, 2003, following the appointment of the new Palestinian prime minister and the confirmation of his cabinet by the PLC (see Box 6.2 for a summary and Annex 6.1 for the full text).

C. Seven Areas of Reform

The road map stressed, inter alia, that the Palestinians should persevere in institution building. To this end performance relevant to phase one of the Roadmap would be judged against the benchmarks established by the Task Force. Since the inception of the 100-day plan in June 2000, progress in the Palestinian reform program has been rather uneven. The Task Force continues to monitor and promote reform in the context of the seven reform support groups reviewing the areas mentioned above. The most marked advances have been made in the areas of financial accountability and the market economy. The pace of reform in the different areas has reflected a variety of considerations, including the zeal of Ministers, the ability of reformers and legislators to surmount the obstacles presented by the continued internal closures, checkpoints and curfews and meet amongst themselves and other interested parties, and the inherent difficulties and vested interests involved. Fiscal reforms and financial accountability were discussed at length in Chapter V. What follows is a description of progress under the other six areas of reform.

1. Market Economy

As noted in Chapter II, during the period of the Intifada, the private sector economy in the West Bank and Gaza has suffered considerably from the dislocation of markets, lack of mobility, and damage to property. Chapter II, III and V also drew attention to the private sector's liquidity problems related both to an ultra-cautious banking system and to government arrears on payment for goods and services and on VAT refunds. But in addition to these physical and financial problems, private sector activity and development are also hindered by a widespread lack of clarity in the legal and regulatory environment. Not all of these problems can be solved by direct government action: those that relate to the closures and curfews will not be solved until there is peace, or at least until both parties to the conflict are firmly on the Roadmap to peace. Reluctance on the part of banks to lend is mostly a matter of judging credit risk, rather than structural or policy deficiencies, and it would not be

BOX 6.1. "100 DAYS PLAN" OF THE PALESTINIAN GOVERNMENT

Released on June 26, the PA's Reform Agenda expressed the commitment of the Palestinian Government to a broad program of reforms. Because a number of specific measures were identified to be implemented within 100days (while implementation of all other measures would be initiated so as to have a "tangible and visible" effect within three months of the plan's adoption), the entire agenda has come to be know as the "100 Days Plan." The agenda items are summarized here:

In the general domain:

- Reinforce separation of powers of the legislative, executive and judiciary branches of government
- Restructure and modernize ministries and government institutions
- Prepare for municipal, legislative, and presidential elections
- Put into force all laws that have been passed
- Improve the standard of living, particularly the unemployed and other segments of society that live in dire conditions
- Rebuild the infrastructure that has been destroyed by the occupation
- Tend to the needs of the wounded, families of those killed during the occupation, prisoners and detainees

In the domain of public security:

- Restructure and modernize the Ministry of Interior
- The ministry of Interior is to be in charge of all matters relating to internal security
- Activate the role of the Ministry of Interior in the enforcement of court rulings
- Respond to the expectations of the people for safety, order and respect of law
- Improve discipline in the security services and strengthen social control
- Reinforce the loyalty of the security services to the job, the Authority and the country
- Raise awareness of the population of the measures above and secure their understanding, cooperation and support

In the financial domain:

- Reform operations in the Ministry of Finance
- Deposit all incomes of the PA in a single account of the treasury
- Manage all commercial and investment operations through a Palestinian Investment Fund, which is subject to stringent standards of disclosure and audit
- Limit expansion of employment in the public sector and unify payroll administration under the Ministry of Finance
- Modernize the Pension scheme
- Strengthen internal and external auditing
- Develop the process of preparing the general budget to include recurrent and developmental expenditure
- Develop a monthly expenditure plan for the remainder of 2002
- Begin preparation of the 2003 budget
- Reorganize the financial relations between the Ministry of Finance and the municipalities/local authorities

In the judicial domain:

- Strengthen the judiciary, through appointment of judges and development of infrastructure
- Implement measures required by the Judiciary Law
- Prepare draft laws, decrees and decisions to accompany the Basic Law
- Establish the Government Legal Cases Administration to handle cases to which the government is party.

In other domains:

- Reinforce the Palestinian values, including the spirit of democracy, enlightenment and openness
- Activate the role of the Ministry of Awqaf to serve national and religious objectives
- Resolve the financial crisis of the universities, schools and hospitals
- Review the government institutions that operate outside the jurisdiction of the ministries with a view to attach or incorporate them with the ministries
- End the role of the security services in civilian affairs
- Improve employment policy to prevent an inflated civil service
- Unify and develop institutions—and promulgate laws—that encourage investment
- Improve the training and conditions of employment of human resources
- Increase the effectiveness of the Palestinian diplomatic corps
- Pay special attention to the pollution of the environment

Source: International Task Force on Palestinian Reform

Box 6.2. The Road Map (summary)

The **first phase** of the Roadmap involves a cessation of violence; performance-based criteria for comprehensive security reform; Israeli withdrawals to their positions of September 28, 2000 (the date of the breakout of hostilities); cessation of new settlement activity and dismantling of settlements erected since March 2001; and free, fair, and credible Palestinian elections, based on the recommendations of the Quartet's Task Force. In the plan's **second phase** the objective would be to establish a transitional Palestinian state with attributes of sovereignty, provisional borders and a new constitution, subject to the Quartet judging the conditions favorable. Toward this end, an international conference would be convened by the Quartet following the successful conclusion of Palestinian elections. The **third phase**, to be completed by 2005, envisages Israeli-Palestinian negotiations aimed at a permanent solution and a second international conference to finalize agreements on borders, settlements, refugees and the status of Jerusalem.

appropriate for the government to override these considerations. But some of the problems that beset the private sector, including elements that affect its creditworthiness, do lie at the door of the government.

The most immediate task of the government was to clear its arrears to suppliers of goods and services as well as regularize VAT refunds when due. These arrears to suppliers and delays on VAT refunds arose in consequence of the financial crisis experienced by the PA in 2002 (see Chapter IV). Following the resumption of regular transfers to the PA of clearance revenues collected by the GoI in December 2002 and the return (by monthly installment) of clearance revenues withheld during 2001 and 2002, the PA was able to begin clearing arrears to suppliers and resume eligible VAT refunds. Beginning in January 2003, with the resumption of transfers from the GoI, the Ministry of Finance resumed systematic repayment of VAT refunds and by April, 2003, all late refunds had been paid.[80] Thereafter the ministry's stated objective was to effect all refunds within thirty days of the relevant transactions. In order to reduce the possibilities for tax evasion, zero-rated activities are required to make VAT payments, subject to the refund guarantee noted above.

The Ministry most closely involved in reforms affecting the private market economy was the Ministry of Economy and Trade. To further extend and harmonize the reform effort, the ministry was restructured and merged with the Ministry of Industry in October 2002 and with the Ministry of Supply in mid-2003, and the combined ministry placed under the authority of one of the key reformers in the cabinet. The merged ministry is now actively engaged in reform in all areas of the market economy, including the regulation of private business and financial activity (excluding banking), trade and tariff regulation and customs reform, as well as various tax reforms (in conjunction with the Ministry of Finance).

[80] VAT refunds were overdue to businesses, exporters and also to international organizations.

Under the aegis of the newly merged ministry, a range of laws designed to establish the legal and regulatory framework for private market activity, some developed in close consultation with international experts and with the help of the Task Force support group on the Market Economy, have begun or resumed progress. Some of these laws are still in draft, some have advanced to ministerial committee level and some are in their final reading in the PLC. These laws include the Competition Law, Company Law, Intellectual Property Law, Securities Law (Capital Markets Authority Law), Insurance Law, Secured Lending and Leasing Law, International Commercial Arbitration Law, and Rental Law. The ministry is also involved, with the Ministry of Finance, in seeking amendments to an Income Tax Law, which is expected to become effective with the 2004 budget. This is intended to be a wide ranging law establishing definitions for the tax base, for tax rates and for taxable entities. It also covers elements of tax administration (registration, assessment, collection, enforcement, and audit).

Efforts are also underway to improve land registration. Only about 35 percent of land in the West Bank and about 50 percent of the land in Gaza has been registered. Reflecting the resulting uncertainty regarding title, property transfers are routinely effected by means of agreeing (selling) an "irrevocable power of attorney" over the land. Such powers of attorney are often not well documented and do not clearly confer title. The lack of clarity regarding title to land and property raises questions about boundaries and legal succession, which in turn prevents land from being effective collateral. The absence of collateral, combined with uncertainty regarding the possibility of foreclosure on collateral (pending the passage of the Secured Lending Law), is one of the many things which hinders the ability and willingness of banks to extend credit. Ambiguities regarding title also hinders capital investment involving property, and especially foreign investment. Efforts are therefore underway to establish a proper land registry in the office of Land Authority with land transfers effected by the transfer of title, as well as to better regulate the practice of transferring powers of attorney.

2. Local Government

The main issues identified by the Task Force for the reform of local government concern (i) the proper role, functions and funding sources for local government, and (ii) the relationship between the central and local levels of government. Progress toward formulating a reform program has been relatively slow, because local authorities have been hampered by the substantial infrastructure destruction and by the constraints on mobility which prevent reformers from reaching the municipalities and seats of local government. Municipalities have lacked the resources needed to function properly, affecting adversely the delivery of basic services as well as the ability to collect payment. Collection rates during the Intifada for municipal electricity and water supplies have been very low, resulting in large municipal deficits and the need for central government to periodically bail them out. It is against this background that a work plan is being developed.

Local government (as opposed to national government) has a long history in Palestine, starting with the (late) Ottoman system in the mid 19th century, followed by the British Mandate during 1917–47, and the separate Egyptian and Jordanian systems for Gaza and the West Bank, and then the Israeli arrangements after 1967. Although there was some limited role for elected officials under the Ottoman system, and rather more under the British Mandate, a significant degree of central control remained. This central control was increased under the Jordanian and Egyptian systems, and under the Israelis it was tightened further.

In 1994, when the Palestinian Authority was established, the local government system in the West Bank and Gaza consisted of 30 municipalities (4 in Gaza and 26 in the West Bank), and 109 village councils. One of the first acts of the PA was to establish a Ministry of Local Government in 1994. This new ministry undertook a limited reorganization of local government, elevating 90 village councils into municipalities and increasing the number of village councils to 251. In 1996, the PLC passed the law for the Election of Local Councils and in 1997 it passed the law of Local Councils. Despite these laws, intended to pave the way for a more decentralized, representative system of local government, municipalities and local councils have not been empowered and still operate under the Ministry of Local Government. There remain a multiplicity of laws in different jurisdictions (Jordanian law in the West Bank, Egyptian law in Gaza, and Israeli military orders still in effect in the area designated as Area C). And there have not yet been elections for local councils.

The most important responsibilities of local government defined under the 1997 law of Local Councils are the management of water and electricity supply and distribution. Beyond that, the law specifies a rather narrow range of responsibilities, covering the issuance and administration of building permits, regulation of local markets and businesses, fire protection, sanitation, parks, and refuse collection. Absent from specified responsibilities are education, health and police, which remain under PA ministerial authority. There is also no definition of the standard of service expected of local authorities. Consequently, standards of service differ widely between councils. Local government revenues are also very low when compared to other countries. And those revenues to which it is entitled have not been consistently remitted to it by the collecting agency, the PA. In consequence, the PA has failed to support the local governments to ensure a minimum level of services.[81]

The city of Qalqilya, for example, has not received any transfers from the PA since its inception. In consequence, following the onset of the Intifada and the collapse of the municipalities' revenue base, the city stopped paying its utility bills (owed to the Israelis), a pattern repeated in other cities in the WBG. This (politically) shifted the burden to the PA, which periodically cleared the outstanding arrears (mainly through offsets on Israeli transfers of withheld clearance revenue). This process, which has generated a complex array of cross-arrearages between the municipalities and the PA, is clearly unsatisfactory.

Given the economies of scale in the provision of water and electricity services, a key reform is likely to relate to the utilities, for which existing local government units are too small for efficient distribution. Two possible courses of action have been identified: to create regional utility authorities, or to corporatize the utilities. Either strategy would have the effect of

[81] Some villages represented by local councils do not have either water or electricity.

separating the management of the utilities from municipalities and village councils. On the other hand, there might be an increase in the scope of responsibilities of local authorities if there were to be some decentralization of health, education and policing. All these options are under consideration.

More than half local government revenues accrue from water and electricity tariffs. Because revenues collected from the utilities often fall short of what is needed for their operation and maintenance, local authorities may be willing to forgo this income as part of their reorganization, provided alternative sources of financing can be identified. Of the remaining revenue sources of local government, more than three quarters come from fees, especially building license fees. A relatively small proportion of revenues come from property taxes, occupation taxes (on businesses) and transportation taxes (vehicle licenses and fines) that are levied and administered by the PA and remitted back to local government under a revenue sharing agreement. The low level remitted reflects, in part, offsets made by the PA for clearing municipal arrears to Israeli utilities, as noted above. Prior to reforming the financing of local authorities it will be necessary to sort out all these cross-arrears between central and local government.

Future reform of local government finances could then include the devolution of responsibility for collection, administration and full retention of local property, occupation and transportation taxes. This would be commensurate with local authorities accepting responsibility to provide higher standards of service, as well as for possibly taking on new responsibilities. Notwithstanding the enhancement of the local revenue base, there may still be a need for equalization transfers or special purpose transfers from the PA to some local authorities. The 1997 law on local councils makes no provision for such transfers. Yet regular equalization transfers may be necessary, if a common standard of service is to be provided across the defined responsibilities of local authorities, because of the differing taxable depth of different municipalities and village councils. Special purpose transfers are also likely to be needed, at least for a period of time, because of the widely varying amount of destruction to local infrastructure between different local authorities.

The likelihood of a continuing financial relationship between the PA and local authorities highlights the need for a clarification of the relationship between them, and especially between the Ministry of Local Government and the local authorities.[82] At present the Ministry of Local Government functions as if the local authorities under it were ministerial departments, over whose direction it exercises full control and whose officers (mayors and council members) it appoints or approves. In its future role, it is expected that the ministry would confine its role to that of regulator and issuer of guidelines. Local authorities would

[82] The relationship of local authorities with, and the role of, "governorates" (of which there are 16 in WBG) and the governors appointed over them need also to be clarified. The existing powers and functions of governorates derive to a large extent from old Egyptian and Jordanian laws.

then be responsible for drafting their own by-laws in accordance with ministerial regulations and guidelines, but reflecting local conditions. Mayors and council members would be elected, rather than appointed. This highlights the need for progress in local elections, which is already provided for in the law on Local Elections (now seven years old), and without which many of the provisions of even the already existing 1997 law on local councils cannot be made effective (as it refers to powers and authorities being provided to "elected local authorities."

3. Ministerial and Civil Service Reform

Although drafted in 1996, and approved by the PLC in 1997, President Arafat did not sign the Basic Law until May 2002. The Basic Law represents a type of interim constitution and establishes a structure of government based on the principle of the separation of powers. It contains a range of checks and balances to prevent domination by any branch, particularly the Executive.[83] Many parts of the Basic Law have yet to be implemented. Some elements require additional legislation to be effective.

The executive branch of the government consists of a directly elected president, who presides over a Cabinet called the Council of Ministers. The President proposes laws to the PLC—directly or through the ministers—and signs or rejects, within 30 days, laws ratified by the PLC. The President can issue decrees (on an exceptional basis) if the PLC is not in session, but such decrees must be submitted for approval of the PLC at its next session. The 88 elected members of the PLC have the ability to vote for a motion of no confidence in the President or in any minister. They can approve the annual budget prepared by the executive and can overturn a presidential veto of their proposed legislation with a two-third vote. They can also amend the Basic Law with a two-third vote. The Basic Law also covers the relationship between the executive and the judiciary (see below), and contains a Bill of Rights chapter similar to those found in the United States constitution.

One of the key objectives of the reform program in the 100-day plan is to implement the provisions of the Basic Law, in particular those aspects that relate to the separation and transfer of powers; the organization and functioning of the Executive Authority, Council of Ministers, and individual ministries; and the role of government in the legislative process. An important first step in this area has been the appointment of a Prime Minister in April 2003, and the formation of a new Cabinet under his authority. This step, which was made within the context of the Basic Law, but not specifically anticipated by it, permitted the long-awaited release of the Roadmap by the United States State Department. In order to facilitate the reform and legislative process, laws pending in the President's office for more that 30

[83] Because the Basic Law is not a full fledged constitution, work is also underway, and is called for in the Roadmap, to develop an accompanying constitution with the help of international experts on constitutional reform.

days will be considered approved (unless explicitly rejected), as per the Basic Law, and published in the Official Gazette.

In light of the Basic Law, work is underway to rationalize the overall structure of government, clarifying the mandates, structures and functions of ministries and institutions. Government agencies will be put under relevant line ministries, including the integration of the Diwan al Fatwa (responsible for drafting judicial legislation) into the Ministry of Justice. This would leave only a limited number of institutions and authorities (the General Personnel Council, the Central Bureau of Statistics, the Palestine Monetary Authority and the Documentation Center) outside the ministries and under the responsibility of the Cabinet. Work is also underway to reform cabinet processes and procedures. Finally, a clear line will be drawn between the authority of the government and that of the parties or political movements that may be represented in the PLC.

Civil Service reform is a key element of the 100-day reform program. Until a hiring freeze (applicable to all but the health, education and judicial sectors) was applied in April 2001, the numbers of employees under the public payroll had been growing steadily. The number of civil servants in the West Bank and Gaza is now about 2.1 percent of the total population of 3.5 million people. This does not seem particularly high, and indeed compares quite favorably with other countries. However, some 1.5 million Palestinians (half the population) are registered as refugees, many of which receive at least some of their public services (health and education) from the United Nations Relief and Work Agency (UNRWA), rather from the PA. If these are removed from the relevant definition of the population for comparing the size of the civil service, a less flattering ratio of 4.0 percent emerges. This suggests that the civil service may be overstaffed for the level of service that is provided. It is also possible that some the "services" provided may be either redundant, or perhaps better delivered at a municipal or local level rather than at a central government level. Outside of the civil service, but still on the public payroll, are the 53,000 strong security services. Many of these are not providing any security services at all, and only continue to hold their jobs because of the absence of a pension. Others may be involved in more questionable activities. Reforming this area of public employment will be a challenge, and will be shared by the Ministry of Interior and the Ministry of Finance.

As well as a rationalization of the services provided, there is also a need for a review of civil service remuneration and terms of employment. Currently, the wage structure is extremely compressed. Compressed wage structures tend to under-reward higher level staff and over-pay lower, less skilled employees. This does not provide a good incentive for employees to perform, and is likely to result in departure of superior performers. Room for an expansion of the wage structure—without a reduction in its size—is however, somewhat limited by virtue of the already substantial cost of the civil service when measured in terms of currently available revenues.

A comprehensive plan for reforming the civil service will require a thorough review of civil service organization, of the services provided, and of the salary structure. While this plan is being developed, the Ministry of Finance has already taken some important interim steps to improve civil service management and to reduce its costs. Management of the civil service budget has been enhanced by the consolidation of the payroll within the Ministry of Finance and making salary payments by bank deposit instead of cash. As well as increasing the ministry's control over this aspect of its budget, this measure has also strengthened the ability of the PA to monitor and verify its workforce.[84]

4. Judiciary and the Rule of Law

A key objective of the Basic Law is the independence of the judiciary from the Executive (President and Council of Ministers). Under the law, the judiciary is headed by an (independent) Supreme Judicial Council (established in June 2000). The process of appointment to the Judicial Council and its relationship with the various courts is spelt out in the Law of Judicial Authority (passed in 1999 but not signed by President Arafat until May 2002). One of the objectives of the 100-day reform program was to further this process of judicial independence and legal reform, in particular through the appointment of members of the Council and of judges consistent with the Law, as well as through the reform of court system and rationalization of laws.

Developments in the judicial area have not always moved in the right direction since the publication of the program. In particular, contrary to the requirements of the Law of Judicial Authority, President Arafat extended the term of existing members of the Council through end-June 2003 on an interim basis, even though their age and qualifications for membership were considered by observers to be inconsistent with the provisions under the new Law. President Arafat also appointed a Prosecutor General without first obtaining the Supreme Council's recommendation, which is also inconsistent with the new Law. The terms of reference of this appointment also seemed to confirm the continued existence of the State Security Courts, one of the most contentious features of the existing court system.[85]

---

[84] Closely related to the reform of the civil service is the reform of the pension system. This formally falls under the purview of the Support Group on Ministerial and Civil Service Reform, but the subject is covered in Chapter V, and so will not be discussed further here.

[85] The ordinary court system includes Conciliation Courts for small criminal and civil cases, District Courts (called Courts of the First Instance in the West Bank, and Central Courts and Major Crimes Courts in Gaza) for more serious crimes and larger criminal cases, and High Courts (one each in Gaza and the West Bank) for appeals from lower courts. In addition there are *Shar'ia* courts for Muslims and tribunals for Christians that deal with matters of personal status. Separate from these courts are the Military Courts that deal with crimes involving the security forces and police, and the State Security Courts that deal with threats to internal and external security (as described above).

The State Security Courts stand outside the Palestinian civil and criminal court system, and remain under the control of the Executive. They were established by the PLO in 1979 and activated under a decree issued by President Arafat in 1995, under international pressure to respond more firmly to anti-Israeli violence. The decree provides the courts with jurisdiction "over crimes which infringe on internal and external state security." These courts have developed serious shortcomings in judicial process. The courts have often omitted the rights of defendants to legal representation, trial before a court of qualified and impartial judges, or appeal against verdicts issued. Proceedings are usually held in secret. Furthermore, although the decree establishing the state security courts limits their jurisdiction to state security matters, civil or criminal cases have frequently been transferred to these courts, thereby disempowering the civil and criminal court system. Reflecting these shortcomings, the Task Force judged the early abolition of these courts to be a crucial element of the reform of the judicial system.

On May 19, 2003, President Arafat issued a decree nominating a new Supreme Judicial Council in replacement of the interim one. The State Security Courts were also abolished and a statement will be issued by the Minister of Justice to this effect. A delineation of responsibilities between the Supreme Judicial Council and the Ministry of Justice is being addressed. Many of the key issues raised by the Task Force have now been resolved, although many practical matters remain to be tackled. These include infrastructural matters, such as the building of law courts, the training of judges, as well as the harmonization of the law itself.

Reflecting the complex history of the region, the West Bank and the Gaza Strip are each governed by different layers of accumulated laws, resulting in considerable confusion. Except where new and unified PA laws apply to the whole PA, the West Bank has relied mainly on civil or French-influenced Jordanian law, while the Gaza Strip has relied on Egyptian and British laws, reflecting more the common law or Anglo-Saxon system. Some Ottoman and Israeli laws and decrees persist in both areas, as well as laws used by the PLO prior to the establishment of the PA. The Law Center at Birzeit University is now looking into ways to harmonize law across the West Bank and Gaza, with the cooperation of the Task Force. Confusion regarding the applicability of law in the West Bank and Gaza, combined with the lack of a clear judicial process or a mechanism for resolving commercial disputes, has been an important factor in holding back the development of private market activity.

5. Elections

In January 1996, Palestinians for the first time chose their own national political leaders, electing an 88-member Legislative Council (PLC) and a chief executive, Yasser Arafat, of the Palestinian Authority. These elections were governed by the 1995 Electoral Law and were overseen by a Central Elections Commission (CEC). The CEC also established District Election Offices and Polling Station Commissions to assist in carrying out the elections at the local level. According to the Basic Law, members of the PLC are elected for a five year term. New elections are therefore now long overdue and have also been made an explicit condition to implement Phase II of the Roadmap. The Roadmap also stresses that such elections must be "free, fair and open."

The 1995 Election Law was enacted by Presidential decree. Given its importance, it has been agreed that this law, or a revised version, should also be approved by the PLC as the basis for the proposed elections. The international community has indicated that it will not show a preference for any particular legal model, other than that it should meet generally acceptable democratic standards. The existing law is known to have a few (mostly technical) problems. It could therefore, with a few minor amendments, meet these standards. The developments of a new (revised) election law has been referred by the PLC Chairman to the PLC Legal Committee. But this committee's progress in preparing a draft law has been very slow, partly because of its inability to meet due to closures.

In the meantime, an independent Central Election Commission (CEC), headed by the President of Birzeit University, was reappointed in October 2002 to oversee presidential and parliamentary elections. The CEC in turn established an administrative arm (Election Administration) and has moved toward the reappointment of 16 District Election Commissions. It is now preparing a mechanism for voter registration.

In 1995, voter registration was carried out through canvassing (door to door) by the Palestinian Central Bureau for Statistics, prior to the election law being decreed by the President. The law, which was passed in December 1995, included detailed provisions for voter registration which experts have later realized are impractical and were not, in any case, followed in 1995. The voter registration methodology to be adopted by the CEC this time around will also likely not adhere to the 1995 law. This is therefore one aspect of the existing law that will need review. Hopefully, the revised law can be ratified before voter registration actually takes place.

Unlike the 1995 voter registers, which were collected by canvassing, the CEC intends that the new voter registers, for all areas in the West Bank and Gaza except East Jerusalem, will be drawn up by Voter Registration Centers. These centers will be placed in the same location where the voter will later vote. In East Jerusalem, where Registration Centers are not considered feasible, registration will be conducted through canvassing, as before. It is intended that voter registration within this proposed framework should be updated regularly, so that elections could be called at any time.

The original date proposed for the elections of January 20, 2003 had to be postponed in light of political developments in the region, which was just as well as the required electoral arrangements discussed above were not in place at that time anyway. Nor would the security situation, with continued closures and curfews, have permitted meaningful elections to take place. It is now envisaged under the Roadmap that elections might take place in January-February 2004.[86]

6. Civil Society

The overall reform program depends importantly for its success upon the involvement of the Palestinian civil society, whose engagement in the development of the future Palestinian state had hitherto been rather limited. An early consensus was reached that the definition of the civil society needs to be as broad as possible, to go beyond proactive non government organizations and their networks and include trade unions, women's organizations and similar bodies. A first step toward extending the PA's "outreach" was the creation of an inclusive Common Council of Civil Society Organizations in the West Bank and a similar organization in Gaza in 2002. The creation of these councils has enhanced the ability of the PA to interact regularly with representatives of civil society on all aspects of the reform process.

The PA is undertaking an information campaign, initiated in January 2003, to present and explain the reform process to the public and/or specialized civil society groups through media, public meetings, and videoconferencing. Trips have also been made by PA Ministers to meet Civil Society organizations in different locations around the West Bank and Gaza, but the continuing restrictions on freedom of movement and the lack of permits has severely curtailed this activity.

D. Conclusion

The progress that has been achieved since the 100 day action plan was announced in June 2002 in reforming Palestinian legal, administrative and governmental institutions, and in laying the groundwork for a market economy, has been very real, if perhaps a little uneven. But much remains to be done. Many of the laws relevant to the development of the market economy are still pending and need to be passed. Land registration has barely begun. Plans for reforming local government need to be finalized and put into action. Civil Service reform is still awaited. The legal framework requires rationalization and harmonization. Law courts need to be built and judges trained. A constitution must be drawn up and, last but not least, there should be elections, both at the national and local level, for which a register of voters must be established.

For the future, much depends on the will and determination of Palestinian reformers to pursue their reform agenda. Much also depends on the willingness of Israel to alleviate the

[86] Local elections are covered by the 1996 law of elections of local councils. As with national elections, the holding of local elections will depend upon the establishment of a voter register. Political considerations are likely to result in local elections being held after national elections.

regime of closures, so as to permit the reformers to go about their work. Both the Israelis and the Palestinians have a common interest in the success of this reform effort. For at the end of the day, if the road to reform that has been mapped out is followed, the future Palestinian state that will emerge will have a much more liberal structure than the more autocratic regimes that prevail elsewhere in the Middle East, with greater limitations on the state and a more vibrant role for the private sector, and with an economy that is well integrated into the world economy and in harmony with its neighbor, Israel.

ANNEX 6.1

A PERFORMANCE-BASED ROADMAP TO A PERMANENT TWO-STATE SOLUTION TO THE ISRAELI-PALESTINIAN CONFLICT

Statement by the Quartet, April 30, 2003

The following is a performance-based and goal-driven Roadmap, with clear phases, timelines, target dates, and benchmarks aiming at progress through reciprocal steps by the two parties in the political, security, economic, humanitarian, and institution-building fields, under the auspices of the Quartet the United States, European Union, United Nations, and Russia. The destination is a final and comprehensive settlement of the Israel-Palestinian conflict by 2005, as presented in President Bush's speech of 24 June, and welcomed by the EU, Russia and the UN in the 16 July and 17 September Quartet Ministerial statements.

A two state solution to the Israeli-Palestinian conflict will only be achieved through an end to violence and terrorism, when the Palestinian people have a leadership acting decisively against terror and willing and able to build a practicing democracy based on tolerance and liberty, and through Israel's readiness to do what is necessary for a democratic Palestinian state to be established, and a clear, unambiguous acceptance by both parties of the goal of a negotiated settlement as described below. The Quartet will assist and facilitate implementation of the plan, starting in Phase I, including direct discussions between the parties as required. The plan establishes a realistic timeline for implementation. However, as a performance-based plan, progress will require and depend upon the good faith efforts of the parties, and their compliance with each of the obligations outlined below. Should the parties perform their obligations rapidly, progress within and through the phases may come sooner than indicated in the plan. Noncompliance with obligations will impede progress.

A settlement, negotiated between the parties, will result in the emergence of an independent, democratic, and viable Palestinian state living side by side in peace and security with Israel and its other neighbors. The settlement will resolve the Israel-Palestinian conflict, and end the occupation that began in 1967, based on the foundations of the Madrid Conference, the principle of land for peace, UNSCRs 242, 338 and 1397, agreements previously reached by the parties, and the initiative of Saudi Crown Prince Abdullah – endorsed by the Beirut Arab League Summit—calling for acceptance of Israel as a neighbor living in peace and security, in the context of a comprehensive settlement. This initiative is a vital element of international efforts to promote a comprehensive peace on all tracks, including the Syrian-Israeli and Lebanese-Israeli tracks.

The Quartet will meet regularly at senior levels to evaluate the parties' performance on implementation of the plan. In each phase, the parties are expected to perform their obligations in parallel, unless otherwise indicated.

PHASE I: ENDING TERROR AND VIOLENCE, NORMALIZING PALESTINIAN LIFE, AND BUILDING PALESTINIAN INSTITUTIONS—PRESENT TO MAY 2003

In Phase I, the Palestinians immediately undertake an unconditional cessation of violence according to the steps outlined below; such action should be accompanied by supportive measures undertaken by Israel. Palestinians and Israelis resume security cooperation based on the Tenet work plan to end violence, terrorism, and incitement through restructured and effective Palestinian security services. Palestinians undertake comprehensive political reform in preparation for statehood, including drafting a Palestinian constitution, and free, fair and open elections upon the basis of those measures. Israel takes all necessary steps to help normalize Palestinian life. Israel withdraws from Palestinian areas occupied from September 28, 2000 and the two sides restore the status quo that existed at that time, as security performance and cooperation progress. Israel also freezes all settlement activity, consistent with the Mitchell report.

At the outset of Phase I:

-- Palestinian leadership issues unequivocal statement reiterating Israel's right to exist in peace and security and calling for an immediate and unconditional ceasefire to end armed activity and all acts of violence against Israelis anywhere. All official Palestinian institutions end incitement against Israel.

-- Israeli leadership issues unequivocal statement affirming its commitment to the two-state vision of an independent, viable, sovereign Palestinian state living in peace and security alongside Israel, as expressed by President Bush, and calling for an immediate end to violence against Palestinians everywhere. All official Israeli institutions end incitement against Palestinians.

SECURITY

-- Palestinians declare an unequivocal end to violence and terrorism and undertake visible efforts on the ground to arrest, disrupt, and restrain individuals and groups conducting and planning violent attacks on Israelis anywhere.

-- Rebuilt and refocused Palestinian Authority security apparatus begins sustained, targeted, and effective operations aimed at confronting all those engaged in terror and dismantlement of terrorist capabilities and infrastructure. This includes commencing confiscation of illegal weapons and consolidation of security authority, free of association with terror and corruption.

-- GoI takes no actions undermining trust, including deportations, attacks on civilians; confiscation and/or demolition of Palestinian homes and property, as a punitive measure or to facilitate Israeli construction; destruction of Palestinian institutions and infrastructure; and other measures specified in the Tenet work plan.

-- Relying on existing mechanisms and on-the-ground resources, Quartet representatives begin informal monitoring and consult with the parties on establishment of a formal monitoring mechanism and its implementation.

-- Implementation, as previously agreed, of the United States rebuilding, training and resumed security cooperation plan in collaboration with outside oversight board (U.S.-Egypt-Jordan). Quartet support for efforts to achieve a lasting, comprehensive cease-fire.

* All Palestinian security organizations are consolidated into three services reporting to an empowered Interior Minister.

* Restructured/retrained Palestinian security forces and IDF counterparts progressively resume security cooperation and other undertakings in implementation of the Tenet work plan, including regular senior-level meetings, with the participation of U.S. security officials.

-- Arab states cut off public and private funding and all other forms of support for groups supporting and engaging in violence and terror.

-- All donors providing budgetary support for the Palestinians channel these funds through the Palestinian Ministry of Finance's Single Treasury Account.

-- As comprehensive security performance moves forward, IDF withdraws progressively from areas occupied since September 28, 2000 and the two sides restore the status quo that existed prior to September 28, 2000.

Palestinian security forces redeploy to areas vacated by IDF.

PALESTINIAN INSTITUTION-BUILDING

-- Immediate action on credible process to produce draft constitution for Palestinian statehood. As rapidly as possible, constitutional committee circulates draft Palestinian constitution, based on strong parliamentary democracy and cabinet with empowered prime minister, for public comment/debate. Constitutional committee proposes draft document for submission after elections for approval by appropriate Palestinian institutions.

-- Appointment of interim prime minister or cabinet with empowered executive authority/decision-making body.

-- GoI fully facilitates travel of Palestinian officials for PLC and Cabinet sessions, internationally supervised security retraining, electoral and other reform activity, and other supportive measures related to the reform efforts.

-- Continued appointment of Palestinian ministers empowered to undertake fundamental reform. Completion of further steps to achieve genuine separation of powers, including any necessary Palestinian legal reforms for this purpose.

-- Establishment of independent Palestinian election commission. PLC reviews and revises election law.

-- Palestinian performance on judicial, administrative, and economic benchmarks, as established by the International Task Force on Palestinian Reform.

-- As early as possible, and based upon the above measures and in the context of open debate and transparent candidate selection/electoral campaign based on a free, multi-party process, Palestinians hold free, open, and fair elections.

-- GoI facilitates Task Force election assistance, registration of voters, movement of candidates and voting officials. Support for NGOs involved in the election process.

-- GoI reopens Palestinian Chamber of Commerce and other closed Palestinian institutions in East Jerusalem based on a commitment that these institutions operate strictly in accordance with prior agreements between the parties.

HUMANITARIAN RESPONSE

-- Israel takes measures to improve the humanitarian situation. Israel and Palestinians implement in full all recommendations of the Bertini report to improve humanitarian conditions, lifting curfews and easing restrictions on movement of persons and goods, and allowing full, safe, and unfettered access of international and humanitarian personnel.

-- AHLC reviews the humanitarian situation and prospects for economic development in the West Bank and Gaza and launches a major donor assistance effort, including to the reform effort.

-- GoI and PA continue revenue clearance process and transfer of funds, including arrears, in accordance with agreed, transparent monitoring mechanism.

CIVIL SOCIETY

-- Continued donor support, including increased funding through PVOs/NGOs, for people to people programs, private sector development and civil society initiatives.

SETTLEMENTS

-- GoI immediately dismantles settlement outposts erected since March 2001.

-- Consistent with the Mitchell Report, GoI freezes all settlement activity (including natural growth of settlements).

PHASE II: TRANSITION—JUNE 2003-DECEMBER 2003

In the second phase, efforts are focused on the option of creating an independent Palestinian state with provisional borders and attributes of sovereignty, based on the new constitution, as a way station to a permanent status settlement. As has been noted, this goal can be achieved when the Palestinian people have a leadership acting decisively against terror, willing and able to build a practicing democracy based on tolerance and liberty. With such a leadership, reformed civil institutions and security structures, the Palestinians will have the active support of the Quartet and the broader international community in establishing an independent, viable, state.

Progress into Phase II will be based upon the consensus judgment of the Quartet of whether conditions are appropriate to proceed, taking into account performance of both parties. Furthering and sustaining efforts to normalize Palestinian lives and build Palestinian institutions, Phase II starts after Palestinian elections and ends with possible creation of an independent Palestinian state with provisional borders in 2003. Its primary goals are continued comprehensive security performance and effective security cooperation, continued normalization of Palestinian life and institution-building, further building on and sustaining of the goals outlined in Phase I, ratification of a democratic Palestinian constitution, formal establishment of office of prime minister, consolidation of political reform, and the creation of a Palestinian state with provisional borders.

-- INTERNATIONAL CONFERENCE: Convened by the Quartet, in consultation with the parties, immediately after the successful conclusion of Palestinian elections, to support Palestinian economic recovery and launch a process, leading to establishment of an independent Palestinian state with provisional borders.

* Such a meeting would be inclusive, based on the goal of a comprehensive Middle East peace (including between Israel and Syria, and Israel and Lebanon), and based on the principles described in the preamble to this document.

* Arab states restore pre-Intifada links to Israel (trade offices, etc.).

* Revival of multilateral engagement on issues including regional water resources, environment, economic development, refugees, and arms control issues.

-- New constitution for democratic, independent Palestinian state is finalized and approved by appropriate Palestinian institutions. Further elections, if required, should follow approval of the new constitution.

-- Empowered reform cabinet with office of prime minister formally established, consistent with draft constitution.

-- Continued comprehensive security performance, including effective security cooperation on the bases laid out in Phase I.

-- Creation of an independent Palestinian state with provisional borders through a process of Israeli-Palestinian engagement, launched by the international conference. As part of this process, implementation of prior agreements, to enhance maximum territorial contiguity, including further action on settlements in conjunction with establishment of a Palestinian state with provisional borders.

-- Enhanced international role in monitoring transition, with the active, sustained, and operational support of the Quartet.

-- Quartet members promote international recognition of Palestinian state, including possible UN membership.

PHASE III: PERMANENT STATUS AGREEMENT AND END OF THE ISRAELI-PALESTINIAN CONFLICT—2004-2005

Progress into Phase III, based on consensus judgment of Quartet, and taking into account actions of both parties and Quartet monitoring. Phase III objectives are consolidation of reform and stabilization of Palestinian institutions, sustained, effective Palestinian security performance, and Israeli-Palestinian negotiations aimed at a permanent status agreement in 2005.

-- SECOND INTERNATIONAL CONFERENCE: Convened by Quartet, in consultation with the parties, at beginning of 2004 to endorse agreement reached on an independent Palestinian state with provisional borders and formally to launch a process with the active, sustained, and operational support of the Quartet, leading to a final, permanent status resolution in 2005, including on borders, Jerusalem, refugees, settlements; and, to support progress toward a comprehensive Middle East settlement between Israel and Lebanon and Israel and Syria, to be achieved as soon as possible.

-- Continued comprehensive, effective progress on the reform agenda laid out by the Task Force in preparation for final status agreement.

-- Continued sustained and effective security performance, and sustained, effective security cooperation on the bases laid out in Phase I.

-- International efforts to facilitate reform and stabilize Palestinian institutions and the Palestinian economy, in preparation for final status agreement.

-- Parties reach final and comprehensive permanent status agreement that ends the Israel-Palestinian conflict in 2005, through a settlement negotiated between the parties based on UNSCR 242, 338, and 1397, that ends the occupation that began in 1967, and includes an agreed, just, fair, and realistic solution to the refugee issue, and a negotiated resolution on the status of Jerusalem that takes into account the political and religious concerns of both sides, and protects the religious interests of Jews, Christians, and Muslims worldwide, and fulfills the vision of two states, Israel and sovereign, independent, democratic and viable Palestine, living side-by-side in peace and security.

-- Arab state acceptance of full normal relations with Israel and security for all the states of the region in the context of a comprehensive Arab-Israeli peace.