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To: Members of the Executive Board

From: The Secretary

Subject: **Financing Needs of the Palestinian Authority in 2004—Background Note for the Group of Eight Meeting on November 17, 2003**

Attached for the **information** of the Executive Directors is a background note on the financing needs of the Palestinian Authority in 2004, which has been prepared jointly by the staffs of the Fund and the World Bank for the G-8 Meeting to be held on November 17, 2003.

It is not intended to publish this paper on the Fund's external website.

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

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November 10, 2003

Financing Needs of the Palestinian Authority in 2004
Background Note for the G8-meeting on November 17, 2003

International Monetary Fund

World Bank

INTRODUCTION

1. This note presents an assessment of the financing needs of the Palestinian Authority (PA) in 2004 for various categories of assistance, namely budget support, humanitarian assistance and development assistance. It was prepared jointly by the staff of the World Bank and the International Monetary Fund and reflects recent discussions with the PA.
2. Preparing such an assessment, given the current volatile circumstances on the ground and the large uncertainties regarding the political and security situation even in the near term, is obviously a very tentative exercise. The approach adopted was to anchor the assessment with a baseline macroeconomic framework based on a conservative evaluation of possible developments in the Palestinian economy in the coming period.

BACKGROUND

3. The *Intifada* has now been ongoing for more than three years. Initially, from October 2000 to Summer 2001, the impact on the Palestinian economy originated from the shock of tight external closure,¹ increased internal closure, and the uncertainties created in the productive sectors by the reversal of previous expectations—leading to sharp declines in economic aggregates that bottomed out by mid year. A second shock occurred in the period March through September 2002, under the impact of Israeli incursions into the West Bank

¹ “Closure” is the summary term for the imposition of restrictions on the movement of Palestinian goods and people across borders and within the West Bank and Gaza. Closures are viewed as essential by the Government of Israel to protect its citizens from violence.

and Gaza (Operations Defensive Shield and Determined Path), and featured significant material destruction and much tighter internal closure in the West Bank.

4. By the end of 2002, some signs of stabilization and recovery could be witnessed. The publication of the Roadmap, some easing of closures, and reduced violence in the first half of 2003 contributed temporarily to a more positive outlook. Assuming no major change in the present economic and political environment during the remainder of 2003, the Palestinian economy is slated to experience positive growth in 2003 for the first time since 1999. Current estimates by the World Bank, the IMF, and the Palestinian Central Bureau of Statistics suggest that real GDP could grow by 4.5 percent in 2003. Still, with the population growing at over 4 percent per year, per capita real income will only increase marginally.

5. The moderately positive outlook for 2003 is mainly the result of three factors: (i) a lower intensity of closures in 2003, compared to 2002, leading to higher economic activity and employment; (ii) a gradual improved access to the Israeli labor market during the first 9 months of 2003; and (iii) the return of a significant portion of the stock of withheld clearance revenues by the Government of Israel. The latter permitted repayment of arrears owed by the PA to the private sector during the first half of 2003 (there were negligible arrears to the private sector remaining by end-August 2003), which provided a boost to Palestinian domestic demand.

6. The *humanitarian situation* has evolved in step with the broader developments in the Palestinian economy during the *Intifada*. Per capita real income at the end of 2002 is estimated to have declined to about a half of its level three years before. The share of the population living in poverty—defined as those consuming less than US\$2.1 of goods and services per day²—has tripled during the *Intifada*, to about 60 percent of the population. The health status of the Palestinian population has declined, and real per capita food consumption has dropped by up to a quarter when compared to 1998 levels.

7. The Palestinian Authority's *fiscal situation* has been—and continues to be—perilous, although some positive developments can be noted since the beginning of the year. In particular, budgetary revenues, including the resumed monthly transfers of clearance revenue from the Government of Israel, have been remarkably strong relative to the depressed economic activity and became even stronger in the last few months. This is consistent with signs that economic activity has stabilized or even slightly improved, but is mostly the result of improvements in tax administration and collection efforts, particularly the increase in petroleum products excises.³ The positive impact of this has, however, been more than offset

² The US\$2.1 poverty line is based on what is considered to be the minimum acceptable level of expenditures (food and nonfood) per capita in a benchmark household consisting of two adults and four children (National Commission for Poverty Alleviation, *Palestine Poverty Report 1998*).

³ The changes in management and pricing policies of the PA-owned Petroleum Commission, following its takeover by the Ministry of Finance in June 2003, is expected to raise excise revenues by about US\$6 million per month from August 2003 onward.

by much lower levels of donors' budget support than was expected in the 2003 budget (US\$250 million vs. US\$467 million in 2002). The shortfall in donor support has forced the PA to further squeeze non-wage expenditures to the detriment of the PA's ability to deliver basic services. It has also prevented the PA to reduce its debt to the banking sector as envisaged in the Budget, and may lead to the accumulation of new arrears. At the same time, the continued increase in civil and security services employment and the implementation of the civil service law that includes wage raises will contribute to a higher wage bill than envisaged.

8. Significant progress in public finance reforms aimed at establishing a transparent and strong revenue and expenditure system, and improving financial control has been achieved. Most notably, revenue has been channeled to the Single Treasury Account (STA), which is functioning very well. The Palestinian Investment Fund was established, largely encompassing all PA assets, with a full valuation being completed by external auditors and a first transfer of profits made to the budget. Execution of current expenditures has been centralized in the Ministry of Finance (MOF) and fiscal data availability was improved through monthly publication on the MOF website, which exceeds best practices in the region. In addition, all civil servants and less than one half of security personnel now receive their salaries by direct bank deposit controlled by payroll instead of cash. Finally, an internal audit system has been put in place and the audit of payroll has been initiated

THE MACROECONOMIC OUTLOOK FOR 2004

9. It should be recognized from the outset that any projections of economic developments, even in the short term, are highly susceptible to regional political developments. The uncertainty that necessarily surrounds any prediction can hardly be overstated. Nevertheless, the IMF and the World Bank, in collaboration with PA counterparts, have developed a scenario for possible developments of the Palestinian economy in 2004 (Table 1).

Table 1. Economic Outlook for 2004 in a Status Quo scenario

	2002	2003	2004
GDP, <i>real annual change (%)</i>	-14.5%	4.5%	3.5%
GNI, <i>real annual change (%)</i>	-16.4%	3.9%	0.9%
Per capita GNI, <i>current prices, US\$</i>	983	1,021	974
Poverty rate (%)	59	61	61
Population, mid-year (1,000)	3,465	3,635	3,780
NIS/US\$ exchange rate, annual average	4.74	4.57	...
Consumer Price Index, annual change (%)	5.7	1.1	0.2

Source: Palestinian Central Bureau of Statistics, IMF and World Bank Staff.

Note: The estimates for 2003 are based on indicators generally covering the first six months only. Preliminary labor market data covering the third quarter of 2003 released on November 1, 2003, was more buoyant than expected—indicating that the above estimates for 2003 may be conservative.

10. To avoid speculations about possible political developments, the outlook as presented below is based on a *status quo* assumption regarding external factors: current political instability and uncertainty are assumed to continue, reflected in a continuation of current levels of internal and external movement restrictions on persons and goods, and transaction costs similar to those of today. The positive impact on domestic activity and incomes of fewer curfews and marginally improved access to the Israeli labor market (relative to 2002) as well as the positive fiscal effects of the resumption of clearance revenue in 2003 are expected to subside in 2004. As a result, real GDP growth would decelerate to approximately 3.5 percent in 2004. Poverty rates would remain close to those of 2003 at about 61 percent, while the absolute number of the poor would grow in line with population growth.

FINANCING NEEDS FOR 2004

Budget support

11. Regarding the budget outlook for 2004, it is assumed on the *revenue side* that the transfer of regular monthly *flows* of tax revenue collected by Israel on behalf of the PA would continue in 2004. Any additional transfers of the *stock* of withheld clearance revenues would be used to reduce remaining PA arrears on government pension contributions and to public welfare recipients, rather than to finance current budget expenditures.⁴ With the full-year impact of recent improvements in tax collection, a slightly better revenue performance is anticipated in 2004, bringing total budgetary revenue to about US\$740 million. On the expenditure side, it can be expected that current budget expenditures will increase both to accommodate the public service needs of a rapidly growing population and as a consequence of the long-awaited implementation of the civil service law (starting with the Ministries of Education and Health in October 2003), which will raise the wage bill. It is also assumed that the PA would continue to cover in 2004 US\$130 million worth of bills owed by municipalities to the Government of Israel.

12. Given developments as described above, **the anticipated budget gap of the PA would amount to about \$630 million in 2004** (Table 2).⁵ Previous studies by the World Bank, which compared budget support to other forms of donor assistance, concluded that it was the most efficient method of sustaining employment and stimulating the economy of the

⁴ In 2003, these transfers have amounted so far to approximately US\$300 million on a gross basis. Net transfers of withheld clearance revenues after deductions for payments of bills owed by Palestinian municipalities amounted to US\$170 million. Such transfers in 2004 would amount to no more than US\$180 million. These amounts are being withheld by Israeli court orders pending the resolution of claims by Israeli companies and individuals against the PA.

⁵ This assumes however that the reduction in the stock of remaining arrears would not exceed the gross transfers out of the stock of withheld clearance revenue. If the objective were to eliminate the entire stock of arrears, including to pension funds, by end-2004, the budget financing gap could reach US\$700 to US\$800 million (depending on the external budget support that would be disbursed in 2003 to prevent accumulation of new arrears in 2003).

West Bank and Gaza (including through the support it provides to the private sector by sustaining demand for Palestinian products). On this basis, the PA has argued that donors should give top priority to bridging the budget financing gap.

Table 2: West Bank and Gaza: Fiscal Developments in 2002-04
(In millions of U.S. dollars)

	2002 Actual	2003 Budget 3/ Proj.	2004 Proj.
Revenue	254	531	741
Domestic	225	207	250
Gross monthly clearance 1/	29	324	491
Expenditure	1,027	1066	1243
Gross wages	676	636	818
Non-wage expenditure	340	408	400
PA financed capital expenditure	11	22	24
Net lending 2/	0	0	130
Balance	-773	-535	-632
External budget support	467	535	0
Total other financing	306	0	0
Gross withheld clearance revenues	46	480	180
Net arrear accumulation	111	-415	-180
Net domestic bank financing	149	-65	0
Financing gap		0	632

Source: Ministry of Finance; and IMF estimates

1/ Includes payments deducted for dues owed to the Israeli water company Mekorot, while the budget figure is on a net basis.

2/ Payments deducted at source by GOI from disbursements of withheld clearance revenue for owed bills by Palestinian municipalities.

3/ Valued at the budget exchange rate of NIS 5 per U.S. dollar.

Emergency and humanitarian assistance

13. The need for humanitarian assistance would remain important in 2004. Although economic growth is the ultimate remedy for poverty, broad growth alone will not be sufficient to significantly raise the incomes of the poor, given that many of them are no longer in a position to benefit from an economic upturn. Many households/firms have now depleted their savings and sold their productive assets, often at depressed prices, in order to maintain minimal consumption levels, and have thereby lost the means to generate income.

14. Three different groups of poor can broadly be distinguished, in need of different types of assistance. A first one comprises the structural poor (elderly, handicapped, widows, etc.), who are economically inactive and will continue to depend on traditional welfare assistance. A second group is constituted of those who have become poor with the recession but could see their situation improving rapidly should economic activity resume, like unemployed wage earners for instance. A third group concerns those who have fallen into “poverty traps” with the intifada and have lost their means to generate income (e.g. small entrepreneurs who have sold their productive capital). This third group might require punctual targeted intervention to be lifted above the poverty line when conditions for sustainable growth will eventually come back. In the meantime, this group will continue to rely on welfare assistance and job creation programs.

15. In 2002, donors provided a total of US\$216 million in emergency and humanitarian assistance in the form of cash and food assistance and job creation programs and through the support to UNRWA’s⁶ emergency appeals. The expected number of people living below the poverty line can be used as a rough indicator for the needs for emergency and humanitarian assistance in 2004. As mentioned above, in a status quo scenario the number of poor can be expected to grow approximately at the rate of population growth. **On this basis, it can be expected that the humanitarian needs in 2004 would amount to about US\$240 million.**

Development assistance

16. The need to finance the development of institutions and infrastructure required by a future Palestinian state would remain important. This includes continued support for the PA’s Reform Program, but also essential repairs of public and private buildings, direct support for the private sector, and necessary expansion of public infrastructure. In May 2003, the World Bank estimated that donors were likely to disburse about US\$250 million against these activities in 2003. The increase was partly due to a slight improvement (compared to 2002) in the operating environment, which enabled donors to accelerate disbursements slightly. This trend is assumed to be sustained in 2004, which in conjunction with the investment priorities indicated by the PA could **bring the needs for development assistance to US\$350 million in 2004.**

17. However, it should be understood that a portion of development assistance that could be committed (maybe up to US\$100 million) might need to be switched into budget support or emergency/humanitarian efforts if the situation deteriorates and does not permit as much medium-term development work as is desirable.

⁶ Thus, the support needed for UNRWA’s (United Nations Relief and Works Agency for Palestine Refugees in the Near East) regular operating budget would be in addition to this amount.

Total financing needs

18. In summary, the total financing needs of the PA in 2004 is estimated at US\$1,220 million, of which about half (US\$630 million) would be needed in the form of direct budgetary support, approximately US\$240 million in the form of humanitarian assistance, and US\$350 million for development assistance.