Responding to the PA’s Mounting Fiscal Crisis

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Brief Analysis

Years of declining international aid, unsustainable public patronage, and controversial policies have pushed the Palestinian government and banking sector to the brink of insolvency.

On August 30, IMF officials concluded an intensive visit to the Palestinian territories **by noting (https://www.middleeastmonitor.com/20220830-imf-to-palestine-government-control-public-spending-and-cooperate-with-israel-to-stimulate-economy/)** the many internal and external challenges that local officials will face if they hope to reverse declining economic growth and address other chronic fiscal problems. These challenges were exacerbated in July when the Israeli government announced a deduction of $180 million from the clearance revenues it collects on behalf of the Palestinian Authority, arguing that these funds would have been used for paying stipends to Palestinian security prisoners and their families. The deduction—which represents about 4% of the PA’s total net revenue—was just the latest setback in a deepening fiscal crisis, preceded by a large budget deficit, a sharp decrease in international budgetary support, and an inability to pay the full salaries of public sector employees.

How Bad Is It?

According to the World Bank, the PA’s budget deficit in 2021 was $1.26 billion, with a financing gap of $940 million (i.e., the deficit minus international budgetary and development aid). This gap is attributable to four main factors: a bloated and inefficient public sector, especially in security, health, and education; a massive drop in budgetary aid; the withholding of clearance revenues in response to prisoner payments; and impaired domestic revenue collection.

The PA employs an estimated 150,000 people in the West Bank and Gaza, out of a population of nearly 5 million. Around 40,000 of these employees are civil service or security personnel in Gaza, most of whom have not worked since the 2007 Hamas takeover of the Strip but are still paid by the PA to ensure their loyalty. The resultant 2021 wage bill was $2.6 billion, or almost half of all PA public expenditures—a proportion that is twice what the global median country spends on wages. This surfeit has political roots: the Fatah

Party led by PA president Mahmoud Abbas has long sought to solidify a middle-class support base through government patronage, yet this strategy has limited the PA's ability to shed jobs or implement crucial reforms.

The security sector is particularly susceptible to bloat and cronyism. According to knowledgeable officials, the PA security forces have about 17,200 officers and 15,000 enlisted soldiers, a ratio of roughly 0.9 soldiers per officer—compared to 4.2 in the Israel Defense Forces and 4.7 in the U.S. military.

Meanwhile, international aid to the PA was halved in 2021 after years of decline. Budgetary aid, which represented a whopping 27% of GDP in 2008, was down to 1.8% last year ($186 million). This steep decline resulted from gradual erosion of the PA's four budgetary pillars: the European Union, the World Bank, Saudi Arabia, and the United States. Temporary crises have also played a role, including the COVID-19 pandemic and European concerns over incitement in PA textbooks.

Although the EU and World Bank remain the largest budgetary donors today, both drew down their support over the past decade amid growing disillusionment with the PA, a desire to shift from direct aid to development financing, and the rise of emergent crises in other regions. Saudi Arabia ended its budgetary support entirely in April 2020 after allotting as much as $200 million in past years, citing similar reasons while also expressing anger over the PA's rampant corruption, perceived sense of ungratefulness, and rhetoric in reaction to the Abraham Accords (the kingdom was not a part of the accords but resented the PA's accusations of Gulf betrayal). The Saudis eliminated other aid as well, including hundreds of millions of dollars in annual donations to the UN Relief and Works Agency (UNRWA).

The U.S. government cut off its budgetary support in 2018 due to the Taylor Force Act, which bars any funding that might finance the PA's so-called "pay to slay" program. This program grants stipends to imprisoned Palestinian terrorists that scale with the severity of their offenses, a practice that U.S. and Israeli officials argue incentivizes terrorism.

Israel pursues a similar policy centered on the Palestinian revenues that it collects on the PA's behalf and transfers to Ramallah monthly—mainly clearance revenue on goods that arrive at Israeli ports destined for the territories, along with income tax on Palestinians working in Israel and certain value-added taxes (VAT). In total, these collected funds represent 60-70% of all PA revenues. In 2018, the Israeli Knesset passed a Taylor Force-like law that compels the government to reduce transferred clearance revenues based on its calculation of how much money the PA is paying jailed militants annually. Palestinian leaders have likewise used the clearance revenues for political leverage, sometimes rejecting the transfers in protest of Israeli policy. In 2019, Ramallah refused to accept payments for eight months, pushing the PA to the brink of financial collapse; it repeated this tactic in May 2020 in response to planned Israeli annexations in the West Bank.

Recognizing that a weak PA is a security risk, the Israeli government has circumvented the 2018 law by extending emergency "loans" to the PA to bridge the gap. In August 2021, it transferred NIS 500 million ($155 million) to the PA after a meeting between Abbas and Defense Minister Benny Gantz, noting that it would pay itself back by the following June using part of the NIS 600 million ($186 million) that it had withheld earlier in the summer and put into escrow. Another NIS 100 million ($31 million) loan was granted in December. Yet while Prime Minister Yair Lapid's current government has a policy of strengthening the PA, Binyamin Netanyahu may reject such workarounds **if he returns to power (https://www.washingtoninstitute.org/policy-analysis/israeli-government-falls-new-election-and-implications-us-israel-relations)** after the November early election.

Problems also abound with the PA's domestic collection efforts, which make up a third of its overall revenues. For one thing, the PA does not collect from Gaza or East Jerusalem, yet it spent **roughly a third (https://www.imf.org/en/Publications/CR/Issues/2022/05/02/West-Bank-and-Gaza-Report-to-the-AD-HOC-Liaison-Committee-517501)** of its budget there in 2021, mostly on wages, benefits, and payments for Israeli electricity. Last year, the PA claimed that it would spend **$1.7 billion (https://www.timesofisrael.com/where-do-the-billions-of-dollars-in-foreign-aid-to-gaza-really-go/)** on Gaza in 2022, roughly in line with **previous claims (https://english.wafa.ps/Pages/Details/96401)** that it was sending $96 million per month to the Strip.

As for the accessible Palestinian tax base in the West Bank, the World Bank **estimates (https://documents1.worldbank.org/curated/en/099407305062233565/pdf/IDU091fed1da019eb042d6090100a9320aa572de.pdf)** that only 30% of those required to pay taxes actually do so. Moreover, a **2020 study (https://documents1.worldbank.org/curated/en/988251593063216893/pdf/Palestinian-Territories-Impact-of-Fiscal-and-Economic-Policies-Estimation-of-VAT-Tax-Gap.pdf)** estimated that there was a yawning compliance gap in VAT collection amounting to 9% of GDP. This gap was largely a function of importers undervaluing their shipments or refusing to provide invoices, leaving the PA unable to access the proper clearance revenues from Israel. Many of these tax leakages stem from flaws in the Paris Protocol, the 1994 agreement outlining economic relations between Israel and the PA. Although the PA now collects roughly 23% of

GDP in taxes—in line with other developing countries—further reforms to Palestinian laws and agreements with Israel are necessary.

To make up for its revenue gap, the PA has gone into arrears with its pension fund, public employees, and the private banking sector. In late 2021, Ramallah announced that it would reduce salaries to 70-80% of their norm. This June, the Finance Ministry announced that it would continue paying just 80%. At the same time, the pension fund's arrears reached a staggering $3 billion in the fourth quarter of 2021, while arrears to the private sector amounted to $975 million.

Trouble for the Banking Sector

By the end of 2021, the PA's total debt to domestic banks (i.e., arrears plus newer obligations) sat at $2.5 billion **(https://documents.worldbank.org/en/publication/documents-reports/documentdetail/099407305062233565/idu091fed1da019eb042d6090100a9320aa572de)**. In response, these banks cut the government off completely, which will make financing its deficit spending even more difficult. Yet the situation also highlights just how exposed the banking sector is to the PA's fiscal instability—with potentially substantial spillover effects on the broader economy.

The $2.5 billion domestic bank debt that the PA has built up over the years far exceeds the Palestinian Monetary Authority's recommended limit on such exposure: $1.4 billion. Predictably, the PA has been unable to make payments on time, spurring banks to turn off the tap. Yet the problem extends well beyond the government—many individual public employees have also taken out loans backed by their future salaries. In total, the PA and its employees now make up around 40% of the banking sector's credits. And since the PA is unlikely to resume full salary payments or pay down its debts anytime soon, local banks will remain on unstable footing for the foreseeable future. Such risky exposure complicates the World Bank's assessment that the Palestinian banking sector has "remained relatively stable largely due to sound financial regulations."

Potential Remedies

One obvious way to make a large dent in the PA's deficits is by increasing foreign aid to past levels and ending Israel's revenue deductions. Yet both steps would require substantial political movement. To overcome the funding restrictions mandated by Israeli and U.S. law, the PA would have to change its prisoner payments program to a more needs-based system, but such proposals have been defeated by the prisoner lobby in Ramallah. Similarly, full Gulf funding is unlikely to resume until the Palestinians mend their relations with Saudi Arabia and other states.

Another option is for the PA to cut back its wage bill and curtail its broader patronage system. Yet this is politically difficult as well—PA officials have told the authors privately that they would rather continue paying partial wages than face the consequences of firing numerous public employees, especially those with military training.

The parties could also increase the revenue side of the equation by promoting Palestinian growth, which has been significantly depressed by the occupation of the West Bank and blockade of Gaza. According to a 2015 study **(http://www.quartetoffice.org/files/image/report.pdf)** by the Office of the Quartet, the occupation's economic restrictions halved Palestinian growth between 1994 and 2014. Concurrently, a RAND study **(https://www.rand.org/international/cmepp/costs-of-conflict.html)** estimated that a two-state solution would increase Palestinian GDP by $50 billion over ten years (in 2014 dollars), with per capita income rising 36%. Although reaching such a solution will not be feasible anytime soon, the parties can still take several interim measures to lessen the occupation's economic impact—in particular, expanding Palestinian access to Area C in the West Bank, which the World Bank estimates **(https://documents1.worldbank.org/curated/en/099407305062233565/pdf/IDU091fed1da019eb042d6090100a9320aa572de.pdf)** could increase revenue by 6% of GDP.

The most significant improvements to revenue collection would require Israeli support for revisions of the Paris Protocol, but one promising option **(https://www.inss.org.il/publication/pa-fiscal/)** that bypasses that obstacle is to reform the exit permit regime for the estimated 140,000 Palestinians who work inside Israel and its West Bank settlements. Their average daily wage is more than double that of Palestinians working in PA-administered portions of the West Bank. If the PA charged these higher-paid workers a flat monthly tax of NIS 700 million ($206 million) for their exit permits in lieu of certain other taxes collected and transferred by Israel, it could potentially slash its deficit by a third while eliminating the exploitative black market run by permit brokers.

In any case, the parties need to act soon given the troubling rise in Palestinian dissatisfaction with the PA, which could boil over if the fiscal crisis becomes a full-blown economic crisis. Some observers argue that Israel would never let this happen because it understands the adverse effect on its own security and will extend as many emergency "loans" as necessary. Yet the potential consequences for Palestinian social stability and political succession should not be underestimated.

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