

Pressing the Palestinian Authority Financially: Not as Easy as It Looks

By Patrick Clawson

AT FIRST GLANCE, Palestinian Authority (PA) finances seem remarkably subject to foreign pressure. After all, the PA collects only \$40 million per month in revenue on its own, while it spends \$190 million per month.¹ That leaves a gap of \$150 million per month that has to be filled with funds from elsewhere—suggesting that the PA could quickly be brought to its financial knees. In fact, the \$40 million per month the PA collects is nowhere near enough to pay its \$100 million monthly wages; without foreign funds, the PA could not even meet its payroll.

Problems with Pressing the PA

Nevertheless, using financial pressure on the PA will in fact be harder than it appears. Several reasons explain the PA's likely resilience.

Reform could generate substantial savings. PA expenses are ridiculously high for the quality of the services delivered. The International Monetary Fund (IMF) had recommended that the PA cut expenditures and increase revenue collection by a total of \$20 million per month, which does not seem particularly ambitious. Consider the \$40 million a month spent on the 76,000 security personnel receiving wages. Indeed, in his June 30, 2005, testimony to the Senate Foreign Relations Committee, U.S. security envoy Lieutenant-General William Ward asserted that of the 58,000-plus employees on the PA security payroll at the time, only 20,000–22,000 actually show up for work on a daily basis. The PA's program with the IMF calls for “retrenching 10,000 inactive security employees in 2006”; quite possibly many of those 10,000 names are fictitious, with some higher-up pocketing the salary. An all-out mobilization for election day produced 13,000 security personnel on active duty; even the PA acknowledges that 16,000 never

show up for work—not surprising, given that many have fictitious names. From the point of view of good governance, much room exists to increase the savings on the security wages from the \$7 million a month proposed in the IMF program.

To be sure, Hamas would have to pay a political cost for economic reform. The main cost would come from the dismissed personnel, who would presumably be the Fatah supporters who make up the overwhelming majority of the security forces. Although their opposition might be tempered if they received pensions, many of those dismissed could be unhappy at losing the social prestige that comes with having a regular job—one that often authorizes carrying a gun, no less. Hamas may well prefer to avoid confrontation with the Fatah-dominated security forces, even if that reluctance complicates the PA's financial picture.

An additional financial pressure will come from Hamas supporters who want to share in the budget pie through both jobs and greater social services. Absorbing the existing Hamas personnel into the PA's budget would not be that much of a strain, however, because Hamas's structures are quite small. For instance, a generous estimate for all Hamas fighters would be 3,000, which is a small figure compared with the existing 76,000 personnel on the PA security payroll.

Furthermore, most U.S. and Israeli estimates of Hamas's existing budget for social services range from \$40 million to \$75 million per year; including military action does not appear to bring the total to more than \$10 million a month. A Hamas-led PA government could have leeway to dispense favors to Hamas supporters well in excess of what Hamas on its own could previously afford, even if at the same time that government cut the PA budget from \$190 million a month to \$160 million a month.

1. On an annual basis, the International Monetary Fund forecast for 2006 under current policies is \$0.46 billion in domestic revenue and \$2.24 billion in expenditure and net lending, for a \$1.78 billion gap.

Arab donors are unlikely to cancel aid. Arab donors provided the PA with \$17 million per month in budget support in 2004, according to the IMF. The proposition that they will cut back in response to Western pressure is, at best, arguable. Indeed, domestic pressure may exist in those countries to increase aid, especially given the flush financial situation in the oil-rich countries (Saudi Arabia has reported that its budget surplus in 2005 was \$57 billion, on revenues of \$148 billion; its \$46 million aid to the PA budget was equal to 0.03 percent of its revenue). Press reports suggest that Saudi Arabia and Qatar have pledged additional donations of \$33 million so the caretaker PA government still under the total control of President Mahmoud Abbas could meet its payroll costs for January, although the record to date suggests that skepticism is in order about whether promised aid will actually be paid.

Israel could face dilemmas in using economic leverage. By the IMF's estimate, Israel owes the PA \$70 million a month from tax money that Israel collects on behalf of the PA—customs duties, value-added tax, and tax deductions from the salaries of Palestinians working in Israel (this latter component was once much more important but has shrunk in line with the reduced numbers of Palestinian workers in Israel). This monetary control would seem to give Israel considerable leverage over the PA, but Israel would face two significant problems in using that leverage.

First, Israel already withholds much of the money to cover bills the PA does not pay. Almost \$30 million is deducted each month to cover what the PA owes Israel for items like electricity, water, and health care—services that Israel has not proposed cutting off, even in the advent of a Hamas-led government, because of the immediate humanitarian crisis and international outrage that would ensue. As part of its economic reforms, the PA was supposed to start paying for these services by forcing consumers to pay their bills, which they rarely do. What little is collected is not enough to repair the electrical and water distribution systems in the West Bank and Gaza, much less to pay the Israeli suppliers. Not surprisingly, the PA has been uninterested in collecting from hard-pressed Palestinian

consumers. The Israel Electric Corporation reports that the PA owes it \$47 million. The bills are likely to remain unpaid, leading Israel to continue making the substantial deductions from the \$70 million a month it collects on behalf of the PA. The IMF estimates that, in the absence of policy changes, Israel's cash transfer in 2006 would average \$42 million a month.

The second problem is the political repercussions from halting the cash transfers. Such a cutoff would violate the Paris Protocol regulating economic relations between Israel and the PA, an integral part of the Oslo Accords. When Israel suspended the transfer of funds to the PA after the violent uprisings that began in late 2000, the reaction from the international community, including the United States, was sharply negative. European countries stepped in to fill much of the gap left by the shortfall in Israeli transfers. The argument was made that the money belonged to the PA rather than to Israel, and Israel's interests were not well served by undermining the Oslo Accords when it wanted the PA to live up to its obligations under those same accords.

During the 2000–2002 suspension of transfers, Israel was able to counterargue that PA corruption and lax financial procedures meant that some of the transferred money was being diverted into bank accounts controlled by Yasser Arafat personally. Indeed, Israel agreed to end the suspension only in late 2002, when Arafat appointed as finance minister a widely respected former IMF official, Salam Fayad, with broad authority to impose strict financial controls. Fayad resigned in November 2005, upset that the PA was violating its financial agreements with the World Bank and IMF—a step that led the World Bank to suspend its aid to the PA budget in November 2005 and the European Union to withhold \$42 million in January 2006, before the Hamas election victory. As long as the World Bank suspends its aid to the PA for economic reasons, Israel has a better argument for why it also is suspending its cash transfers. The challenge for a new Hamas-led government would be to return to the kind of strict financial controls and sound economic policies implemented by Fayyad. Were it do so, then Israel would have more difficulty justifying suspension of its cash transfers.

Iran may fill the financing gap. If Arab aid continues at present levels and the PA carries through with the \$20 million per month in savings envisaged in the IMF program, the remaining financing gap would be \$85 million per month without Israeli cash transfers, or \$43 million per month with Israeli cash transfers.

The obvious candidate to fill the remaining gap would be Iran. To date, Iran has not provided aid to the PA. The amount of aid the PA needs is extremely small relative to the Iranian economy. Even \$85 million a month is equivalent to only eighty cents on each barrel of oil Iran exports—not exactly a crushing burden. Another telling comparison is that Iran has more than \$30 billion in foreign exchange reserves, which is enough to provide \$85 million per month for thirty years. And Iran has provided considerable funding for anti-Israel movements, including at least \$10 million a month to Hizballah. To be sure, Iran is under considerable budget pressures from the populist spending promised by President Mahmoud Ahmadinejad, and Iran has historically not financed movements outside of its tight grip. But powerful political pressure would exist inside Iran for it to fund a Hamas-led PA. Not only does the Ahmadinejad faction put great importance on opposing Zionism and supporting Palestine, but the Hamas election victory also has been greeted by Iranian hardliners as another indication the Muslim world is experiencing a new wave of Islamic revolution.

In 2003, the Israeli government estimated that Iran provided Hamas with \$3 million and individual Arab donors in Gulf countries provided an additional \$12 million, in addition to what Hamas raised in the West Bank and Gaza and from other sources, such as donations from individuals in the West or criminal activity. Presumably Hamas would continue to raise and spend money on its own, outside of the PA budget.

Aid to Palestinians Rather than to the PA

Part of the reason the PA is not as vulnerable to foreign financial pressure as is commonly thought is that most aid donors long ago gave up on the PA and have instead sent their aid to Palestinians through other channels, such as nongovernmental organizations (NGOs).

Many reports confuse aid to the Palestinians with aid to the PA. To make an analogy: Katrina victims in New Orleans are grateful for the aid they get from the Red Cross, or for that matter from the U.S. government, but that aid does nothing to pay the bills of the city of New Orleans. When foreign donors provide funding for NGOs to build schools or run day care centers in Gaza and the West Bank, that aid is a boon to Palestinians, but it does nothing to help the PA meet its payroll. To be sure, if foreign donors fund maternity health-care clinics, that financing reduces the pressure on the PA to provide the same service, but foreign support for the clinics does nothing to help the PA pay the salaries of its own hospitals, schools, and police.

In their respective reports to the December 2005 donors' conference, the World Bank estimated that in 2005, aid to Palestinians from foreign governments (that is, excluding aid from foreign individuals) was \$1.1 billion and the IMF estimated aid to the PA was \$362 million—suggesting that \$738 million in aid went to NGOs or was directly distributed by donors. Those figures may actually understate how much aid is distributed outside the PA's budget, because the World Bank figures do not include all of the several hundred millions dollars per year spent by the UN Relief and Works Agency (UNRWA) in the West Bank and Gaza.

U.S. aid has only under the most limited circumstances gone directly to the PA. Since 1993 the United States has provided \$2.5 billion for aid to Palestinians (although some of the \$1.2 billion given to UNRWA was spent for refugees in Jordan, Lebanon, and Syria rather than in the West Bank and Gaza). Of that, only \$80 million has been available for the PA budget directly: \$20 million in 1994 (\$10 million for the World Bank's Holst Fund, \$5 million for police salaries, and \$5 million worth of weapons donated to the police); \$20 million in summer 2003 (of which \$9 million was for utility bills owed to Israel); and \$20 million in December 2004 (all for utility bills owed to Israel). In August 2005, the U.S. Agency for International Development agreed to let the PA administer a \$50 million program to build housing, which was a sign of confidence in the PA but did nothing to help the PA meet its payroll or other current expenses.

Some of the aid to NGOs is likely to continue flowing despite the new Hamas government. In part, the donors fund what are traditionally called humanitarian activities, such as UNRWA's food assistance to the poor. A strong international consensus exists that such aid should be maintained, irrespective of the nature of the government ruling an area. Thus, for instance, the United States long provided food aid to North Korea, stopping only when Washington became worried the food was not reaching the intended recipients. On the basis of its record to date in running charitable activities, every reason exists to think that Hamas would let the humanitarian aid flow to recipients. In this circumstance, a cutoff of international humanitarian aid is highly unlikely.

Foreign donors also fund what are usually called development activities, such as building schools and digging wells. Donors are more ready to cut such activities if they disapprove of the policies of the host government. But the usual approach is to look at each project on a case-by-case basis. Indeed, statements by U.S., European, and World Bank officials since the Hamas election victory emphasize the importance of continuing with aid that benefits the Palestinian people—which suggests that many of these projects may well continue.

In practice, the European and American decision about whether to keep funding development projects implemented by NGOs is likely to be influenced by whether Israel keeps up the cash transfers to the PA. No matter how much lawyers and diplomats argue that Israel's cash transfers are different from aid—that is, that the transferred money belongs to the PA and Israel has a treaty obligation to make the transfers—if Israel transfers tax revenues to the PA, then politicians and the general public are more likely to ask why the West should be tougher on the Hamas-governed PA than the Israelis are.

How Much Does Aid Matter?

But all this analysis on aid may miss the point. Palestinian popular attitudes toward a Hamas-led government may be shaped more by how well the economy performs than by how much aid flows. Even despite the

extraordinary aid flows that the West Bank and Gaza enjoy, most Palestinians work for private businesses, not the PA or aid-supported NGOs.

The most likely outcome is that a Hamas-led government will be a disaster for the economy. The principal problems facing the Palestinian economy have been the rampant insecurity and the Israeli-imposed barriers to free movement of people and goods, which are made necessary because the PA has not closed down the terrorist infrastructure. It would take great optimism to think those problems will attenuate under a Hamas-led government. The most likely prospect is for tension between the Hamas-led government and the Fatah followers who predominate in the security services—meaning that insecurity will continue to prevail, with armed gangs preventing any regular rule of law. Add to that scenario the likelihood that Hamas will take little action to rein in terrorists and that Palestinian Islamic Jihad and the Fatah-linked al-Aqsa Martyrs Brigades may wish to show that they are at least as militant as Hamas—which means that Israel may have every reason periodically to impose security-related closures. With a dysfunctional police and legal system plus periodic Israeli closures, businesses are not likely to risk major new investments.

One development that would particularly hurt the Palestinian economy would be an end to the customs union with Israel, which Hamas has called for and Israel might also find attractive to implement unilaterally. Ending the customs union would mean that Palestinians would face more problems exporting to the large Israeli market. At least initially, Palestinian imports would have to come through far-off ports in Jordan and Egypt, where bureaucratic tangles can raise costs substantially. It would take years and hundreds of millions of dollars to build a commercial port in Gaza of any size and quality, rather than the small port planned now, and the port would operate at high cost. A Gaza airport would make more economic sense, but air transport is prohibitively expensive for almost all goods.

A sudden end to the customs union, rather than one phased in over years, would throw trade patterns into disarray. The dislocation could be bad enough to cause

humanitarian problems. If no customs union existed, presumably Gaza trade would go through Egypt, but arranging that trade would require whole new networks of importers, wholesalers, and truckers that would take many months to put in place even if all the bureaucratic arrangements with the Egyptian authorities were smoothly handled, which is not likely. Meanwhile, West Bank trade would presumably go through Jordan. Israel would want to inspect this trade, as it does at present, if for no other reason than to prevent arms imports. But unless Israel dramatically increases resources devoted to inspection—which to date it has had greatly difficulty organizing itself to do—or the trade process is dramatically changed, there could be a serious problem: Israel is not set up to inspect enough trucks to bring in the minimal humanitarian needs.

Ending the customs union would pose several serious problems for Israel as well as Palestinians:

- Israel would have great difficulties exercising any control over Gaza's trade with Egypt. Israel would have no means in practice, or reason that would withstand international scrutiny, to control the trade. Indeed, without a customs union, it is difficult to see the European Union agreeing to stay as observers. Under those circumstances, Egypt would be responsible for controlling trade on its side of the border, which may become so porous that the PA (or others) could easily traffic in arms; indeed, the PA might begin to import its own heavy weapons, such as anti-aircraft missiles or long-range rockets.
- In the past, Israel has strongly opposed the prospect of Palestinians importing into the West Bank tax-

free goods that can then be smuggled into Israel; this scenario could become a multibillion-dollar business with huge profits for Palestinian criminal gangs or terrorist groups. Just the easy-to-smuggle, high-duty items like alcohol and cigarettes could produce tens of millions of dollars in profits a year—not to mention income from smuggling electronics such as televisions. Plus, smuggling in cheap goods now kept out by trade restrictions (for example, clothing) could negatively affect Israeli employment.

- In the absence of the customs union, the taxes Israel would withhold from the paychecks of Palestinian workers inside Israel would be insufficient to cover the cost of electricity, water, and health services Israel now provides to Palestinians. Furthermore, the absence of trading relations could poison the economic atmosphere, leading the PA to cut off payment for such services. Israel could face the difficult choice of either providing the services free to the PA; cutting the services off, which would generate a humanitarian crisis; or asking the United States to foot the bill, which in effect would mean that the United States finances the PA by paying its bills to Israel.

In short, the West Bank/Gaza economic situation is likely to be worse under a new, Hamas-led government than it was in the last year, irrespective of aid flows. Presumably, Hamas will blame the economic deterioration on Israel and the West. To the extent that the importance of aid for the West Bank/Gaza economy is exaggerated, that argument will help Hamas pin the blame for economic problems on foreigners rather than on its own weaknesses and shortcomings.