New Palestinian Cabinet Faces Governance and Fiscal Challenges

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Brief Analysis

Lost revenue transfers from Israel frame the latest crisis, and Washington can help ease it even without restoring direct aid to the PA.

On April 13, the new Palestinian Authority (PA) cabinet, under Prime Minister Mohammad Shtayyeh, was sworn in amid one of the sharpest fiscal and governance crises since President Mahmoud Abbas took office in 2005. The debilitating financial picture and eroding governance capacity confronting this cabinet have led to a domestic legitimacy crisis and concerns among donors. These factors, alongside a deteriorating security and political environment, are raising alarms regarding PA and West Bank stability. And continued West Bank stability is firmly in the U.S. interest.

Governance Challenges

In recent years, the PA has presided over a marked backslide in governance reform, exacerbated by an increasingly narrow political space, a heightened public perception of corruption, and diminishing capacity in PA institutions. This has prompted particular concern regarding public financial management, which is key to reassuring donors that their funds are being well spent. In a symbolically striking example, the PA Ministry of Finance recently stopped publishing financial reports on its website. Once touted by former prime minister Salam Fayyad as visible proof of the government's transparency, this practice has been suspended due to "implications with the Israeli side." A growing sense has thus emerged of stalled reforms and a weakened PA, worrying Palestinians and foreign diplomats alike. As a consequence, PA donors are expressing growing skepticism, and the authority's domestic legitimacy is eroding. In a March 2019 survey conducted by the Palestinian Center for Policy and Survey Research, 82 percent of respondents indicated their belief that the PA is corrupt, while 47 percent considered it a burden on the Palestinians. In late 2018, in a sign of potential instability, the West Bank witnessed unprecedented protests over socioeconomic issues.

Fiscal Challenges

As for the deepening fiscal crisis, in February, Israel moved to withhold $138 million annually, or $11.5 million a month (roughly 6% of the tax revenues it collects on the PA's behalf), in rebuke for the PA's payments to the families of prisoners and "martyrs"—a practice on which Abbas has refused to negotiate. In response, the PA has refused to accept the remaining portion of the transfer as long as Israel continues to withhold any of it. This has reportedly led the PA to adopt strict austerity measures, including payment of only partial salaries to government employees in both March and April.

This is not the first time the PA has been cut off from such transfers, which, at $2.25 billion in 2018, account for nearly 70 percent of the authority's revenues and cover 95 percent of the PA wage bill. Since the transfer mechanism was adopted under the Paris Protocol, an economic agreement signed by Israel and the Palestine Liberation Organization in 1994, it has been suspended or delayed a handful of times by Israel, including for two years during the second intifada, for the year Hamas led the PA, and for three months in 2015 to protest the Palestinian bid to join the International Criminal Court.

This time, however, the PA seems to be calculating that concerns over instability in the PA and the West Bank will prompt Israel to reverse its decision. Such a reversal, in addition to stabilizing PA finances, would give Abbas a political victory. Yet while effective in the past, the same approach is less certain to work this time around. For Israel, the basis for partial withholding of the funds is enshrined in the law and enjoys Israeli consensus across the political spectrum. Moreover, in the past, Israel's decision to withhold *all* the funds mobilized the international community to reject the action and support the PA both financially and diplomatically. But this time, the PA's decision to reject any partial transfer from Israel struck some international actors as grandstanding, eliciting neither sympathy nor support. European ambassadors have reportedly told Palestinian officials that their countries could not help make up financing shortfalls as long as the PA refused to accept the partial transfers. In early April, the Arab League renewed its commitment to provide the PA a "financial safety net" but did not appear to designate any new support. Donor support to the PA budget in general has declined steadily since 2008, reflecting a combination of waning confidence in the PA reform agenda, competing regional priorities, and overall donor fatigue. U.S. cuts to assistance in 2018 amounted to hundreds of millions of dollars. At its height, direct U.S. budgetary assistance to the PA averaged $400 million.

Even before this recent crisis, the PA was facing significant fiscal challenges. Suggested stopgap measures for the current shortfall—e.g., cutting expenditures, borrowing more, and accumulating additional arrears to the private sector (i.e., not paying bills)—were close to exhausted. Funding cuts to Gaza beginning in 2017 reined in the budget deficit in 2018; and a full 17 percent savings to the wage bill were realized largely from forced retirements and partial salary payments in Gaza. But further such cuts in Gaza would be ill-advised. Beyond the humanitarian and political costs, an even greater decline in the Gaza economy could blow back on West Bank firms and financial institutions with significant exposure to the coastal territory.

Palestinian banks already face significant direct and indirect exposure to the PA. The latest numbers put the debt owed by the PA directly to commercial banks at $1.3 billion. The local regulator, the Palestinian Monetary Authority, has capped banks' exposure to the PA as a function of bank equity, which is currently $1.9 billion. Separately, the PA has set its own bank borrowing limit at $1.5 billion, although it may exceed this limit in the coming months if the current crisis continues. Palestinian banks have an additional $3 billion in loans outstanding to PA employees, who risk defaulting the longer they go without full pay.

The constraints on borrowing make likely the further accumulation of private-sector arrears. Already, however, construction and pharmaceutical firms have reportedly faced cash flow and financing difficulties due to nonpayment of invoices by the PA. The World Bank estimated that in mid-2018, arrears to the PA pension fund stood at $1.6 billion, with insolvency likely to follow in just a couple of years if the existing trend continued. Given these challenges, beyond the restoration of clearance revenues—whether in part or in full—external budget support will remain a necessity in the near term to avoid what the IMF called in September 2018 a "disorderly expenditure rollback disruptive to growth."

Recommendations

Two main factors are limiting Washington's ability to improve the situation in the West Bank: its own decision to suspend aid to the Palestinians, and the PA's decision to cut off all contacts with the administration.

While not perfectly analogous, this situation is reminiscent of U.S.-Palestinian relations during the first term of President George W. Bush, when U.S. calls for reform and a new Palestinian leadership led to a rupture of bilateral relations. Since Washington at the time had little direct interaction with the PA, it worked through the international donor system to advance U.S. objectives. Working with key actors such as the World Bank, European countries, Arab states, and the Ad Hoc Liaison Committee—which coordinates donor assistance to the PA—the Bush administration succeeded in introducing demands for PA reform as a central feature of donor engagement with the authority, leaving it no choice but to embark on reform efforts.

Similarly, the Trump administration can engage the donor community—already alarmed by the state of PA governance—to introduce elements to bring stability to the West Bank and the PA. These need not be of the overarching nature of Bush-era policies, but they can focus on sharpening donor pressure to dissuade the PA from grandstanding on the tax clearance matter and to address specific issues to steady the ship. The latter includes restoring budget transparency to bolster donor confidence, stabilize budget flows, improve revenue generation, lower the wage bill, and minimize additional arrears. This will require the United States to commit funds to international efforts to stabilize the PA, but would not at the moment call for resumption of direct U.S. funding to the Palestinians.

The Trump administration has defined Israeli-Palestinian peace as a goal to be achieved through the possibly imminent release of an American peace plan. Failure to address the immediate fiscal and governance challenges facing the PA may render the larger U.S. objective moot.

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