

# The PA Financial Crisis:

## Causes and Implications

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### Brief Analysis

**E**ighteen months have passed since the Paris donor conference, where members of the international community promised the Palestinian government \$1.45 billion in assistance for its 2009 budget. The Palestinian Authority (PA), however, has received less than a quarter of this amount, and Arab governments in particular have fallen short, contributing only \$78 million of the \$600 million pledged. Palestinian prime minister Salam Fayad has been forced to borrow \$530 million from local banks this year in order to pay the salaries of PA employees, who with their families constitute one-quarter of the Palestinian population. When combined with the loss of internal revenue from the Gaza Strip since the Hamas takeover and the continuing Israeli restrictions on West Bank movement, the failure of donors to live up to their commitments threatens the tenuous economic progress the PA has made to date.

### The Current Financial Crisis

The PA's 2009 budget of approximately \$3 billion expects \$1.63 billion of internal revenue and \$1.45 billion of external funding (including \$300 million approved at the March Sharm al-Sheikh conference for Gaza reconstruction). To meet its \$250 million monthly budgetary needs, the PA relies on international donors for \$120 million of this total. According to its own financial reports, the PA received a total of \$328 million in external financing in the first five months of this year, far short of the \$600 million it required.

To cover the deficit, the PA is borrowing from private banks and drawing on excess 2008 donor aid. The record \$1.76 billion of external financing in 2008 exceeded the PA's expected budgetary support by \$130 million. The European Commission was the largest donor last year, providing \$651 million, while the United States was the largest individual donor nation, contributing \$302 million. Arab countries gave \$526 million and the World Bank granted \$283 million. The 2008 donor commitment allowed the PA to cover its \$1.12 billion deficit and ensure regular payments to PA employees, repayment of all wages in arrears (\$317 million), private sector loans (\$70 million), and some of its commercial banks loans (\$29 million).

### Reasons for the Current Budget Deficit

Three major developments have contributed to the current PA budget deficit:

Lack of Arab government commitment to the PA budget. While international donors pledged an impressive \$7.7

billion at the November 2007 Paris conference and \$4.2 billion at the March 2009 Sharm al-Sheikh conference to rebuild Gaza and support the PA budget, the lack of follow-through this year by Arab governments has left the Fayad government in a precarious position.

The miniscule contributions by Arab governments are particularly troubling when compared to their bold promises made at the 2007 Paris conference when Saudi Arabia, the United Arab Emirates (UAE), Kuwait, and Qatar together promised \$400 million in annual budget support between 2008 and 2010. As of June 15, only Algeria, Saudi Arabia, and the UAE had delivered their share -- a total of \$78 million -- of the promised aid for 2009. While Arab states contend they are withholding aid in order to pressure the Palestinian factions into forming a unity government, this approach is unrealistic and counterproductive. The Ramallah-based PA government is already spending almost half of its budget on Gaza. If the PA is forced to curtail spending on Gaza, this would only intensify the division between the West Bank and Gaza, making reconciliation more difficult.

The loss of Gaza revenue. Although Fayad's budget performance in 2008 was impressive, the Hamas takeover of Gaza has narrowed the tax base from which the PA is able to draw revenue. While 2008 saw overall revenues exceed budget targets due to increased economic activity in the West Bank and Fayad's administrative reforms, the PA draws revenue only from the West Bank -- there is no real income from Gaza. Indeed, while taxes collected by Israel on behalf of the PA increased in 2008 by 6.2 percent over 2007, this percentage conceals a much higher increase in the West Bank and a sharp decline in Gaza. In the West Bank, there was a 20 percent increase in value added taxes (VAT) on goods sold by Israel, and a 10 percent increase in petroleum purchases, but Gaza witnessed a sharp decline in receipts with a drop of 65 percent in VAT and 7 percent in petroleum purchases. Hamas, on the other hand, is able to raise funds in Gaza by collecting taxes and various domestic fees and by smuggling commercial goods (in addition to arms) through hundreds of tunnels under the Egyptian border. According to Tor Wennesland, the Norwegian representative in the Palestinian territories, Hamas runs nearly 1,000 tunnels (400 of which are officially approved), allowing the Islamist group to generate revenue to pay the salaries of its own employees and security forces while preventing the PA from collecting taxes on goods that would otherwise come through Israel.

Israeli restrictions on movement. In addition to cash donations, countries also promised to take on various development-related projects in the West Bank. In 2008, donor-financed expenditures on large infrastructure projects were estimated at about \$190 million, less than half the \$492 million commitment detailed in the Palestinian Reform and Development Plan of 2008. Cumbersome Israeli restrictions on movement resulted in frequent delays in projects and some cancellations. According to a June 8 World Bank report, "Israel's system of security has weakened the growth of the Palestinian economy and increased the dependence on the public sector." Restrictions on internal movement and goods transfers (import/export) have hampered efforts to build a developed economy and have made the Palestinian public heavily dependent on the government; the PA is now responsible for 145,000 employees whose salaries constitute 45 percent of the total budget. While the PA has tried to invest in small community projects that are less vulnerable to Israeli movement restrictions -- water sanitation, irrigation projects, electrifying villages or rural road paving -- these smaller initiatives do not have the economic impact of the larger infrastructure projects.

## Conclusion

While Fayad's achievements are numerous -- improving law and order in the West Bank, creating a more favorable environment for local and foreign investment, reducing the back payments owed on salaries, enhancing the collection of domestic revenues, and reducing dependence on external donors -- his government faces major economic obstacles. According to the Palestinian Central Bureau of Statistics, the West Bank's gross domestic product grew by 2.3 percent in 2008, but the lower than expected level of international donor assistance and continuing movement restrictions in the West Bank make it unrealistic for the PA to reach its 2009 growth target of 5

percent. Spending on Gaza consumes almost half of the PA budget while Israeli restrictions on movement hampers economic development and makes the Palestinians more reliant on the public sector and international aid.

The failure of donor states to deliver on their pledges this year will weaken government confidence and threaten the PA's fragile financial stability. More importantly, it signals to the Palestinian public that its government lacks international support at a time when the PA is confronting Hamas, enforcing law and order, and implementing its security obligations under the Quartet's 2003 Roadmap peace initiative. This confrontation includes recent crackdowns on two Hamas cells in Qalqilya in early June and the killing of five Hamas Izz al-Din al-Qassam Brigades militants.

For Washington, U.S. special Middle East envoy George Mitchell should work with Israel to ease restrictions on Palestinian movement as security improves in the West Bank, and convince the Gulf Arab states to live up to their donor commitments.

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