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Budgetary and fiscal policy for a new Palestinian state

by

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Abstract
This paper investigates the budgetary experience of the PA so far, discusses the constraints on the use of fiscal policy in a new Palestinian state and examines the range of structural challenges which fiscal policy will have to confront, from reconstruction and development to demographic changes and immigration. It argues that the constraints arising from the fiscal structure (eg high dependence on indirect taxes and customs duties) and from the likely monetary arrangements mean that fiscal policy will have to be relatively conservative. The fiscal challenges are not insuperable but the reforms, which the PA has already initiated, will need to be taken further.

1 INTRODUCTION

Between 1967 and 1994, the budgetary policy of the Israeli administration in the West Bank and Gaza Strip (WBGS) seems to have been much like that of former British colonial regimes. Owen and Pamuk (1998: 52) described the major budgetary principle of colonial economic practice as follows: 'Colonies should pay for themselves without recourse to special financial assistance from the metropolis. This produced pressures for fiscal conservatism including the need to make sure that they balanced their budgets. This, in turn, ensured that, given the fact that the first call on their resources was to spend money on administration and the police, there were usually only small sums left for welfare or public works.' In the WBGS there was little infrastructural spending by the Israeli administration, and health and education services were largely provided by NGOs.

The Palestinian Authority (PA) began to function as a fiscal authority in 1994. Since that time it has substantially increased its tax-gathering capacity, to a point that compares well with other countries in the region. The PA's expenditure has also been substantial and significantly above revenues, but as a result of significant support by external donors, most of which went to finance capital expenditures which the PA could not fund, the domestic fiscal balance remained moderate. However, it should be emphasised that the PA was starting from scratch as an entirely new administration, and that its operations were subject to a high degree of political and economic turbulence, related in particular to the intensity of closures in 1994-96 and then the start of the second intifada in September 2000.

The government of a new Palestinian state will inherit the budgetary and fiscal arrangements put in place by the PA. But it will need to move decisively towards a

budget that will be self-sustaining at some point in the future. And it will need to cope with particular challenges which arise from the need to overcome the effects of occupation and conflict, to welcome and absorb a large number of returning refugees, and to expand the role of the state to cover a wider range of activities including comprehensive health and education provision, pensions and other social support programmes.

Section 2 examines the PA's budget from 1996 to 2003, highlighting some of the key structural characteristics of the budget and placing it in a regional and international context. In Section 3 we consider the challenges facing a new Palestinian state in designing a fiscal programme that is consistent with the needs and aspirations of the new state and those it represents. In doing so we focus both on the 'structural' aspects of fiscal policy design – issues of the structure of taxation, public expenditure, debt and the institutions of fiscal management – and on the question of the macroeconomic sustainability of the fiscal stance. Section 4 concludes.

2 THE PALESTINIAN AUTHORITY'S BUDGET

Overall performance

Tables 4.1(a) and 4.1(b) provide basic data on the PA's budget since 1996, including the planned budget for 2003, where Table 4.1(b) expresses the fiscal position in terms of estimated GDP.[1] The PA began for the first time to raise revenues in its own right in 1994, and achieved remarkable success by increasing revenues from 17.6% of GDP in 1996 (and 8% in 1994) to consistently over 20% of GDP between 1997 and the second intifada in 2000. This is substantially above the average in neighbouring Arab countries (IMF, 2003a: 62).

On the expenditure side, the budget is partitioned between the recurrent budget, which was overwhelmingly funded by domestic revenues, and the development budget, a large proportion of which has been donor-financed. Soon after the signing of the Declaration of Principles (DoP) in 1993 an international conference of donor countries was held and pledged $2.4bn to assist the Palestinian reconstruction and development programme (1994-99). Further contributions increased the total to $3.4bn. The initial understanding between the PA and donors was that funds would not be used for short-term budgetary expenditure after 1994, but would be devoted to long-term public investment, hence the separation between the two budget components. Over time it was anticipated that the PA would make gradually increasing contributions to the development budget. While the Authority was moving in this direction (the recurrent budget deficit was progressively eliminated between 1994 and 1999) the adverse conditions caused by closures and the intifada, and then by Israel's withholding of clearance revenues (see below), necessarily reversed this trend, with all the aid going to support the budget and nothing to capital expenditure, a situation which forced the PA to allocate some money itself to finance certain urgently needed capital expenditure.

Over the first half-decade of its existence, the PA was also remarkably successful in maintaining a tight control on the level of domestic deficit financing. The PA's overall fiscal deficit declined from almost 12 percent of GDP in 1996 to around 5% in 1999 (or from around 5% of GDP to a position of overall balance when directly foreign-financed expenditures are excluded), and this was accompanied by a sharp reduction in the PA's net domestic deficit (i.e. its direct borrowing from the banking

sector). Since then, however, fiscal performance has been severely disrupted by the second intifada (which started in September 2000) and the intensification of the Israeli closure (physical siege) policy. Domestic revenues declined sharply as the result of economic crisis, political turmoil and difficulties in tax collection. Clearance revenues collected by the Israeli tax authorities on behalf of the PA also declined, but more importantly the Israeli government refused to transfer these monies in 2001 and for all except the final month of 2002. By the end of 2002 Israel had transferred only NIS556m (16%) out of the NIS3,370m due (see Table 4.1a). At the same time, with the sharp drop in the number of Palestinians working in Israel there was strong pressure on the PA to increase expenditure and alleviate economic hardship. However, expenditure was broadly stabilised, while the large increase in the overall fiscal deficit which emerged was made up by increased external finance – partly from the European Union and partly from the Arab countries – which was now paid directly to the PA and, given the domestic revenue crisis, was increasingly used to fund current instead of capital expenditures. As we discuss later, external developments and the fiscal reforms underpinning the 2003 budget have helped to return the overall fiscal stance to a broadly sustainable position, at least given continued levels of external support.

[Tables 4.1a and 4.1b near here]

It is important to stress, however, that the accounts of the PA do not fully reflect the overall fiscal position of the Authority. In particular, the data in Table 4.1 omit some important revenues and expenditures. A large part of actual expenditure in the WBGS on health, education, social services and maintenance and buildings has been carried out by international organisations and foreign financed NGOs. The most important of

these is probably the United Nations Relief and Works Agency (UNRWA) which is in charge of the welfare of the refugees and refugee camps in the WBGS. Table 4.2 shows the levels of expenditure by UNRWA in recent years, both in the WBGS and in the refugee camps elsewhere. For 2003, for example, UNRWA's total planned expenditure in the WBGS amounted to about $154m, or to some 14% of the planned expenditure in the PA budget. On the revenue side, and especially until 2000, certain tax and non-tax revenue flows remained off budget. Between 1995 and mid-2000, a total of approximately $590m of excise revenues on tobacco, alcohol and petroleum were diverted into accounts which were neither under the control of the Ministry of Finance nor incorporated in the PA's budget. As the IMF reports, however, most of this revenue – equivalent to around 2.3% of GDP (or 12% of annual PA revenue) per annum – was used for investment in PA commercial operations through the Palestinian Commercial Services Company (PCSC) (IMF, 2003a: 88-9). The PA rapidly acquired a number of commercial assets, many of which were in effect awarded monopoly status (notably cement and petroleum), and for several years these activities were not publicly accounted for. Other assets (including, for example, a stake in ORASCOM Telecommunications) were bought or set up out of diverted tax revenues. The PA's commercial entities, some 67 in total, were highly profitable. The IMF report makes a rough estimate of their profits over the years 1995-2000 at around $300m, which was also channelled outside the PA budget (IMF, 2003a: 89, 91).

In addition, fees and charges levied by some ministries (health, education, car licensing, etc) were paid directly to the ministries' bank accounts and spent at the discretion of ministers, which reduced the Treasury's ability to control revenues and expenditure (IMF, 2003a: 89).

Key features of the PA's fiscal operations

The PA's short, albeit intensive and occasionally dramatic, experience in fiscal matters has revealed a number of bottlenecks and weaknesses. Some of these have now been dealt with in the fiscal reform which accompanied the preparation of the 2003 budget (see below), but others are of a more structural nature and cannot be tackled under the present geopolitical and economic constraints.

Tax structure and fiscal leakages

One of the initial successes of the PA was the creation of a healthy revenue base. Between 1994 and 1999 the PA managed to raise revenue to around 21% of GDP, which is high relative to both other countries in the region and countries with similar structural characteristics. Although the WBGS is currently classified as a lower-middle-income country its per capita income ($930 per capita) places it in the lowest quartile of the lower-middle-income range,[2] while many of its structural characteristics, such as relatively low levels of industrialisation, openness to trade, and vulnerability to external shocks, mean that its natural comparators consist of low- rather than middle-income countries. Estimates for low-income countries suggest that revenue mobilisation in the late 1990s averaged between 15% and 18% of GDP (see Abed et al, 1998, and Gupta et al, 2002). This level of revenue mobilisation, which is much closer to that enjoyed by middle- or upper-middle-income countries, is all the more striking given that it has been achieved with tax rates that are relatively modest by international standards.

However, these impressive aggregate figures mask the fact that the PA revenue base is disproportionately weighted towards indirect taxes and away from direct income taxes. Indirect taxes (domestic indirect taxes plus taxes on trade) account for nearly 80% of total WBGS revenue, compared to around 50% for Jordan, Lebanon, Morocco and Tunisia, a similar share for all low-income countries, and just over 30% for Israel (IMF, 2003a: 66, and Adam and Bevan, 2003). This structure is not the outcome of an explicit choice over the tax regime but rather reflects the Oslo agreements which imposed the overall structure of indirect taxes,[3] the relative efficiency of the Israeli clearance and tax-gathering mechanisms, and the effect of the economic and political crisis on the PA's ability to collect income tax.

The high dependence on indirect taxation in general gives rise to a further feature of the budget. Tax revenues accrue to the PA through two channels: domestic direct and indirect tax collection, and tax clearances remitted by Israel. The former are collected by the PA itself, while the latter are collected by Israel on behalf of the Palestinian Authority and refunded via clearance procedures which were agreed upon in the Oslo Accords. The share of clearance revenues in total revenues increased from 54% to 63% between 1996 and 2000, and the degree of fiscal vulnerability associated with the tax clearance system was dramatically illustrated when Israel stopped the transfers in 2001. The tax clearances remitted by Israel to the PA consist of three main flows:

- VAT collected by Israel on goods sold by Israel to the Palestinians (against invoices)
- Customs duties and excise (purchase tax) collected by Israel on goods imported through Israel and specified as destined for the WBGS.

- 75% of the income tax paid by Palestinians working in Israel (and all the taxes paid by Palestinians working in the Israeli settlements).

While the clearance mechanism was technically efficient, it was also a source of disputes (Kanafani, 2001). Actual implementation of the system meant that the PA has been losing customs duties on indirect imports, i.e. goods which are re-exported by Israel to the WBGS; purchase taxes on (as well as customs duties on the import content of) Israeli manufactured products sold to the Palestinians; and customs duties, excise taxes and VAT on purchases which are not documented by invoices. Conservative estimates of this fiscal leakage (the revenues which accrue to Israel but are not transferred to the PA) put the figure at somewhere between 3% (Naqib, 1996) and 4.2% (Dumas, 1999) of GDP.[4]

Arrears and debt

Even after external budget support the PA's budget was running at a small deficit during the relatively 'good' years of the late 1990s, but it reached alarming levels during the crisis years of 2001-2002. The sharp increase in deficit was financed partly by borrowing from domestic banks and partly by the accumulation of payment arrears. With the suspension of clearance transfers from Israel and the deepening fiscal crisis, the PA's fiscal management came to depend on 'forced credit' from the private sector. By the end of 2002 the stock of payment arrears was estimated by the IMF at $531m, equivalent to around 18% of GDP (or 12% of 2000 GDP, i.e. the level of income prevailing before the sharp crisis-induced collapse in GDP) (IMF, 2003a; 77, 95). The PA also borrowed from the commercial banks and from the PMA. Net PA liabilities to domestic commercial banks peaked at the end of 2000, but declined slightly by the end of 2002 to $121m, or 4% of GDP (IMF, 2003a: 77). Although the

stock of domestic bank debt was low, it was expensive, with interest rates of 10% on dollar and 15% on NIS loans. Unlike expenditure arrears, however, which contributed to the pressure on the private sector in the WBGS, PA borrowing from the banking system is likely to have had a positive effect on the private sector. The banking system had always (i.e. since 1993) lent out to the private sector only a relatively low proportion of the deposits it took in, and it was even more reluctant to lend under the intifada. Its loans to the PA would not therefore have crowded out loans to the private sector and, by allowing the PA to pay for more of what it was ordering, would have eased the financial pressure on the private sector.

The PA was also accumulating foreign debt. Development expenditure remained almost totally financed by foreign donors, but finance was increasingly in the form of loans rather than grants. The stock of foreign debt stood at about $530m in mid 1999 (MAS, 1999), some 13% of GDP, but increased to $872m by 2002 (approximately 20% of pre-Intifada GDP) (IMF, 2003a: 82).

The true scale of the external debt burden is rather difficult to measure. However, most of this debt has been contracted on highly concessional terms and there is a reasonable expectation that a significant proportion would be rescheduled and written-off in due course. Hence in net present value terms, the true external debt burden is likely to be significantly less than this 20% figure, even accounting for some continued increase over the coming years. This would place a future Palestinian state well below the mean levels of external indebtedness for developing countries as a whole. For example, the latest figures from the OECD, relating to 1999, estimate the nominal average external indebtedness of all developing countries to be

approximately 85% of GDP, while Pattillo et al (2002) report that even after accounting for concessionality the present value of this external debt is close to 50%.

Public sector employment

The public sector wage bill in the WBGS is relatively high, as a ratio of GDP or of current expenditure, compared to other Arab countries and other comparable countries around the world. The IMF calculated the ratio to GDP, for example, at 15.2% for the WBGS in 2000, as against between 6% and 9% in each of Algeria, Egypt, Israel, Jordan, Lebanon and Syria and around 12% in Morocco and Tunisia in 2001 (IMF, 2003a: 92). For lower-middle-income countries as a whole, wages and salaries accounted for approximately 22% of total expenditure during the latter half of the 1990s (somewhat less than 10 percent of GDP),[5] while Gupta et al (2002) report similar shares for a sample of 39 low-income countries (25% of total expenditure and 7% of GDP). This relatively high ratio for the PA may reflect in part the 2000 fall in GDP; but as Table 4.3 shows, the ratio in 1999, before the crisis, was still 11.6% of GDP, significantly bigger than comparator countries. The evolution of total expenditure is also telling. While in 1996 wage and non-wage expenditures were of comparable size, there was some tendency for the former to rise more rapidly with the increase in public sector employment, which was around 10% at an annual rate from 1997 to 2000; and the growth was in both civil service and security jobs. This phenomenon was largely a response to strong political pressures to increase public sector employment, not least the importance of jobs for returning PLO personnel. However, two things should be noted here. First, the WBGS figure does not include the significant wage bill for people employed by UNRWA. Second, the distribution of new posts was poorly directed: nearly half of public sector workers were employed in

the security services, and there continued to be shortages in education, health and the judiciary (Erickson von Allmen, 2001: 14).

(Table 4.3 near here)

Fiscal reforms and the 2003 budget

An attempt was made to deal with some of these weaknesses in the Economic Policy Framework which was introduced in June 2000 in response to growing dissatisfaction among donors. The diversion of revenues was largely ended, but public sector wage employment, which was still only imperfectly controlled by the MoF, continued to rise. There was a sharp squeeze on non-wage spending but a continued, albeit slower, rise in the wage bill: this was largely the result of a conscious decision by the PA to offset, in the way and to the extent that it could, the economic depression associated with the Israeli closures.

A second wave of reforms was initiated in June 2002, partly in response to the deepening political crisis resulting from Israeli incursions into the WBGS. The most important of these reforms were the consolidation of all public revenue – including the profits from PA commercial assets – into a Single Treasury Account; the introduction of stricter controls on spending, with limits on the growth of employment to be properly enforced; increased transparency in the budget; the bringing together of all the PA's commercial assets in the Palestinian Investment Fund, with the introduction of policies to prevent monopolistic practices; and moves to reform existing pension systems (IMF, 2003a: 102).

Fundamental to the budget plan for 2003 were an agreement by which the Israeli government resumed the transfer of clearance revenues, including the gradual transfer of the arrears that had built up since January 2001, and expectations of continued external donor support of $535m for recurrent and $212m for development expenditure. The budget also envisaged a continuation of the current low level of domestic revenue and a freeze on the wage bill, together with a much needed fillip to non-wage spending which had been cut in the two previous years. The intention was that the transfer of past clearance revenues would be used mainly to reduce the PA's expenditure arrears and repay some bank borrowing, while it was assumed that significant external budgetary support would continue.[6]

3 FISCAL CHALLENGES FOR A NEW PALESTINIAN STATE

A political settlement based on the principles spelt out in the introduction to this volume (an independent and fully sovereign Palestinian state in the WBGS) will change the nature of some of the key features dealt with in the previous section. For example, the state will enjoy greater autonomy over the design of its tax structure and the problems of fiscal leakages will no longer exist, while relationships with external donors may be expected to take on a different character. At the same time, however, the new circumstances of independence and the return of refugees will intensify other problems and bring with them new fiscal challenges as well. In this section we start by considering the macroeconomic constraints within which any future fiscal stance must be defined before turning to a range of structural issues.

Defining a sustainable fiscal stance

A desirable sustainable fiscal stance should have three different attributes: (i) a tax structure which maximises revenue while maintaining tax rates which are stable, progressive, but not excessive; (ii) a path for the fiscal deficit which is consistent with stable and low inflation, a moderate debt to income ratio and a path for the domestic interest rate which does not directly threaten short-term macroeconomic performance; and (iii) a fiscal stance that is counter-cyclical and hence capable of smoothing shocks to private sector consumption.

One of the striking aspects of the short history of the PA has been the remarkable degree of overall fiscal control, at least up to the period of the second intifada, which means that the new state can contemplate the design of a fiscal strategy without having to deal with the latent fiscal and debt crises that plague many low-income countries. As we noted in Section 2, although the PA's overall budget deficit has been substantial since the mid-1990s, this has principally reflected substantial levels of (highly concessional) external finance. By contrast, the domestic net borrowing requirement (i.e. the overall budget deficit after foreign financing and the accumulation of arrears) remained at relatively low levels between 1996 and 1999, moving from a deficit of 1.4% of GDP in 1996 to a small surplus of 0.3% of GDP in 1999 (Table 4.1b). These deficits, which were significantly lower than the 4% of GDP average for low-income countries as a whole over the same period (IMF 2003b), meant that domestic debt on the eve of the crisis of 2000 was exceptionally low.

The revenue collapse occasioned by the closures of 2000-2002 clearly undercut this performance in a dramatic and debt-augmenting way, but the budget (and outturn) for 2003 has seen the previous flow position more or less restored, even after the

elimination of a significant proportion of the domestic arrears that built up during the period when revenue clearances from Israel were halted. Partly as a result of the speed with which fiscal balance was restored, and partly due to the high level of grant financing received from key international donors, this catastrophic fiscal shock saw external indebtedness rise to only just over 20% of GDP.

While the relatively low level of debt and high revenue mobilisation are clearly of immense value to the putative fiscal regime, they mask a number of structural weaknesses in the fiscal setup which ultimately limit the scope for active fiscal management. The first is that a significant proportion of tax revenue is raised through taxes which are either internationally negotiated (eg customs duties) or where the scope for varying rates is likely to be limited (eg VAT). Between 26% and 30% of the PA's revenues during 1998-2000 came from customs duties (either collected directly by the PA or reimbursed by Israel, see table 4.1a). This is a little higher than the average in low-income countries, but substantially higher than that in lower-middle-income countries (which is about 13%). Customs duties amounted to 6.1% of the WBGS's GDP in 2000, much more than in other Middle Eastern countries (IMF, 2003a: 86). These ratios are surprisingly high in the light of the customs union arrangements with Israel, the 'fiscal leakages' discussed in section 2, the interim Association agreement with the EU and a number of free trade arrangements with the Arab countries. It is clear, therefore, that the trade regime to be adopted by the Palestinian state will have significant effects on the PA's fiscal revenues. Customs duties are typically an easy and accessible source of revenues, and many developing countries hesitate to adopt a more rational and ultimately more beneficial trade regime in order to preserve that source of income. In the case of Palestine, however, a more

appropriate trade regime (such as the non-discriminatory trade regime, recommended in chapter 2 of this volume) may actually deliver higher customs revenues than the current customs union arrangements with Israel, thereby holding out the prospect that a future Palestinian government may be able to reduce customs rates without adverse effects on the gross proceeds. Set against this, however, whatever new trade regime replaces the Oslo arrangement will require Palestine to put in place a competent administrative structure to manage customs control and customs collections, and the cost of that may turn out to be higher than the fees currently charged by Israel for collecting customs and excises on behalf of the PA.

The relative size of these offsetting effects is difficult to assess (although see World Bank, 2002, chapter 2 for a discussion of possible revenue effects), but whatever the change in net revenue yields from trade reforms, it will remain the case that a new Palestine will be heavily dependent on trade-based revenues. Since tariff and duty rates will continue to be constrained by international negotiation and the need to ensure that the trade regime remains competitive, a new Palestinian state is unlikely to find itself with much scope for discretionary changes in taxes.

The second, and certainly the most challenging, feature of the current budget is the size of the government wage bill. The PA figures may well overstate the size of the wage bill if the high level of off-budget expenditure is less labour intensive than that reported in the budget, but even so, and setting aside questions of the optimal composition of public expenditure, the large size of the public sector wage bill presents a serious challenge to efficient fiscal adjustment to adverse revenue shocks, especially in an environment of low inflation where any significant real wage

adjustments will require correspondingly large nominal adjustments. Even in circumstances where employment legislation and public sector unions are relatively weak, it is notoriously difficult both to reduce the public sector wage bill when downward adjustment is required, and to oppose pressures to increase it in the face of positive external or revenue shocks, including aid surges. Tanzi (1993), for example, argues that efficiency wage effects are particular severe in public sector employment (since public sector employees are often better placed to switch into secondary employment in response to real wage cuts). The political economy literature, on the other hand, stresses the role of 'voracity effects' where the strength of interest groups can induce inefficiently large responses to positive revenue shocks and inefficiently small responses to negative ones (eg Tornell and Lane, 1999; Adam and O'Connell, 1999).

One implication of this kind of structural rigidity is that in the face of revenue or interest rate shocks requiring expenditure adjustment, the cost of this adjustment will fall disproportionately on the non-wage component of the budget and, if evidence from elsewhere is any guide, on operations and maintenance expenditure on the public capital stock. The exact pattern of adjustment will depend in large measure on the fungibility of donor- and NGO-funded projects and programmes. If they are non-fungible, a much greater share of the cost of fiscal adjustments will fall on the PA's own non-wage budget.

This, in turn, raises two related issues. The first concerns the nature of the fiscal shocks a Palestinian budget might face, and the second is whether, and to what extent,

the budget deficit may be used to smooth public expenditure, and thereby avoid costly non-wage expenditure adjustments.

Revenue and aid volatility

The revenue account is likely to be vulnerable to two sources of volatility. The first arises from the heavy dependence on revenue from tradable goods for which Palestine is, and will continue to be, a price-taker, and is likely to have limited discretion over tax rates. Given the openness of the Palestinian economy and the likelihood that the price elasticity of demand for imports is relatively low, the revenue account is therefore vulnerable to real exchange rate shocks which, unless there is rapid pass-through to public sector wages, will be transmitted rapidly onto either the budget deficit or, again, non-wage expenditure. In these circumstances, given the high non-tradable content of public expenditure, real exchange rate appreciations will tend to be budget worsening.

The second major source of vulnerability arises from the continued dependence of the budget on foreign aid. In the past foreign (concessional) financing of the PA budget has been high and volatile, at 5% of GDP (25% of revenue) in 1998 and 1999, but 16% in 2002 (more than 100% of domestic revenue). In the future it seems likely that foreign aid would be high immediately after a political settlement but would then begin to taper off. Aid can affect the budget in two ways. The first is through traditional ‘Dutch disease’ channels whereby aid inflows not only stimulate ‘voracity effects’ on the expenditure account but, to the extent that they induce an appreciation of the real exchange rate, may also reduce the domestic value of trade-based revenues. In the case of Palestine, while these Dutch disease effects may be potentially

problematic in the medium term, the short-run risks seem less severe since the combination of the exchange rate arrangements (discussed in chapter 3) and the likely supply side effect of returning refugees is likely to mitigate the tendency for the nominal exchange rate to appreciate.

The second, and possibly more difficult, problem is that aid flows tend to be more volatile than domestic revenue (Bulir and Lane, 2002). Moreover, and despite the fact that some elements of aid, such as food and emergency relief, are explicitly designed to be counter-cyclical, there is evidence that for most developing countries aid flows are weakly pro-cyclical. This reflects in part the effect of conditional aid programmes and the influence of political standoffs between donors and recipients, and in part the internal disbursement arrangements of donors. But these points mean that the likely continued high levels of aid to Palestine will not necessarily make the fiscal management task easier.

Deficit financing and monetary arrangements

The structural rigidities discussed above are not unique to Palestine, nor are they a defining feature of developing countries. In virtually all countries, international agreements and domestic political considerations limit discretion on revenue, while real wage rigidity and/or high non-distortionary expenditure constrain rapid expenditure adjustment. What matters, though is the extent to which deficit financing can be used to avoid costly tax rate adjustments and to smooth consumption in the face of output or other macroeconomic shocks. It is here that industrialised and developing countries are fundamentally different. Gavin and Perotti (1997) find that for industrialised countries the fiscal balance is strongly pro-cyclical, improving in

good times and falling in bad times. Moreover, this pattern is strongly asymmetric so that fiscal deficits increase more in bad times as expenditures increase, than they decrease in good times. This pattern – which implies a broadly sustainable fiscal stance over the medium term – is consistent with efficient stabilising or tax-smoothing arguments in general, and with the idea that recessions are politically more costly (and require a more expansionary response) in particular. By contrast, for Latin American countries, they find that the fiscal balance is only very weakly pro-cyclical and that the cost of fiscal adjustment is overwhelmingly borne by expenditure adjustments. Adam and Bevan (2003) extend this analysis, showing that for middle-income developing countries the fiscal balance is broadly acyclical and the full weight of adjustment to output and hence revenue shocks falls on expenditure. In the lower income countries, while this is true for moderate output shocks, there is evidence that fiscal deficits are strongly pro-cyclical in response to adverse output shocks. Taken together, this suggests a pattern of fiscal response composed of either significant expenditure adjustment (in the case of middle-income countries) and/or periodically large fiscal deficits in low-income countries, where the latter are typically financed by arrears accumulation, unsustainable recourse to inflation tax, and debt default.

Given what has been written elsewhere and the recommendations of chapter 3, it seems reasonable to assume that the new state will soon introduce a new currency under a currency board arrangement with a peg to the NIS. Assuming that such an arrangement was sufficiently credible, this would strictly limit the government's use of central bank finance, and commercial bank borrowing. There would be some seigniorage, but as argued in chapter 3 the likely seigniorage revenue at sensible inflation rates would be small. Thus in the short-run the scope for discretionary deficit

financing would be heavily circumscribed and all fiscal adjustment would fall on non-wage expenditure. Over the medium term, however, especially as the domestic debt market developed, there may be scope for shifting the task of short-run fiscal adjustment from expenditure to the deficit. But the need to maintain credible fiscal control will remain a priority.

Traditionally, for a government to 'tie its hands' to a fixed exchange rate or a currency board arrangement has been seen as a means of enforcing discipline. However, Tornell and Velasco (1995) have argued the reverse: by delaying the inflationary consequences of fiscal laxity, a fixed exchange rate regime can actually induce greater opportunism. Gavin and Perotti (1997) find weak evidence in support of this for Latin America, but the only robust evidence on exchange rate regimes and fiscal discipline appears to support the view that 'hard peg' arrangements do seem to foster robust fiscal restraint (Fatas and Rose, 2001).

If greater exchange rate flexibility was pursued, the government could look to domestic rule-based mechanisms for fiscal control such as the cash budgets increasingly used in many Sub-Saharan African countries. Such rules effectively place spending agencies and government as a whole on a cash-in-advance basis, thereby limiting the growth in reserve money. Aside from proving an effective method for addressing inflation (and domestic arrears) problems, such rules serve to embed day-to-day fiscal management in the culture of public policy and tend to strengthen the hand of central agencies (i.e. the Ministry of Finance) relative to spending agencies. The cost, of course, is that deficit rules necessarily imply a loss of discretion and return the whole burden of fiscal adjustment onto expenditure. Clearly

there is a trade-off between credibility and discretion; if discretion is at risk of being abused, the case for rules is stronger.

Both the fiscal structure and the monetary/currency arrangement therefore imply a need for a conservative fiscal policy, such that deficits are kept to low levels even in adverse circumstances. Fiscal policy in the future is therefore likely to be unable to play anything more than the most minimalist role in stabilising employment and output – a position that was tacitly accepted in the 2003 budget.

Fiscal policy choices and structural challenges

Given the macroeconomic constraints on fiscal policy in a new Palestine, it follows that the most obvious challenge lies in maintaining the relatively vigorous growth of public revenues and in controlling and limiting the expansion of expenditure. In the past, the PA has benefited from the efficiency of the Israeli tax authorities in collecting taxes and has itself performed well in securing the documentation for reclaiming the money. In a fully sovereign state the Palestinian tax authority will be in charge of directly collecting the taxes, and this will require new administrative structures and skills, as well as substantial transparency and comprehensive enforcement. And if the PA does not continue to collect at least the same proportion of taxes to GDP as during the Oslo period, the arguments about fiscal leakage will lose much of their force.

Attitudes to paying taxes

It is hardly surprising that an anti-tax culture flourished among the Palestinians during the long years of occupation. People did not see either collective or personal benefits in return for paying taxes and tax evasion was considered as a form of resistance against the occupiers. Prior to 1994 Palestinians were systematically 'over-taxed'. Taxes to the Civil Administration and the Israeli treasury in the 1980s and early 1990s amounted to some 18-24% of GDP. At the same time the level of public expenditure was less than 15% of GDP, which 'is very low compared to other countries and implies a net transfer to the treasury' (UNCTAD 1996: 35).[7] Changing that attitude will be difficult and will take time but it is essential, not only to secure sufficient public revenues to finance the public services, but also to consolidate the democratic foundations of the future Palestinian society. At the same time a successful strategy to change attitudes and to enhance social commitment will require significant accountability, transparency and public participation in decision-making.

Reconstruction and development expenditure

A future independent Palestinian state will confront three major expenditure challenges: the short-run requirement for large reconstruction and development expenditure; the medium term challenge of responding to the demographic change, including the consequences of absorbing returnees; and the longer-term challenge of funding high quality social services from own resources.

The most pressing challenge will be the need for immediate large-scale infrastructural spending to rebuild facilities destroyed by Israeli military action, to establish an adequate social and physical infrastructure and to reorganise the road network to reintegrate the Palestinian territories. Soon after the signing of the DOP the World

Bank designed an emergency assistance programme for the Occupied Palestinian Territories with a total cost of $3.7bn over the five-year period 1994-98. The Bank estimated that $2.4bn of this would be in the form of public investment, to be financed almost entirely by international donations, while the remaining $1.3bn would come from private capital inflow. These estimates are no longer valid: some of the infrastructural spending was carried out but there has been widespread destruction of public and private properties carried out by the Israeli army during the years of the second intifada. It is unrealistic to assume that the PA would be able to finance a comprehensive reconstruction programme from its own resources. However, it is important that the PA should, from the beginning, devote a share of its revenues to reconstruction and long term development, not only to emphasise that all expenditure should be ultimately financed from own resources in the long run, but also to affirm Palestinian national 'ownership' of the development strategy. The allocation of a modest amount of money to development projects in the PA's 2003 budget is a positive sign in that direction.[8]

As the Palestinian government increasingly contributes directly to the finance, as well as the design and control, of reconstruction and development efforts the case for an integrated budget incorporating all the activities of the public sector is strengthened. There are some arguments for maintaining a partition between the recurrent budget (predominantly government financed) and the development programme (predominantly donor funded), reflecting principally the greater uncertainty over the scale and timing of donor funding. However, as the evidence from highly aid-dependent low-income countries is beginning to suggest, these arguments are outweighed by the gains in terms of the coherence and coordination of public

expenditure that derive from integrated frameworks for public expenditure management. Moreover, the same evidence suggests that an inclusive and integrated budgetary framework tends to strengthen the hand of governments relative to donors in ensuring that public expenditure as a whole reflects domestic government priorities rather than those of external donors.[9]

Demographic changes

Public finance is highly sensitive to demographic change, and Palestine is likely to experience significant demographic shifts in the next few years, even without taking the issue of returnees into account. The PCBS's estimates suggest that endogenous population growth in the WBGS will decline to 3.2% by the year 2010 (from about 3.8% in 1999) but labour force growth will outpace that substantially and will reach an annual rate of 4.4% (see Davoodi and Erickson von Allmen, 2001). The impact of the resulting significant rise in the share of the labour force in total population could be 'unambiguously positive for fiscal revenues', leading to an increase in fiscal revenues by 1.3% of GDP, according to Jenkner (2001: 100). Obviously, this is subject to the condition that the economy would be able to provide employment and absorb the additional labour force. On the other hand, the same study argues that the demographic impact will be 'less clear for expenditure', but suggests that the reduction in the age-dependency ratio (smaller proportions of people older than 65 and of school children relative to total population) along with stringent expenditure control would reduce expenditure by 1.4% of GDP. Thus, natural demographic change in the WBGS by year 2010 would lead to fiscal consolidation, reducing the budget deficit by a little less than 3% of GDP.

The same framework was applied by Jenkner to examine the impact of a possible return of 600,000 refugees to the WBGS. She concluded that revenues would rise by a further 0.3% of GDP while expenditure would fall, through a further slight reduction in the age-dependency ratio, by a further 0.3%. Thus, the budget deficit could shrink by a further 0.6% by 2010. The study concluded that 'Immigration may have beneficial macroeconomic and fiscal effects over the medium term – but only if the economy is able to generate and sustain employment without undue compression in real wages' (Jenkner, 2001: 111).[10]

However, as Jenkner points out in several places in her study, her analysis is based on some simple and questionable assumptions: not only that the economy would achieve sufficient growth to absorb the ever expanding labour force (at reasonable real wages), but also that the policy environment in Palestine would be conducive to growth in general and with respect to the tax system and trade regime in particular. Equally important is the implicit assertion that current per capita public expenditures, by the PA or the UNRWA, whether in the form of social services or infrastructural spending, are generally adequate and would be capable of supporting the assumed acceleration of growth in the economy.[11]

Overall, then, there are no inevitable adverse consequences of the demographic shifts which the WBGS are expected to face in the near future. Population increase, and labour force growth in particular, could make it easier to pursue a 'sound' fiscal policy – but this depends crucially on whether the additional labour could be absorbed and on the policy decisions which are made with respect to both revenue collection

and public expenditure. The PA's policy decisions could turn the demographic shifts into a fiscal blessing or a fiscal curse.

Public services and social expenditure

Along with the poor state of basic physical infrastructure, the WBGS suffers from limited and deteriorating public services which, in a number of important areas, are worse than in neighbouring Arab countries. Per-capita consumption of electricity is substantially lower than in neighbouring countries, as well as the number of doctors per 100,000 inhabitants, fresh water supply and sewage (only 38% of total households in the WBGS are connected to sewage networks). Poverty is widespread (20% of households in 1998 were earning less than NIS 1460 per month), provision of cultural services is extremely limited, illiteracy is as high as 14% (1997), there is a large number of pupils per class (37.5 pupils per class at the secondary level and 47.7 pupils at the elementary level in the UNRWA schools), and over 40% of the population are without health insurance of any type.[12]

The new Palestinian state is likely to want to assume a significantly wider responsibility for social spending of various kinds, notably education and health, partly to improve the levels of service currently on offer and partly because it will eventually have to take over those services now provided by UNRWA and other NGOs. Actually, about 28% of the students enrolled in basic education in the WBGS were in UNRWA schools in the school year 1999/2000 (MAS, 2000). Table 4.2 shows the levels of expenditure by UNRWA in recent years, both in the WBGS and in the refugee camps elsewhere. Assuming that most of the residents of the refugee camps in neighbouring countries will return to the WBGS (see Arnon and Kanafani,

chapter 10 in this volume), then it is not totally unrealistic to suggest that all of this expenditure – some $344m in 2003 as against $1278m of expenditure in the PA's budget – will need to be assumed by the PA.

Additional costs will be involved in enhancing the provision, and the quality, of public services. Health and unemployment insurance as well as comprehensive pension schemes are of particular importance here. However, it is possible to design insurance schemes to be self-financing and fiscally neutral (see Sayre and Olmsted, chapter 7 in this volume), and this will ease a fiscal burden which is already large enough.

The tax system as a policy tool

Alongside their primary role of providing revenues to fund public expenditure, tax systems are often designed to fulfil two other major functions: the redistribution of income between different social groups and the stimulation of growth by mobilising savings and changing the incentive structure to divert investment and consumption in specific directions.

Due to lack of reliable data on household income distribution (see World Bank, 2001: 26) we rely instead on the distribution of consumption expenditure. Distribution of consumption reveals poverty more directly than income distribution, but inequality with respect to consumption can also be substantially lower than inequality as measured by the distribution of income. Table 4.4 makes clear that while average per capita consumption in the West Bank was more than 25% higher than that in Gaza, inequality was almost identical in the two regions in 1998. Average consumption of

an individual in the richest quintile is about five times that of a person in the poorest quintile, and the richest 20% of the population undertake about 40 percent of total consumption.

[Table 4.4 near here]

This is the sort of inequality that a steeply progressive income tax scheme can aim to address. In fact the PA had such a scheme with a high marginal tax rate up to 1999, when it was substantially reformed and replaced by a less progressive system with lower tax rates. Table 4.5 shows the income tax rates and brackets for 1995-98 and since 1999. While in the former case there were eight brackets with tax rates varying from 5% to 48%, the structure introduced in 1999 has only four brackets and a top rate of 20%. At the same time the corporate tax rate was reduced from 38.5% in the West Bank and 37.5% in the Gaza Strip to 20%. This tax reform would appear to have undermined both the pursuit of redistribution and the PA's proceeds from income taxes. But the experience of the past decades, in both developed and developing countries, has demonstrated that high marginal rates have strong negative effects on incentives, and correspond usually with widespread tax evasion and corruption. In addition, a highly progressive income tax system requires for its implementation a highly sophisticated administrative apparatus. Modern conventional wisdom in public finance suggests that a simpler income tax scheme with lower marginal rates leads to higher rather than to lower tax proceeds (as the result of simpler administration, weaker incentives to evade and stronger incentives to earn). Modern thinking in public finance also stresses that a progressive income tax can play only a limited role in bringing about substantial redistribution of income, and that this can be more efficiently achieved via the allocation of public expenditure. Thus the PA's income

tax reform does make economic sense and may actually lead to larger tax proceeds. But this also implies that more emphasis should be placed on public expenditure to achieve equity targets.

[Table 4.5 near here]

Redistribution could also be pursued by the imposition of excises and special purchase taxes (and high customs duties) on luxury goods. But the trade off between equity objectives and maximisation of the tax proceeds is even stronger here than with progressive income taxes: to maximise the proceeds, excise should be imposed on goods with low price elasticity of demand, but these goods are usually income inelastic (since they are consumed also by the poor). The chronic dilemmas between the efficiency, neutrality and equity objectives of the tax system are behind the near-universal tendency to depend increasingly on VAT to finance public expenditure. The main attractions of this indirect tax are its relative simplicity, its low 'excess burden' and its limited distortionary effects. However, VAT is an unambiguously regressive tax, especially when it is set at the same rate on all goods. As already noted, the Paris Protocol required the PA to set VAT at a rate close to Israel's. The main aim behind this was to prevent harmful consequences to the Israeli economy in the absence of a customs border with the WBGS. UNCTAD (1996: 33) had earlier argued forcefully that 'Fifteen percent is a very high rate for the Palestinian economy in its present state of development. A much lower rate may be considered more appropriate from the viewpoint of equity and growth consideration,' while the rates on the newly introduced VAT in Jordan and Lebanon were set at 13% and 10% respectively. Jordan's proceeds from a 13% rate amounted to 8.2% of its GDP in year 2001 while the 17% rate brought VAT revenues equal to 7.2% of GDP only in year 2000 in the

WBGS and 10.4% in Israel (IMF 2003a: 86). This may be due to the narrow base of the (high) VAT rate in the WBGS, which suggests that it would be possible to reduce the VAT rate without negatively affecting the tax proceeds provided the tax base was expanded (one reason for the narrowness of the tax base in the WBGS is the preponderance of small enterprises which under the Paris Protocol are exempted from VAT). On the other hand, the regressive nature of the tax can be eased either by introducing multiple VAT rates (lower on basic staple foods and services) or by exempting these goods and services from VAT altogether. But these measures imply, of course, narrowing the tax base.[13]

The second major function of a tax system is to stimulate growth by mobilising savings and changing the incentive structure to direct investment and consumption in specific directions. However, the idea that higher taxes can increase savings and investment is now subject to serious doubts as governments' propensity to consume has proved to be in many instances much higher than that of the private sector. The PA has deployed the income tax tool to encourage investment. Under the investment promotion law most investment projects benefit from income tax holidays during the first ten years of operation. This explains why almost all of the modest amount of income taxes collected in the WBGS came from individuals rather than from companies. But the experiences of other countries do not show that such tax exemptions substantially encourage corporate investments (Naqib, 1996). Many countries also use variation in income tax rates as a tool in their regional development policy, to encourage investment in underprivileged regions.[14] It may be argued that property in general, and real estate in particular, is under-taxed in the WBGS, and that more appropriate taxation here would moderate the strong historic tendency for a

substantial amount of domestic investment to be directed towards residential construction. Much will depend here on the future influx of the returnees and the fate of the housing units in the Israeli settlements in the WBGS (see Arnon and Kanafani, chapter 10 in this volume). What remains certain, however, is that the clash between using the tax structure as incentive instrument and maximising public revenues will remain a major dilemma for policy makers.

4 SUMMARY AND CONCLUSION

In the Oslo period the PA succeeded in creating new budgetary mechanisms where none had previously existed, increasing its revenues to internationally respectable levels, and keeping overall deficits and debt under control, at least up to the start of the second intifada in late 2000. However, the PA relied heavily on indirect taxes to generate revenue, the clearance arrangements were a source of vulnerability (as demonstrated in 2001-2 when the Israeli government refused to transfer the revenues it collected), the PA's accounts were not comprehensive (some revenues and expenditures were effectively off-budget), and its spending, with respect to public sector employment in particular, was not firmly under control. The overall performance was also heavily dependent on foreign aid, and there was an undesirable split between recurrent and development budgets. The intifada created additional pressures on the budget, and one outcome of these was an intensification of fiscal reform from 2002.

A new Palestinian state, which will inherit its basic budgetary arrangements from the PA, will face a series of new challenges in a variety of areas. It would be hard to change the fiscal structure significantly even in the medium term, which means that

revenue will continue to be subject to volatility arising from external trade and aid shocks, while expenditure is difficult to adjust. Moreover, the likely monetary and currency arrangements – in the form of a currency board peg to the NIS and later a hard peg to the euro, as discussed in chapter 3 – will limit the possibility of deficit financing. Hence the fiscal structure, on the one hand, and the likely monetary arrangements, on the other, indicate the need for a conservative fiscal policy, with budget deficits to be kept low even in adverse circumstances. At the same time the new state will need to grapple with the development of public services (and the take-over of those currently provided by UNRWA and other NGOs), the demand for large-scale reconstruction and development, demographic changes and the return of refugees.

Efforts should be made to enhance public revenues through broadening the tax base rather than increasing the tax rates. Equity issues are probably better dealt with via expenditure policy rather than high marginal taxes. Foreign support to the PA's budget, which has been so important, is unlikely to decline abruptly in the early years after the establishment of the new state. Thus international good will, together with compensation from Israel (as argued in chapter 10), would allow the new authority to spend more than it collects for some years. What is essential however is to start planning, from the beginning, to achieve a sustainable fiscal stance in the foreseeable future. The fiscal challenges are not insuperable but the momentum of the reforms, which the PA has already initiated, will need to be maintained and taken further, not least in the areas of transparency and involving the public at large in selecting the priorities and deciding upon their ranking.

NOTES

[1] GDP estimates for WBGS remain highly tentative. The values used in Table 4.1b are taken from IMF (2003a, 23: Table 2.2).

[2] The *World Development Report 2004* (World Bank, 2003) defines lower-middle income countries as those with per capita Gross National Income in 2002 of between $736 and $2934, based on the World Bank Atlas Method.

[3] The Paris Protocol, the economic agreement within the Oslo Accords, required the PA to levy VAT at a minimum of 15% compared with the rate in Israel which was then at 17%. Israel increased its VAT rate to 18% in mid 2002, and the PA is generally following the Israeli rate. The Protocol specified also that VAT exemption can be applied only to businesses with annual turnover of less than $12,000.

[4] Israel began in 2000 to transfer some purchase tax revenue on Palestinian purchases of Israeli goods, but a methodology put forward by the PA for taking account of the customs duties and purchase tax on indirect imports was rejected by the Israeli government in the summer of 2000 (IMF, 2003a: 87).

[5] World Development Indicators (2001).

[6] Preliminary indications from the monthly reports published on the internet by the MoF (at http://www.mof.gov.ps/reports.htm, accessed 12 January 2004) suggest that both revenues and the wage bill were slightly above plan, and external finance was well below the expected level. The PA was therefore cutting back on non-wage spending, repaying less arrears than hoped, and borrowing from rather than repaying the domestic banking sector.

[7] Until 1994 most of the taxes paid by the Palestinians went directly to the Israeli treasury and expenditure by the Civil Administration, the Israeli body which was in charge of running the WBGS, and spending by municipalities was limited to the

revenues collected by them (taxes, fees and utility tariffs). The shortfall between the revenues collected by the Civil Administration and the amount of taxes that were actually paid by the Palestinians led to what the World Bank called ‘fiscal compression and underfinancing of public sector investment needs’. During the 1970-90 period, public sector capital expenditure amounted to a mere 3.5% of GDP in the Occupied Territories, which was significantly below the average for developing countries (World Bank, 1993 vol 1:10).

[8] There is a ‘fungibility’ risk here, though: the PA has allocated some resources to urgent development projects because of the lack of foreign aid to finance such projects, but when foreign finance becomes available, the PA might shift those resources back to financing recurrent expenditure.

[9] The difficulties of classifying expenditures are well known. For example, expenditure on education and health which are in the recurrent budget could also be considered as investment expenditure which would increase the economy’s productive capacity in future.

[10] The Jenkner study did not take account of the point that the PA will have to take responsibility for all the services currently provided by the UNRWA, whether for the refugees that are resident in the WBGS or for the 600,000 returning refugees. She made a very rough estimate of these costs, putting them at $394m per year (some 9% of GDP in 2000), and concluded that ‘Obviously, such an expense could not be covered by an improved revenue effort alone but highlights that sustained donor support will be required together with stringent expenditure controls in the PA’ (Jenkner, 2001: 110).

[11] Text books in public finance stress the importance of Wagner's Law according to which the relative weight of the public sector (as a percentage of GDP) tends to increase with the increase in per-capita income. As often with these types of trends, it is difficult to establish strictly the line of causality. However, the endogenous growth theory literature argues that long-term growth can depend heavily on the level and nature of public expenditure and the strategy underlying it.

[12] For information about the state of the physical infrastructure see Mody (1999). Comprehensive coverage of various social/cultural indicators are available in *MAS Social Monitor* (2000 and 2001).

[13] The adoption of multiple VAT rates involves administrative difficulties as well as a higher degree of distortion in relative prices. There is a trade off between equity (based on the concept of 'ability to pay' and the notion that the richer should pay more) and distortions: the least distorting tax is a 'neutral' tax, a tax which leaves the relative prices of goods and services intact. Lebanon's 10% VAT was introduced in February 2002, but with the exemption of a relatively long list of activities and goods including livestock and raw agricultural products, bread, milk, yoghurt, pasta, baby food, feed, books and newspapers, gas for household consumption, agricultural machinery, medicines, etc. The Lebanese Ministry of Finance expects the 10% VAT to produce revenues equal to 4% of GDP (See the VAT Law, Ministry of Finance, December 2001 at: http://www.finance.gov.lb/main/vat/vatlaw_e02.pdf (accessed on January 1, 2004).

[14] Regional imbalance is apparent in the WBGS, not only between Gaza and the West Bank, as made clear in table 4.4, but also within each area. About one-half of the poor

in Palestine live in three districts: Khan Yunis, Gaza City and Hebron (World Bank 2001: 6).

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Table 4.1a: The budget of the PA, 1996-2003, (in NIS m)

	1996	1997	1998	1999	2000	2001	2002	2003[1]
Revenue (actual)	**2,059**	**2,785**	**3,300**	**3,898**	**3,829**	**1,148**	**1,574**	**5,057**
1. Domestic Revenue	937	1,143	1,233	1,498	1,434	1,148	1,018	1,037
Tax revenue	663	735	865	1026	982	759	640	593
Income tax	168	228	260	310	278	177	145	
VAT	209	268	316	367	393	323	271	
Customs duties	76	75	94	144	98	33	13	
Property tax	3	2	2	6	6	7	4	
Excises	207	162	193	199	207	219	207	
Non-tax revenue	274	408	368	472	452	389	378	444
Transportation fees	72	112	110	117	117	98	51	
Health insurance	40	44	55	83	75	46	64	
Health fees	30	35	39	38	40	33	27	
Others	132	217	164	234	220	212	236	
2. Revenue from clearances[2]	1,124	1,642	2,066	2,400	2,395	1,749	1,620	1,620
Customs duties	226	476	780	1.030	1.013	736	740	
VAT	543	709	777	844	907	708	620	
Petroleum excises	303	371	406	415	371	305	260	
Income tax	13	18	35	26	27	0	0	
Health fees	20	28	35	36	27	0	0	
Other clearances	19	40	33	49	50	0	0	
Actual disbursement	1,122	1,642	2,067	2,400	2,395	0	556	4,020
Expenditure	**3,420**	**3,899**	**4,084**	**4,893**	**4,946**	**4,714**	**4,980**	**6,394**
1. Total current expenditure	2,647	2,994	3,188	3,902	4,891	4,621	4,937	5,198
Wage bill	1,286	1,622	1,774	2,147	2,537	2,862	3,124	3,123
Non-wage	1.361	1.372	1.414	1.755	2.354	1,759	1,813	2,075
Recurrent Balance	**-588**	**-209**	**112**	**-4**	**-1,062**	**-3,473**	**-3,363**	**-141**
2. Total capital expenditure	773	905	896	991	55	93	43	1,195
Overall Balance	**-1,361**	**-1,114**	**-784**	**-995**	**-1.117**	**-3,566**	**-3,406**	**-1,337**
Total Financing	**1,361**	**1,114**	**784**	**995**	**1,117**	**3,566**	**3,406**	**-1,337**
Foreign	1,197	1,043	907	1,014	221	2,238	2,214	3,735
Direct current expenditure	157	20	2	23	0	0	88	
External budget support	267	118	9	0	221	2,238	2,126	2,675
Direct capital expenditure	773	905	896	991	0	0	0	1,060
Domestic								
Expenditure arrears	0	18	288	42	268	978	558	-2,075
Net borrowing (residual)	164	53	-411	-61	628	350	634	-324

Notes: 1 planned budget; 2 including payments withheld.
Source: adapted from IMF(2003, Table 4.2) and the PA's MoF website (www.mof.gov.ps).

Table 4.1b. The budget of the PA, 1996-2002 (in % of GDP)

	1996	1997	1998	1999	2000	2001	2002
Revenue (actual)	**17.6%**	**20.1%**	**20.4%**	**20.8%**	**21.1%**	**7.2%**	**11.2%**
1. Domestic Revenue	8.0%	8.3%	7.6%	8.0%	7.9%	7.2%	7.2%
Tax revenue	5.7%	5.3%	5.3%	5.5%	5.4%	4.8%	4.5%
Nontax revenue	2.3%	2.9%	2.3%	2.5%	2.5%	2.5%	2.7%
2. Tax clearances							
Accrual	9.6%	11.9%	12.8%	12.8%	13.2%	11.0%	11.5%
Actual	9.6%	11.9%	12.8%	12.8%	13.2%	0.0%	3.9%
Expenditure	**29.2%**	**28.2%**	**25.2%**	**26.2%**	**27.3%**	**29.7%**	**35.3%**
1. Total current expenditure	22.6%	21.6%	19.7%	20.9%	27.0%	29.2%	35.0%
Wage bill	11.0%	11.7%	11.0%	11.5%	14.0%	18.1%	22.2%
Nonwage	11.6%	9.9%	8.7%	9.4%	13.0%	11.1%	12.9%
Recurrent Balance	**-5.0%**	**-1.5%**	**0.7%**	**0.0%**	**-5.9%**	**-21.9%**	**-23.9%**
2. Total capital expenditure	6.6%	6.5%	5.5%	5.3%	0.3%	0.6%	0.3%
Overall Balance	**-11.6%**	**-8.1%**	**-4.8%**	**-5.3%**	**-6.2%**	**-22.5%**	**-24.2%**
Total Financing	11.6%	8.1%	4.8%	5.3%	6.2%	22.5%	24.2%
Foreign	10.2%	7.5%	5.6%	5.4%	1.2%	14.1%	15.7%
Direct current expenditure	1.3%	0.1%	0.0%	0.1%	0.0%	0.0%	0.6%
External budget support	2.3%	0.9%	0.1%	0.0%	1.2%	14.1%	15.1%
Direct Capital Expenditure	6.6%	6.5%	5.5%	5.3%	0.0%	0.0%	0.0%
Domestic							
Expenditure arrears	0.0%	0.1%	1.8%	0.2%	1.5%	6.2%	4.0%
Net borrowing (residual)	1.4%	0.4%	-2.5%	-0.3%	3.5%	2.2%	4.5%
Memorandum Items							
GDP (US$m)	3668	4009	4258	4517	4442	3765	2974
NIS/US$	3.19	3.45	3.8	4.14	4.08	4.21	4.74

Source: See Table 4.1a

Table 4.2 UNRWA's regular budget by programme and field (US$000)

	West Bank		Gaza		Total UNRWA*	
	2002	2003	2002	2003	2002	2003
EDUCATION PROGRAMME	**26,963**	**28,176**	**57,077**	**60,171**	**172,255**	**179,066**
General Education	20,506	21,687	53,467	56,452	150,458	156,952
Elementary Education	13,416	14,100	32,852	34,477	91,934	95,141
Preparatory Education	7,090	7,587	20,615	21,975	56,956	60,017
Secondary Education	0	0	0		1,568	1,794
Vocational & Technical	5,017	5,012	2,122	2,168	13,563	13,715
Teacher Education	636	639	0	0	1,097	1,102
Management	804	838	1,488	1,551	7,137	7,297
HEALTH PROGRAMME	**12,410**	**12,704**	**16,764**	**17,305**	**58,911**	**60,662**
Medical care services	9,394	9,636	11,435	11,924	42,201	43,686
Environmental health	1,738	1,764	3,450	3,468	9,375	9,505
Supplementary feeding	684	698	1,409	1,436	4,320	4,407
Management	594	606	470	477	3,015	3,064
RELIEF & SOCIAL SERVICES	**4,982**	**5,156**	**11,748**	**12,211**	**33,630**	**34,908**
Relief services	4,106	4,277	10,679	11,140	29,423	30,669
Social services	702	702	868	866	2,770	2,781
Management	174	177	201	205	1,437	1,458
OPERATIONAL SERVICES	**6,456**	**6,514**	**8,311**	**8,393**	**61,422**	**65,916**
RISIDUAL	**2,374**	**2,142**	**2,156**	**1,387**	**4,530**	**3,529**
GRAND TOTAL	**53,185**	**54,692**	**90,056**	**99,467**	**330,748**	**344,081**

* Total in all fields of operations, i.e. Jordan, Syria and Lebanon as well as Geneva headquarters. Ref UNRWA'S Web (accessed 3.12.2003)

Table 4.3 The PA's employment and wage bill

	1995	1999	2002
Employment (1000)	57.0	98.5	124.8
Civil Service	32.6	54.1	71.2
Security	24.4	44.4	53.6
Wage bill (mill NIS)	915.9	2,163.5	3,198.0
Civil Service	583.3	1,323.5	1,952.5
Security	332.6	840.0	1.245.5
Wage Bill as % of GDP	8.6%	11.6%	22.6%

IMF (2003)

Table 4.4 Inequality in Palestine:
consumption expenditure per capita by Quintile, 1998

Quintile (fifth)	West Bank		Gaza Strip	
	US $ cent	Per	US $ cent	Per
Top 20%	3,027	39.0	2,227	39.7
Fourth 20%	1,762	22.7	1,245	22.2
Middle 20%	1,324	17.1	937	16.7
Second 20%	1,007	12.9	727	13.0
Lowest 20%	636	8.2	472	8.4
Average	1,551		1,122	

The World Bank (2001).

Table 4.5 Income brackets and tax rates

Pre-reform: 1995-1998		Post-reform: since 1999	
Income bracket (NIS)	**tax rate**	**Income bracket (NIS)**	**Tax rate**
From 1 – 4.200	5%		
From 4,201 – 10,500	10%		
From 10,501 – 16,800	15%	From 1 – 27,000	5%
From 16,801 – 29,400	20%	From 27,501 – 66.000	10%
From 29,401 – 50,400	30%	From 66,001 – 110,000	15%
From 50,401 – 84.000	35%	From 110,001 – and over	20%
From 84,001 – 147.000	40%		
From 147,001 – above	48%		
Corporate tax:		**Corporate tax:**	
Gaza Strip	37.5%	WBGS	20%
West Bank	38.5%		

Ministry of Finance (cited in Erickson von Allmen, 2001)