# The Impending Palestinian Fiscal Crisis, Potential Remedies

1. The Quartet has stated that the Hamas movement must meet a number of basic political conditions, and has connected Hamas' response to levels and forms of future donor assistance to the Palestinian Authority (PA)[1]. The Government of Israel (GOI) has also indicated that it is not prepared to conduct political relations with Hamas unless it modifies its basic stance towards the State of Israel[2].

## The Evolving Economic Situation

2. In mid-March, the Bank modeled the impacts of a possible combination of actions by GOI and the donor community—see the ***Attachment***. Readers are referred to Scenario 4, which assumed for 2006 the following:

- continued GOI withholding of Palestinian tax revenues collected on the PA's behalf;
- border trade restrictions comparable to those enacted in 2005;
- a 50 percent reduction in the average 2005 level of daily labor flows into Israel from Gaza and the West Bank; and
- a reduction in donor disbursements of US$200 million, or 15 percent, as compared with last year.

3. Even with these restrained assumptions, the economy would experience a dramatic decline over the coming eight months: by the end of 2006, average personal income would decrease by 30 percent in real terms, unemployment would increase from the pre-election figure of c. 23 percent to about 40 percent, and poverty levels would climb from 44 percent last year to 67 percent.

4. Based on evolving GOI and donor policies, these projections now appear too rosy.

- Palestinian revenues continue to be withheld, though GOI has decided to use a portion of them to reimburse Israeli public sector providers for electricity, water and health referral services supplied to the PA[3];

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[1] "The Quartet concluded that it was inevitable that future assistance to any new government would be reviewed by donors against that government's commitment to the principles of non-violence, recognition of Israel, and acceptance of previous agreements and obligations, including the Roadmap", *Quartet Statement*, London, January 30, 2006, S031/06.

[2] "Israel ascribes great importance to the formation of a united international position that will make it clear to the Palestinians that under no circumstances can we either accept nor countenance a PA, part or all of which is composed of an armed organization that calls for the destruction of the State of Israel." Acting Prime Minister Olmert before the Cabinet, January 29, 2006. Source: GOI.

[3] The Israeli press (Yediot, Ha'aretz) noted on April 10 an Israeli Cabinet decision to allow a portion of the tax revenues to be used to pay Palestinian debts to utility companies and hospital arrears. In 2005,

– Border trade restrictions are proving more stifling than in 2005, particularly in Gaza (where the border has been sealed to imports and exports for over a half of the year to date)[4];

– Donor disbursements could well prove lower than projected: the suspension of direct transfers to the PA by OECD donors is being implemented more rapidly than the Bank anticipated;

– Commercial banks in West Bank and Gaza have been reminded of their potential legal liability under US anti-terror legislation, leading them to withhold services to the PA; this is impeding the PA's ability to receive transfers of funds from abroad (in particular, from Arab League donors), and to operate an internal payments system[5]. Similar concerns have also led two major Israeli banks to announce that they will sever their relationship with Palestinian banks, and other Israeli banks are considering their position[6].

5. The Bank's recent projections will be revised in the forthcoming *Economic Monitoring Note #2* using updated macroeconomic data, and in light of evolving developments. At the time of writing, though, the key aggregates seem likely to decline by several additional percentage points; this would make 2006, by a margin, the worst year in the West Bank and Gaza's dismal recent economic history.

6. The recession has already begun, with March and April's public sector salaries so far unpaid and with signs of food and gasoline shortages manifesting in Gaza, the result of faltering supply (due to persistent closure of the passages into Gaza)[7]. In early April, the UN's Office for the Coordination of Humanitarian Affairs (OCHA) conveyed to Israel's Ministry of Foreign Affairs its concern at the early emergence of

payments deducted at source by GOI for payments of utility bills amounted to US$11 million per month; in addition, the PA made direct payments to Israeli suppliers of another US$13 million per month.

[4] As of March 23, the Karni crossing had been closed for 46 days of 2006, or 56 percent of the year; this proportion has since worsened. In comparison, Karni was closed for a total of 18 percent of the year in 2005, following closure for 19 percent of the year in 2004.

[5] The Arab Bank has informed the PA that it will no longer host the PA's Central Treasury Account (CTA), and no other bank operating in West Bank and Gaza has offered to take its place—though over a dozen of them continue to maintain accounts with PA agencies. The suspension of CTA operations has already impeded PA efforts to pay public sector salaries and suppliers' bills; if the PA's other accounts are closed, such operations will become impossible other than through outright cash payments. Legally the Palestinian Monetary Authority (PMA) can serve as a financial agent for the PA but this is unlikely to occur in practice due to potential legal liability—and would also take time to set up. See also Reuters, *PA Banking Crisis Looms*, April 23, 2006.

[6] On April 4, 2006 Bank Hapoalim and Bank Leumi announced that they would "terminate all banking transactions with Palestinian banks as follows: all non-shekel transactions within 2 weeks and all shekel transactions within three months" (*Ha'aretz*, April 5, 2006). Bank Hapoalim and Bank Leumi's decisions will further complicate trade and increase the cost of Palestinian/Israeli business transactions. Although too early to predict clearly, third party banks could in time fill this void and enable Palestinian-Israeli traders to make US dollar-denominated transactions (the US dollar is already used widely in West Bank and Gaza).

[7] GOI asserts that the closure of Karni is a response to direct security threats to the passage, and that it has offered the PA the alternative of Kerem Shalom for imports. The PA maintains that Kerem Shalom is able to handle only a fraction of Gaza's daily import needs.

a supply-induced humanitarian crisis[8]. GOI, which is calibrating the flow of commodities into West Bank and Gaza, remains confident said that the situation is under control, and believes such claims to be exaggerated[9].

## The Current Fiscal Emergency and its Possible Impacts

7. The PA's liquidity crisis is unprecedented. In 2005, the PA was able to access a total of US$2.15 billion for the Budget, or some US$180 million per month[10]; in the first quarter of 2006, Budget resources declined to approximately US$130 million per month[11]. For April, resources may not exceed US$50-55 million[12]. This contraction has been caused by a combination of factors, the most important of which is Israel's withholding of Palestinian revenues. The OECD donors' suspension of budget-related disbursements, the failure of the Arab League states to come forward with promised levels of support and the reluctance of commercial banks to lend to/bank for the new government are also significant.

8. If today's strictures remain or intensify, the PA may be looking at no more than US$25 million in domestic revenues per month, and no banking system with which to distribute them. Under such circumstances, with current monthly wage bills running at c. US$95 million, those Palestinians employed by the PA or dependent on PA salaries (estimated at 30 percent of the population[13]) will suffer major income

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[8] "David Shearer, head of the UN Office for the Coordination of Humanitarian Affairs (OCHA), told Foreign Ministry officials that if there is no significant change in the situation, Gaza will face a humanitarian crisis as bad as the one in Kosovo. A report by the UN Relief and Works Agency (UNRWA) warns of a lack of basic food supplies due to the frequent closures of the Karni crossing that are preventing goods from reaching Gaza from Egypt. The report also said there has been a significant increase in the number of hungry people since financial aid has been halted." *Ha'aretz*, April 4, 2006.

[9] "The day before yesterday there was a discussion of senior security officials on how to deal with the Hamas government. The coordinator of government activities in the territories, Maj.-Gen. Yosef Mishlav, said in the discussion "there is no humanitarian crisis in the territories." Mishlav described the Palestinians' ability to do with little—"an olive or two"—at times of hardship. Other speakers at the meeting agreed with his assessment" (*Ha'aretz*, April 5). Also on April 5, Lt. Colonel Baruch Persky, Head of the Economic Branch of COGAT, said the following on Channel 2 TV: "Unfortunately recently we have been witnessing an unfounded media assault on the whole humanitarian and economic issue in the Gaza Strip. That propaganda comes from the Palestinians and a number of international parties. I can tell you clearly and on the basis of examinations we made that there is neither a humanitarian crisis nor severe economic hardship nor hunger in the Palestinian Authority."

[10] Consisting of US$1.232 billion in tax revenues (US$476 million domestic, US$757 million in revenue transfers collected by Israel on behalf of the PA), US$349 million from donors, US$173 million in "exceptional" Palestine Investment Fund (PIF) profits, US$137 million in rebates of tax revenues from GOI (partly tax revenues withheld by Israel in the December 2000—November 2002 period, and partly the one-time transfer of the so-called "equalization tax") and US$254 million in commercial borrowing. Source: PA, IMF and World Bank estimates.

[11] In the first quarter, the PA treasury accessed a total of US$390 million in financing, equivalent to c. US$130 million per month: US$200 million in revenues (US$90 million from domestic collections and US$110 million from revenue transfers, which were suspended in March), and US$190 million from donors (US$79 million from OECD sources and US$111 million from Arab League members). It should be stressed here that available information on the PA's fiscal situation is subject to a good deal of uncertainty; *inter alia*, no monthly budget execution reports have been published since December 2005.

[12] This assumes between US$25-30 million in domestic revenues plus c. US$25 million in withheld revenue (applied by GOI towards the payment of utility and hospital charges accruing in Israel).

[13] Ministry of Finance data show a total payroll at the end of 2005 of 136,772—a number that does not include the approximately 15,000 security "recruits" taken on board during the second half of 2005, nor

reductions—while the PA is unlikely to be able to provide basic services or maintain law and order.

9. As a result of such dramatic fiscal compression, one or more of the following may occur in the coming months.

- *A Humanitarian Crisis*—As noted, GOI has expressed confidence that it can regulate humanitarian supply. Under the pressure of loss of income, demand factors are likely to manifest as well, and the need for humanitarian relief may rise steeply. The most serious pressure point will be Gaza, both because of the relative dependence on PA wages (almost 40 percent of those employed in the Gaza Strip work for the PA, earning almost twice what private sector employees do[14]) and because of the Strip's dependence on a single supply passage which is subject to frequent closure. International experience of the onset of humanitarian crises shows that needs often emerge suddenly rather than cumulatively—and can outrun pre-emptive planning[15]. This could happen in Gaza, given that certain aspects of humanitarian supply are not in GOI's hands: the UN's Consolidated Appeal (CAP) for 2006 is seriously underfunded[16], meaning that the UN is unlikely to receive adequate aid shipments soon; the emergence of increasing insecurity (see below) could seriously hamper UN and NGO humanitarian delivery operations[17]; any functional collapse of the PA (see also below) could further complicate the distribution of relief supplies, in light of the central role the PA plays in this process[18]. The international media has already begun to warn of impending famine[19], and such stories can be expected to intensify.

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the additional hiring that appears to have taken place during the first couple of months in 2006; neither are donor-financed PA jobs (e.g., project staff and PA job-creation programs) included. Conservatively assuming that the two latter categories add up to c. 20,000, a total of c. 172,000 persons receive some form of payments from the PA. With an average dependency ratio of 6, therefore, approximately 1 million people are dependent on these payments out of a total Palestinian population of 3.5 million.

[14] Source: *Assessment of the Future Humanitarian Risks in the Occupied Palestinian Territory*, UN, April 11, 2006.

[15] The World Food Programme's experience suggests that serious food crises can evolve rapidly in situations of conflict, political instability, and/or economic failure. Famine can occur when several of these factors are made worse by governments' failure to deal with the situation—food prices are driven up, existing systems of health, general administration and law and order are overwhelmed, and widespread malnutrition, disease and death eventually result (see WFP, http://www.wfp.org/newsroom/in_depth/Europe/050729_foodcrisesQ&A.asp). See also *Predictable Funding for Humanitarian Emergencies: a Challenge for Donors*, Oxfam Briefing Note, October 24, 2005. "Humanitarian aid often arrives too late to prevent…suffering. More widely, although UN flash appeals (for rapid onset natural disasters or sudden deterioration in existing humanitarian crises) are put out within days, most of them receive less than 30 percent of the requested funds within the first month)."

[16] As of April 11, only 8 percent of the appeal has been committed. Source: UN-OCHA.

[17] "If…funding to the PA is reduced or halted, the non-payment of security staff could increase the risk of criminality and factionalism that have been witnessed for several months. Should this eventuate, it will affect UN relief operations. In recent months, the UN has temporarily evacuated staff from the West Bank and Gaza Strip on two separate occasions." UN, April 11, 2006, op. cit.

[18] According to UN sources, the PA handles almost one half of all relief supplies.

[19] See, for example, *Gaza Faces Crisis Over Closure of Crossing into Israel*, The Independent, February 2, *Hamas Faces a Rude Awakening*, Time, April 6, which referred to "empty food stores and bellies…mounting hunger in Gaza", *Gaza on Brink of Implosion as Aid Cutoff Starts to Bite*, The

- *Rising Insecurity*—Non-payment, part-payment or unequal payment of salaries could precipitate breakdowns in force discipline in the PA security services; in the past year there have been many instances of security personnel threatening or using force to pressure the PA on salary and benefits issues, including recently[20]. A deteriorating security environment could make it difficult for government, commerce and relief efforts alike to operate properly. Destabilization of this kind, if protracted, could also lead to a deterioration in the bilateral security environment—with adverse implications for the security of Israelis.

- *Institutional Dissolution*—If the PA remains unpaid/minimally paid for several months, it may cease to function: civil servants have already begun to withdraw their services in protest, and this can be expected to intensify as personnel down tools and look for other ways to subsist. International experience in 'fragile states' contexts shows that mainstream institutional breakdown is very hard to reverse: complex structures such as school systems are not machines to be switched on and off at will[21]. A protracted period in which the PA is disabled might result in the unraveling of a dozen years of donor efforts to build the responsible, accountable institutions needed for a future Palestinian state—or for continued governance *ad interim*. It is also hard to envisage how the PA could meet the Quartet's conditions if it is not operative. The crisis could lead the public to look for basic services, such as education, from informal and less secular providers. Institutional paralysis could also increase calls by the Palestinian public for wrapping up the PA and handing administrative responsibility back to Israel[22]. In this context it is worth reiterating the point made in the Bank's March 15 paper (***Attachment***)—that the PA delivers the vast bulk of public services[23], and

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Observer, April 16, 2006 and *Gaza Patients Turned Back as Health Crisis Worsens,* and *Gaza Hospital Fights for Life after International Aid Cuts,* Reuters, April 24.

[20] Such as the following incident in Gaza on April 23 between the security forces and Hamas cadres guarding the Minister of Health: "The fighting Sunday came a day after Health Minister Bassem Naim announced that he was cutting 2 million from the monthly health budget to help alleviate the financial crisis by halting payments for patients to get treatment abroad", *Hamas Gunmen Protect Health Minister in Shootout*, AP, April 23.

[21] Recent experiences in LICUS (low income under stress) countries have shown that central government institutions can be fatally weakened through insecurity, which keeps public services from operating, and through economic pressures that distort or stop the payment of civil servants or the supply of basic goods. It may also spur large-scale migration of skilled personnel abroad, which is difficult to reverse. A key challenge in fragile states where governance is deteriorating is to maintain institutional capital, by protecting social spending and continuing with capacity-building activities. See *Fragile States—Good Practice in Country Assistance Strategies*, World Bank, Operations Policy and Country Services, January 2006, and *The International Peace Academy's State-Building Project,* Sarah Cliffe and Nick Manning, 2006.

[22] See, for example, *Palestinian Center for Public Opinion Poll No. 153*, conducted April 14-17, 2006. Responding to the question, "In the light of the grave Israeli escalation against the Palestinian people and the corresponding declaration of the Israeli government about the suspension of its relations with the Palestinian Authority, and the resolutions of the governments of the US and EU to the effect of halting the financial and economical aid to the Palestinian people, what should—according to your opinion—the Palestinians do at present?", 17.9 percent suggested "finally dissolve the Palestinian Authority."

[23] In primary and secondary education, the PA employs almost 36,000 staff (72 percent of all education personnel), runs 76 percent of all schools (1,679 of 2,209) and educates 70 percent of all schoolchildren. In health, 11,000 staff are employed to run 62 percent of all health facilities (800 of

cannot be summarily replaced by alternative service providers, be they non-governmental, private or drawn from institutions that happen to be affiliated to the Presidency or the PLO[24]. To press for such a realignment of Palestinian governance would also contradict previous donor doctrine on the importance of transparency, accountability and the separation of powers.

10. While institutional stability is clearly at issue, the experience of the last few years suggests that Palestinian *social* stability is less at risk. In 2001-2, donor literature made frequent reference to the impending implosion of coping mechanisms and social structures[25], but these remained largely intact. Reflecting on this, it appears that commentators mistook the nature of the Palestinian economy—which is middle-income, if looked at in personal income terms, but undeveloped if analyzed from a structural perspective. This peculiarity is explained by West Bank and Gaza's history of occupation. After 1967, Palestinians benefited from a borderless relationship with Israel and were able to access to labor opportunities and to trade freely with their wealthy neighbor—and incomes rose significantly. At the same time the complex controls and economic uncertainties associated with military rule retarded public and private investment and delayed any substantive transformation; instead, savings went disproportionately into housing stock and other forms of quasi- or actual consumption. In consequence, today's productive economy remains rooted in family farms and firms, which provide over 90 percent of private employment[26] and account for about 80 percent of private value added. In times of economic stress Palestinians—unlike many other middle-income populations—still have recourse to family- and clan-based forms of social protection and risk-sharing. While this does not prevent those who lack access to wealthy networks from suffering, it has so far cushioned the impact of major recessions—though personal savings are now considerably depleted.

11. These observations have been used by some to argue that a humanitarian crisis is not imminent, but this would be a superficial conclusion. First, large numbers of families will still fall through the Palestinian social safety net under today's circumstances. Second, the phenomenon has important political implications. The dominant popular response to intense economic pressure in 2001-2, as expressed in the Palestinian opinion polls of the time, was anger at Israel as the perceived agent of

1,290). These proportions are significantly more pronounced if refugee camps (in which UNRWA delivers such services) are excluded.

[24] The largest potential alternative service provider is the UN, but "the UN is in no position—in terms of mandate or capacity—to duplicate or replace the role of the PA or the quality and extent of its services." UN, April 11, op. cit.

[25] "What is quite remarkable is the continued cohesion of Palestinian society. Despite violence, economic hardship and the daily frustrations of living under curfew and closure, lending and sharing are widespread and families for the most part remain functional…..[d]onors were saying even prior to Operation Defensive Shield that Palestinian society was absorbing levels of unemployment that could well have fractured the social contract in industrial societies" *Twenty-Seven Months—Intifada, Closures and Palestinian Economic Crisis*", World Bank, May 2003.

[26] Source: Palestinian National Authority, Palestinian Central Bureau of Statistics, *Establishment Census*, 2004, Main Findings.

economic distress—not rejection of the violence that Israel was acting to prevent, or of its main proponents at that time[27].

## Restoring Fiscal Stability

12. Countering the current fiscal crisis and its potentially dangerous consequences requires the restoration of an adequate flow of budget funds. This would permit regular public sector salary payments, thereby dampening the demand for additional humanitarian assistance, ensuring that public services were maintained and helping preserve the functionality of the security services.

13. Recent GOI and OECD donor measures overlay a pre-existing fiscal emergency of the previous government's making, and have acted to intensify it[28]. The new government cannot escape the need to address these serious imbalances through a major retrenchment of public servants, a significant reduction in public sector salaries, or a combination of both. Unless the PA is in receipt of a meaningful flow of budget resources, though, orderly fiscal management will be impossible and any reform agenda will be overwhelmed by institutional disintegration.

14. If Israel and the donor community decide that the downside risks associated with fiscal chaos are excessive, and if they adjust their current policy stances accordingly, the fiscal situation can be retrieved—though not without difficulty, and probably not unless action is taken soon. Under the best of circumstances the PA is likely to face a very tight budget outlook. It can not plan on the basis of budgetary flows equivalent to the 2005 monthly average of US$180 million: a significant proportion of those resources were non-sustainable, and are now unavailable[29]—while PA revenues are also undergoing a considerable decline as economic activity winds down. A more realistic point of departure for budget formulation would be the PA's 'real income' in 2005, i.e., what it received by way of monthly revenues (domestic and clearance revenues) and donor contributions. This averaged just over US$120 million per month.

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[27] Public support for "military actions against Israel" rose from 40 percent in May 1997 to a peak of 85 percent in October 2001, and declined thereafter to 68 percent in December 2003 and to 54 percent by July 2005. Support for suicide operations increased from 33 percent in May 1997 to 76 percent in April 2001, declining to 62 percent in December 2003 and 50 percent by July 2005. Source: *Palestinian Opinion Pulse Polls*, Jerusalem Media and Communications Center.

[28] The salary, pension and recruitment decisions made by the previous government are described in the note submitted by the IMF to the Ad Hoc Liaison Committee (AHLC) in December 2005 as well as in *The Palestinian Economy and the Prospects for its Recovery: Economic Monitoring Report to the Ad Hoc Liaison Committee Number 1,* World Bank, December 2005: "Under pressure from public employees, the PA has acceded to salary and pension demands which it cannot finance on a sustained basis…..Looking ahead, the PA faces an unfinanceable fiscal deficit in 2006. One of the first priorities of the new government will be tackling the budget crisis." Subsequent to this report, in the weeks following the election, the transitional government appears to have added many thousands more persons to the security payroll.

[29] Approximately 20 percent of the budget expenditures made in 2005 (c.US$560 million, or c. US$45 million per month) were by definition unsustainable—short-term bank borrowing, and exceptional transfers from GOI and the PIF.

15. Resource flows on this scale are a reasonable proposition for the remainder of this year—but only if Israel resumes revenue transfers and allows orderly import and export trade to take place through the West Bank and Gaza borders.

16. A solid basis for trade facilitation would be the implementation of the *Agreement on Movement and Access* (AMA) of November 15 2005. Thus far, the AMA has not been seriously implemented (including during the 10 weeks prior to the PLC election). The AHLC has on several occasions supported the proposition that the twin goals of maintaining Israeli security and enhancing Palestinian movement and access are mutually compatible[30]. Israel's willingness to facilitate movement and trade would be essential to sustaining any new-found stability arising from an improvement in today's fiscal position.

17. Given a resumption of transfers of revenues collected by Israel on behalf of the PA and adequate trade facilitation, PA tax revenues in the near term could reach perhaps US$75-85 million per month (US$25-30 million per month in domestic revenue, and revenue clearances of US$50-55 million). In addition, Arab League and OECD budget support might conceivably average another US$25 million per month. If the PA decides to sell or mortgage Palestine Investment Fund assets, it might also be possible to add a further US$15-25 million per month while revenues recover[31].

18. It goes without saying that an expenditure program averaging around US$120-130 million per month will only restore economic and social stability if the PA acts decisively to reduce the inflated public payroll.

## A Possible Interim Funding Mechanism

19. Cognizant of the grave dangers described in paragraph 9, the European Commission and a number of OECD donors have been exploring ways to maintain income payments to PA employees and to sustain basic public services to the Palestinian population. Most of those in favor of this advocate some kind of "bypass mechanism", under which funds are routed directly to the ultimate recipients (to employees' bank accounts, to commercial suppliers). The mechanics of such an operation are relatively simple to conceive of[32]. Irrespective of which agency/ies might take on such a task, however, several points need to be made.

- No mechanism is likely to restore fiscal predictability and stability unless GOI agrees to resume revenue transfers[33]—this is the key to countering the present

[30] See the AHLC Chair's Summaries from the meetings of December 2004 and December 2005.
[31] In 2005, "regular" domestic plus clearance revenue averaged US$92 million per month.
[32] See, for example, *Financing Basic Services to Palestinians outside PA Systems*, an informal DFID note of April 2006, revised in May. This paper argues for the adaptation of the successful 1990s multi-donor *Holst Trust Fund*, used to channel start-up finance to the nascent PA (in the form of salaries for health and education workers as well as funds for the purchase of supplies and equipment). Under such a scheme, the administrator of the bypass mechanism would receive contributors' funds and, with the assistance of a Payments Agent, would disburse them to authorized recipients. Under the *Holst Fund* a Financial Agent (Touche Ross working under contract to the World Bank) carried out spot checks to ensure that lists of salary recipients were accurate and that equipment was actually purchased and received at its intended destination.
[33] There is speculation that considerable sums of support may be forthcoming from various Middle Eastern sources. Without prejudging the probabilities, it is worth pointing out that comparisons with

crisis. It would thus make little sense to establish a mechanism *unless* GOI is prepared either to resume transfers direct, or to route the clearance revenues through the bypass mechanism[34].

– Any party that managed such a facility would run appreciable political risks; these need to be adequately addressed in advance, with appropriate assurances provided by all parties. For example, any agency, company or commercial bank involved would need explicit assurances from donors and from GOI that it would not be liable for prosecution or other forms of official or unofficial sanction as a result of its work.

– For simplicity of administration, it might make sense to confine the proceeds of the bypass mechanism to the payment of salaries alone, leaving the PA to manage non-salary expenses from other resources.

– The bypass mechanism would need the approval of the PA: it is not realistic to imagine that an instrument that lacked the PA's support could function, or that the mechanism could operate without regular contact[35]. By the same token, the PA is unlikely to accept 'political conditionality' such as any vetting of lists of salary recipients or adherence to specific social policy criteria.

– Donors would prefer to avoid funding the PA's security services, and favor confining the proceeds of a new mechanism to civilian service provision—in particular, education and health[36]. This may not be practical: if civilian employees were paid while security employees were not, disruption as well as anger at the operators of the mechanism would be likely[37]. These concerns have been expressed both by the current PA administration and by the PA Presidency.

– It is preferable that the mechanism disburse against a financeable PA Budget. The Palestinian Legislative Council needs to decide how to reduce the unsustainable PA wage bill. In the absence of a process owned by the legislature, those who may need to be retrenched/recipients of reduced salaries could direct their frustration at the manager of the mechanism.

20. Due to the sensitivities and risks involved, obtaining institutional buy-in for such a mechanism and for the direct management role required to operate it may take

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2001, when Arab League donors disbursed over US$400 million, are of limited value. On that occasion, for example, the Islamic Development Bank was able to disburse considerable sums of money from pre-existing Palestinian trust funds; no such reserve exists today.

[34] A possible attraction of a bypass mechanism to GOI is that funds would be routed directly to very specific end-uses, and their disbursement would be subject to tight on-site verification. This can be contrasted with the preceding revenue clearance system suspended in March, whereby funds were deposited directly into the PA's Central Treasury Account.

[35] While PA spokesmen have indicated on several occasions that the new government has no objection to the direct payment of employees and suppliers, detailed understandings would be needed from the outset on how the bypass mechanism would work.

[36] Others have argued that a more comprehensive view of service provision is needed, and that solid waste, sewerage, water supply, electricity distribution, road maintenance, and safety net provisions for the chronically poor must also be maintained.

[37] Thus it would make sense to confine payments to civilian employees only if there were reliable indications that security services wages could be covered from resources outside the mechanism.

more time than is available. There is a danger that a bypass mechanism could become the mustard after the meal.

21. A swifter alternative would be to use an existing mechanism, the Bank-administered *Emergency Services Support Program*, which has a successful track record and could be modified in two ways: first, in order to handle salary payments; and second, to tighten fiduciary controls—in particular, by hiring a Monitoring Agent to help scrutinize the PA's management of all transactions related to the instrument, and by introducing stiff consequences in the event of deviations from agreed funds uses. An ESSP approach could also include a crash program of capacity-building for the Council for Financial Control[38], the PA's independent external auditor. With the ESSP administrator and the Agent relieved of direct responsibility for funds management, the process of institutional approvals and of agent procurement would be greatly simplified. It is worth reiterating that without a GOI decision to resume revenue payments (either through this mechanism or independently), a modified ESSP would no more resolve the current crisis than a bypass mechanism would.

[38] Formerly the General Control Institute (GCI). A new Auditor-General, appointed by and answerable to the President, was selected in February 2006 after a search of more than a year, responding to one benchmark of the Bank-administered *Public Financial Management Reform Trust Fund*. The Islamic Development Bank had been using the GCI for the auditing of its projects in West Bank and Gaza.

# Attachment

## World Bank Economic Projections
## March 2006 (US$ million)

| | 2005 | Scenario 1 | | | Scenario 2 | | | Scenario 3 | | | Scenario 4 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Assumptions** | **(est.)** | **2006** | **2007** | **2008** | **2006** | **2007** | **2008** | **2006** | **2007** | **2008** | **2006** | **2007** | **2008** |
| Revenues transferred | 740 | 790 | 783 | 778 | 100 | 0 | 0 | 704 | 696 | 689 | 100 | 0 | 0 |
| Revenues withheld | 0 | 0 | 0 | 0 | 489 | 568 | 573 | 0 | 0 | 0 | 422 | 503 | 507 |
| Palestinian workers in Israel and settlements | 44,800 | 32,800 | 20,100 | 7,400 | 22,700 | 13,400 | 7,400 | 32,800 | 20,100 | 7,400 | 22,700 | 13,400 | 7,400 |
| Foreign assistance | 1,300 | 1,300 | 1,200 | 1,100 | 1,300 | 1,200 | 1,100 | 1,100 | 1,000 | 900 | 1,100 | 1,000 | 900 |
| Public consumption | 1,514 | 1,551 | 1,567 | 1,583 | 1,243 | 1,243 | 1,243 | 1,514 | 1,514 | 1,514 | 1,071 | 1,071 | 1,071 |
| Exports | 590 | 647 | 681 | 723 | 500 | 540 | 576 | 655 | 690 | 732 | 506 | 547 | 585 |
| Population (million) | 3.51 | 3.63 | 3.76 | 3.88 | 3.63 | 3.76 | 3.88 | 3.63 | 3.76 | 3.88 | 3.63 | 3.76 | 3.88 |
| Inflation (CPI, %) | 3.5 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 |
| | | | | | | | | | | | | | |
| **Outcomes** | | | | | | | | | | | | | |
| GDP | 4,044 | 4,296 | 4,272 | 4,264 | 3,192 | 3,110 | 3,132 | 4,038 | 4,006 | 3,983 | 2,910 | 2,835 | 2,851 |
| GDI | 5,815 | 5,983 | 5,766 | 5,560 | 4,799 | 4,549 | 4,429 | 5,550 | 5,316 | 5,085 | 4,353 | 4,096 | 3,959 |
| Private consumption | 3,652 | 3,829 | 3,837 | 3,856 | 3,044 | 2,947 | 2,950 | 3,708 | 3,721 | 3,754 | 2,953 | 2,792 | 2,777 |
| Investment | 1,022 | 1,161 | 1,044 | 927 | 588 | 480 | 467 | 861 | 742 | 604 | 405 | 369 | 362 |
| Imports | 2,734 | 2,892 | 2,857 | 2,824 | 2,183 | 2,100 | 2,104 | 2,700 | 2,660 | 2,622 | 2,026 | 1,945 | 1,944 |
| | | | | | | | | | | | | | |
| GDP per capita (US$) | 1,152 | 1,183 | 1,136 | 1,099 | 879 | 827 | 807 | 1112 | 1066 | 1026 | 802 | 754 | 735 |
| GDI per capita (US$) | 1,657 | 1,648 | 1,533 | 1,433 | 1,322 | 1,210 | 1,141 | 1,529 | 1,414 | 1,310 | 1,199 | 1,089 | 1,020 |
| Real GDP growth (%) | 6.3 | 4.9 | -2.3 | -1.7 | -18.5 | -4.3 | -0.8 | -0.2 | -2.6 | -2.1 | -24.5 | -4.3 | -1.0 |
| Real GDP p.c. growth (%) | 2.7 | 1.3 | -5.5 | -4.9 | -21.3 | -7.4 | -4.0 | -3.6 | -5.8 | -5.3 | -27.1 | -7.4 | -4.2 |
| Real GDI p.c. growth (%) | 4.3 | -2.6 | -8.6 | -8.5 | -21.9 | -10.1 | -7.7 | -10.2 | -9.2 | -9.3 | -30.0 | -10.8 | -8.3 |
| Cumulative real GDP p.c. change since 1999 (%) | -30.6 | -29.7 | -33.6 | -36.8 | -45.4 | -49.5 | -51.5 | -33.1 | -37.0 | -40.3 | -49.4 | -53.2 | -55.1 |
| Unemployment (%) | 23.4 | 22.4 | 28.7 | 34.1 | 35.5 | 41.4 | 44.9 | 24.2 | 29.7 | 34.8 | 39.6 | 44.3 | 47.0 |
| Poverty (%) | 44 | 43 | 48 | 51 | 62 | 67 | 70 | 47 | 51 | 55 | 67 | 72 | 74 |

Scenario 1: No Abrupt Change
Scenario 2: Suspension of Clearance Revenue Transfers, Trade and Labor Restrictions
Scenario 3: Reduced Aid Flows
Scenario 4: Suspension of Clearance Revenue Transfers, Trade and Labor Restrictions, and Reduced Aid Flows