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Fiscal Impacts of Counter-Terrorism Measures on the Palestinian Authority: A Preliminary Assessment

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MIDDLE EAST

Contents

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EXECUTIVE SUMMARY

Israel and the United States (US) have introduced new counter-terrorism legislation aimed at discouraging the Palestinian Authority (PA) from providing funding to people involved in terrorist activities, or to their families, by withholding funds and foreign aid to the PA. A new Israeli law suspends a portion of the taxes that Israel collects on behalf of the Palestinians and transfers every month to the PA, while moves by the US administration significantly cut funding to the PA and restrict US aid to the Palestinians.

Recent counter-terrorism legislation introduced by Israel and the US could lead to a doubling of the Palestinian Authority's budget deficit to about $800 million a year, and a fall in tax revenues of 13 per cent.

These measures, which were introduced in 2018 and came into force in 2019, will have significant impacts on the fiscal and economic stability of the PA. The PA will have few good options to deal with this situation and will probably have to reduce its public expenditures.

KEY FINDINGS

- **If the US and Israeli measures are fully implemented in 2019, PA net tax revenues may decline by 13 per cent in 2019 from 2018 and the PA budget deficit after external financing may double to about $800 million a year.** Given its already high level of borrowing, the PA is unlikely to be able to finance this deficit through further significant increases in debt to local banks and arrears, and will need to reduce its public expenditures in both the West Bank and the Gaza Strip.

- **If most of these expenditure cuts are applied in Gaza, the PA will probably have to cut more than half of its 2018 financing of the public sector in Gaza.** This would result in a cumulative additional decline in Gaza's gross domestic product (GDP) of 10–15 per cent by 2020 and an increase in unemployment to 60–65 per cent. Public-sector expenditures in the West Bank would also need to be reduced, probably by around 5 per cent in 2019 and 2020. This would cause West Bank GDP to fall by about 2 per cent a year and unemployment to rise to about 20 per cent by 2020.
- **If the PA applies most of the expenditure cuts in the West Bank, the effects on that territory would be worse.** In this scenario, West Bank GDP would decline by a cumulative rate of about 5 per cent for 2019 and 2020, and unemployment would increase to around 22–23 per cent by 2020.
- **In the worst-case scenario, the PA's ability to operate in the longer term would be severely curtailed.** If the PA continues to refuse all monthly transfers of funds from the Israeli government (known as clearance revenues), this would lead to an even more severe and rapid deterioration in both the West Bank and the Gaza Strip. In the West Bank, GDP would fall by 15 per cent by the end of 2019, while unemployment could reach 30 per cent. In Gaza, GDP would drop by 25 per cent, and unemployment could top 75 per cent by the end of September 2019. The PA budget deficit after external financing may reach about $2.6 billion in 2019. In such a scenario, by the third quarter the PA may start to disintegrate, and regular functioning would be impossible. If the PA accepts the remaining clearance revenues again by the end of the second quarter of 2019, most of the negative impact in the West Bank associated with the initial refusal can be reversed in the third quarter.
- **Even Israel's withholding of some $12 million a month, together with the US measures, will have a dire impact.** Although Israel has withheld clearance revenues in the past, this was a short-term measure and the result of a cabinet decision, rather than of legislation. Under the 2018 law, for Israel to release the funds, the minister of defence must present a report stating that the PA has ceased to pay any funds in relation to terrorism. It is

therefore expected that Israel will continue to withhold around $12 million a month in clearance revenues. This will add to the financial difficulties the PA is already facing. If the PA continues to refuse all the clearance revenues from Israel, the PA will cease to function properly almost immediately.

- **The PA can be expected to delay the impact of the crisis, but economic turmoil is inevitable this year.** By cutting public expenditures in both the West Bank and the Gaza Strip and by using donor emergency aid, the PA may be able to postpone the worst effects. Ultimately, however, the Israeli and US measures are bound to lead to an economic crisis by the second half of 2019.

THE MEASURES

In 2018, Israel and the United States (US) introduced new counter-terrorism legislation to withhold funds and foreign aid to the Palestinian Authority (PA), with the aim of discouraging the PA from providing funding to people involved in terrorist activities, or to their families. This section outlines the measures contained in this legislation.

MEASURES BY ISRAEL

In July 2018, the Israeli legislature (Knesset) enacted the "Law for freezing funds paid by the Palestinian Authority in relation to terrorism from funds transferred to it by the Government of Israel, 5778-2018"[1]The law requires the Israeli minister of defence to submit a report at the end of each year, detailing the payments made by the PA in relation to terrorism that year, to the Ministerial Committee for National Security for approval.

The law defines "funds paid by the Palestinian Authority in relation to terrorism" as "money, or monetary equivalent, paid by the PA, directly or indirectly, to each of the following:

1. To a terrorist during the term of his imprisonment or his detention or after his release, or to his family, due to him being a terrorist
2. To a prisoner or detainee, who is not a terrorist, during his imprisonment or his detention or after his release or to his family due to commission or an attempt to commit an offence that could harm the security of the State [of Israel] or the security of the public".

The law states that from the taxes that Israel collects on behalf of the Palestinians and transfers to the PA each month, known as clearance revenues, a sum will be withheld that is equal to one-twelfth of the total funds that the PA paid in relation to terrorism,

1 See Official Gazette Principal Legislation, page 732, https://www.justice.gov.il/SitePages/OpenDocument.aspx?d=btfoGU%2fzRz98U4QZbe1n0IiUCe6eTbiY64L4Rs6Tn10%3d.

pursuant to the report approved by the Ministerial Committee for National Security.[2]

On 10 February 2019, after a Palestinian killed an Israeli teenager in Jerusalem, the Israeli prime minister, who is also the acting minister of defence, announced that he would convene the ministerial committee and pass the required decision to implement the law. On 17 February, the committee decided to withhold about $140 million from the total annual funds Israel will transfer to the PA in 2019.

The prime minister also instructed defence officials to look further into additional payments the PA provides to terrorists and their families[3]Following the decision, on 27 February the Israeli Ministry of Finance withheld about $11.7 million out of the total of $193 million it owed to the PA for February 2019.[4]

Israel has withheld clearance revenues in the past, but that was a short-term measure and the result of a cabinet decision, rather than of legislation. Under the 2018 law, the ministerial committee may decide to transfer all or part of the withheld funds to the PA only if the minister of defence has presented to the committee a report stating that the PA has ceased to pay any funds in relation to terrorism. [5]It is therefore expected that Israel will continue to withhold around $11.7 million a month in clearance revenues.

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2 Ibid., article 4(a).

3 Noa Landau and Jack Khoury, "Israel Freezes Transfer of 500 Million Shekels of Palestinian Authority Taxes", Haaretz, 17 February 2019, https://www.haaretz.com/israel-news/israel-freezes-transfer-of-500-million-shekels-of-palestinian-authority-taxes-1.6941078. Some Israeli sources estimate the amount of "funds paid by the Palestinian Authority in relation to terrorism" to be about $350 million for 2018. This amount could increase to about $390 million if related administrative expenditures are included. See Yossi Kuperwasser, "Continued PA Payments to Terrorists in 2018", Jerusalem Center for Public Affairs, 10 December 2018. See also Yoav Zitun, "Defense Ministry reveals: This is what a terrorist makes", Ynetnews, 1 September 2018, https://www.ynetnews.com/articles/0,7340,L-5068496,00.html

4 "Palestinian Authority refuses tax revenues from Israel", Times of Israel, 27 February 2019, https://www.timesofisrael.com/palestinian-authority-refuses-tax-revenues-from-israel/; Jackie Houri and Amira Hass, "The Palestinians: We have rejected hundreds of millions of shekels from Israel following the first setback of PA funds", Haaretz, 27 February 2019, https://www.haaretz.co.il/news/politics/.premium-1.6978361.

5 See Official Gazette Principal Legislation, article 4(b).

MEASURES BY THE UNITED STATES

Until 2018, the US government was among the largest donors to the PA and the largest donor to the UN Relief and Works Agency for Palestine Refugees in the Near East (UNRWA). Assistance to the PA since 1994 has totalled more than $5 billion. US contributions to UNRWA through global humanitarian accounts since 1950 have totalled more than $6 billion.[6]

However, in 2018 the US administration significantly cut funding to the PA and to UNRWA. This included:

- reprogramming $232 million of economic assistance intended for the West Bank and Gaza for other purposes;
- ending US humanitarian contributions to UNRWA, which in 2018 amounted to $65 million, compared with $359 million in 2017; and
- restricting Palestinians from participating in programmes funded by the United States Agency for International Development (USAID) and the US Embassy in Israel.[7]

Moreover, legislation enacted in 2018 significantly restricted US aid to the Palestinians. In March, Congress enacted the Taylor Force Act. [8]This law suspended US bilateral economic assistance for the PA unless and until Palestinian officials cease certain payments deemed under US law to be "for acts of terrorism". In October, the Anti-Terrorism Clarification Act (ATCA) came into force.[9]It seeks to ensure that the Palestine Liberation Organisation (PLO) and PA

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6 "U.S. Foreign Aid to the Palestinians", Congressional Research Service, updated 12 December 2018, https://fas.org/sgp/crs/mideast/RS22967.pdf.

7 Landau and Khoury, "Israel Freezes Transfer".

8 See article X of division S of "H.R. 1625 - Consolidated Appropriations Act, 2018", US Congress, https://www.congress.gov/bill/115th-congress/house-bill/1625/text?q=%7B%22search%22%3A%5B%22%5C%22Taylor+Force+Act%5C%22%22%5D%7D&r=1&s=3.

9 See "S.2946 - Anti-Terrorism Clarification Act of 2018", US Congress, https://www.congress.gov/bill/115th-congress/senate-bill/2946/text?q=%7B%22search%22%3A%5B%22%5C%22Anti-Terrorism+Clarification+Act%5C%22%22%5D%7D&r=1&s=5

would be subject to the jurisdiction of US courts for past acts of Palestinian terrorism against US citizens.

Because the ATCA uses US aid to Palestinians as a means of establishing this jurisdiction, the PA prime minister informed the US secretary of state that as of 31 January 2019, the PA fully disclaimed and no longer wished to accept any form of assistance that might trigger the ATCA. This led to a complete cessation of US aid to the Palestinians by February 2019, including nonlethal US security assistance for the PA security forces of about $60 million a year.[10]

10 AFP, "US aid to Palestinian security services to end Friday, at Abbas's request", Times of Israel, 30 January 2019, https://www.timesofisrael.com/us-aid-to-palestinian-security-services-to-end-friday-at-pa-request/.

IMPACTS ON THE PALESTINIAN AUTHORITY

According to preliminary calculations, the measures outlined above will have significant impacts on the fiscal and economic stability of the PA. This section details those impacts in terms of the PA's tax revenues, current deficit financing, public debt and arrears, and macroeconomic situation.

TAX REVENUES

Independently of the Israeli and US counter-terrorism measures, total PA net revenues in 2018 declined by 5 per cent compared with 2017, from about $3.6 billion to about $3.4 billion (see figure 1). Taxes and other payments transferred by Israel to the PA—clearance revenues—declined by 8 per cent from about $2.4 billion to about $2.2 billion (see figure 2). However, growth in domestic tax collection helped scale down the fall in total net revenues.[11]

11 Based on analysis of PA Ministry of Finance and Planning monthly reports, which can be found at http://pmof.ps/pmof/en/internal.php?var=11&tab=01.

Figure 1: Total PA Net Revenues, 2014–2018

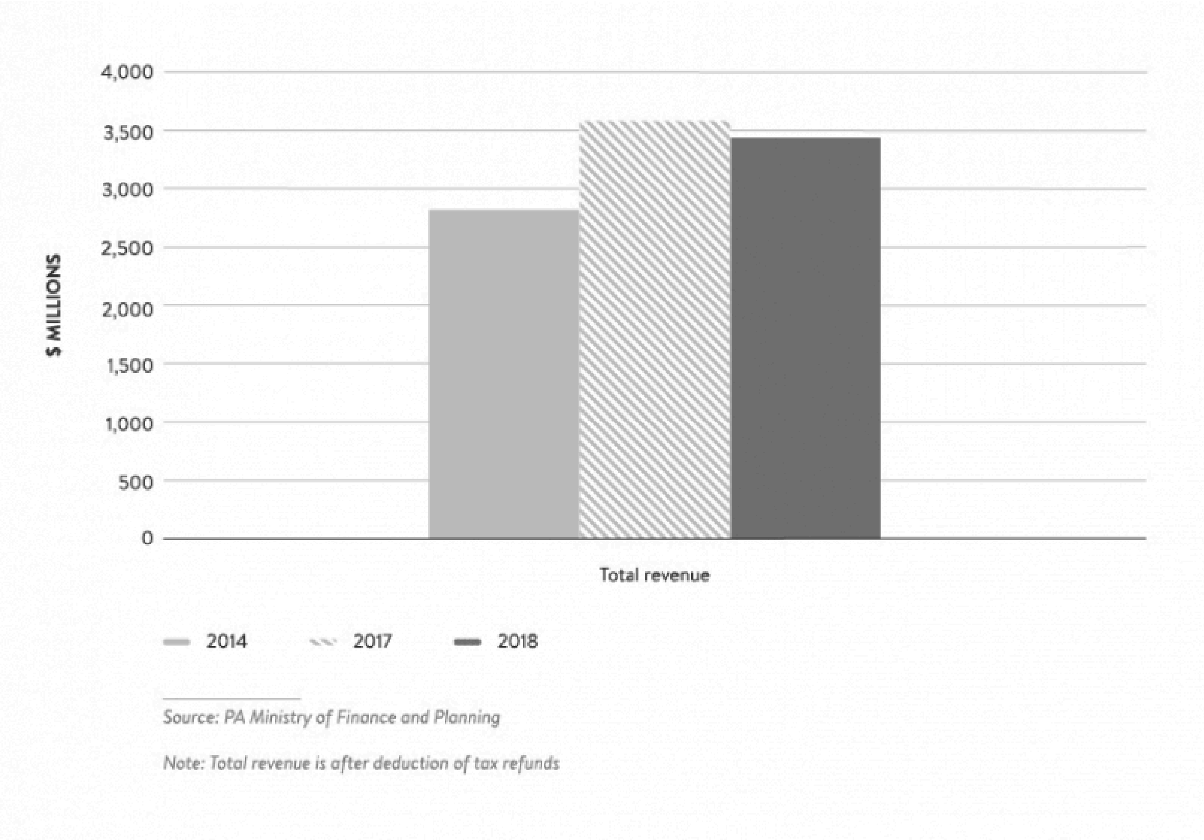
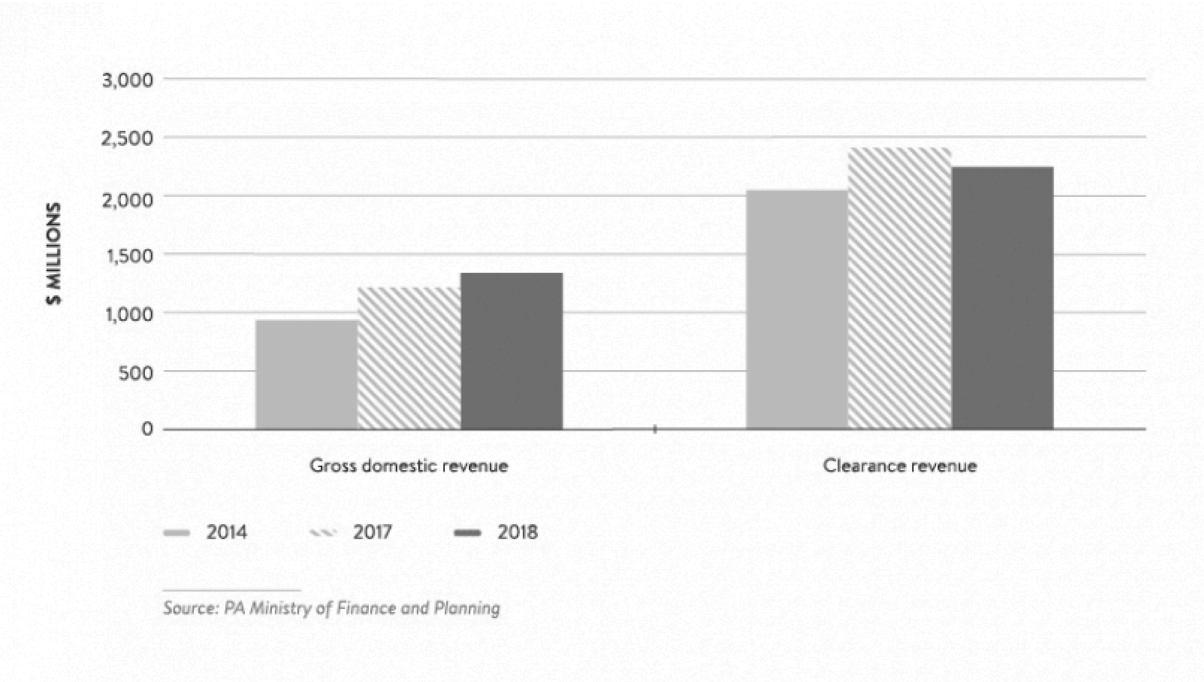


Figure 2: PA Revenues by Main Sources, 2014–2018



Clearance revenues from Israel include:

- value-added tax (VAT) on goods and services bought by PA-registered businesses from Israeli-registered businesses;
- excise on fuel bought from Israel;
- purchase tax on alcohol and cigarettes made in Israel and sold in the PA;
- import taxes collected by Israeli customs on goods imported to the PA;
- income tax and other payments collected from Palestinian workers in Israel and in Israeli settlements in the West Bank; and
- border-crossing fees.[12]

In 2014, clearance revenues from Israel accounted for 73 per cent of total Palestinian revenue. However, since then, the PA has increased the collection of local taxes and fees. Consequently, the share of clearance revenues from Israel dropped to 68 per cent in 2017, then to 65 per cent in 2018. Yet the clearance revenues remain a significant and essential source of income for the PA.[13]

The decline in clearance revenues was a result of two main factors:

- a sharp decline of 15 per cent in revenues from excise on fuel (about $120 million), due to lost excise on fuel imports to Gaza—because of fuel imports through Egypt and the supply of excise-exempted fuel donated by Qatar; and
- a sharp decline of 12 per cent in VAT revenues (about $120 million), due mainly to a decline in imports to Gaza from Israel because of diminishing purchasing power.

The PA clearance revenues are likely to continue to fall in 2019 and 2020 as a result of the worsening situation in Gaza and the economic slowdown in the West Bank. Combined with Israel's decision to withhold about $140 million of the clearance revenues,

12 See annex V of the Interim Agreement on the West Bank and the Gaza Strip, 1995, and chapter E of the Israeli Law for the Implementation of the Agreement Regarding the Gaza Strip and the Jericho Region (Economic Arrangements and Miscellaneous Provisions) (Legislation Amendments), 5755-1994.

13 Landau and Khoury, "Israel Freezes Transfer".

PA net tax revenues are expected to decline by 13 per cent (about $446 million) in 2019 compared with 2018.

However, if the PA stands by its decision to refuse to receive all monthly transfers of the clearance revenues from Israel (an additional $171 million a month on average), this will have three consequences:

1. The PA will suffer an immediate decline equivalent to two-thirds of total net tax revenues in the first two months after the cessation of transfers, from an average of $286 million to just $100 million a month.
2. In the following months, local tax collection will start to decline because of a drop in public spending and consumer consumption. Total tax revenue could decline to an average of $75 million per month in the second and third quarters of 2019.
3. By the end of the third quarter, unless the PA receives emergency funding from donors, it will not be able to function, and tax collection may cease completely.[14]

Although the US measures do not affect PA revenues directly, they significantly constrain the PA's ability to finance its budget deficit, as explained below

FINANCING THE CURRENT DEFICIT

While the revenue side of the PA budget has fallen, the PA has managed to cut its expenditure in recent years, especially in 2018. Total current expenditures declined by 7 per cent, from $4.5 billion in 2017 to $4.1 billion in 2018. This was due mainly to PA cuts in financing the public sector in Gaza. Wage and salary expenditures declined by 16 per cent, from $2.1 billion in 2017 to $1.8 billion in 2018. As a result, the current deficit declined in 2018 to a low of about $700 million, compared with $860 million in 2017 and $1.3 billion in 2014.[15]

However, external budget support halved between 2014 and 2018 from about $1 billion to only $500 million, and external

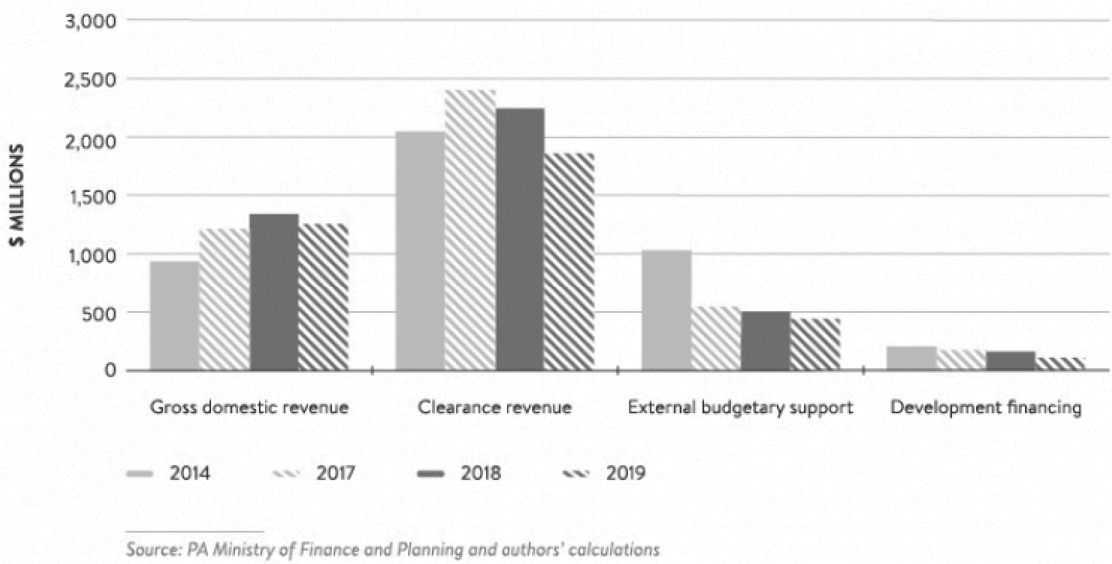
14 "Palestinian Authority", Times of Israel.

15 Ibid.

development financing declined by a quarter from $205 million to $160 million over the same period, making it more difficult for the PA to finance its current deficit.[16] Accordingly, the PA deficit after external financing was around $400 million.

The US measures created an additional deficit in 2019 of about $60 million in the security budget, and further lowered external financing of development expenditures (see figure 3, which is based on the Israeli decision to withhold $140 million of clearance revenues in 2019).

Figure 3: PA Revenue and External Aid Forecast, 2014–2019



Due to the expected sharp decline in clearance revenues in 2019, in addition to the decline in external aid, the PA budget deficit after external financing may almost double in 2019–2020 to a total of about $800 million, unless the PA takes severe measures to reduce its current expenditures and salary expenditures or find alternative external funding.

If the PA continues to refuse all monthly transfers of the clearance revenues from Israel, this will cause the current deficit to increase dramatically. According to our estimates, unless the PA takes drastic action to lower its current expenditures, or finds

16 PA Ministry of Finance and Planning monthly reports, table 1.

alternative outside funding, the PA budget deficit after external financing may reach about $2.6 billion in 2019 in this scenario.

PUBLIC DEBT AND ARREARS

In recent years, the PA has increased its reliance on local banks and on the accumulation of arrears to suppliers for short-term financing of budget deficits. The PA's total domestic short-term debt, mainly to local banks, grew from $200 million in 2014 to $850 million in 2018.[17]The PA's accumulated arrears doubled over 2017 and 2018, reaching close to $830 million in December 2018, up from $420 million in December 2016.[18]

Given already high levels of borrowing, it is expected that the PA will be unable to rely on further significant financing from local banks and arrears in 2019. Should the PA continue to refuse all clearance revenues from Israel, it may decide to cease virtually all public payments in the Gaza Strip, increase lending from private banks by $300 million in 2019 and require large companies in the West Bank to pay advanced tax payments for their expected revenues in 2019.

These three measures may help the PA continue to finance its activities in the West Bank for the first two months. However, the PA will need to reduce public employees' salaries in the West Bank by up to 50 per cent. If the PA continues to refuse the funds, it might have to reduce these payments by 75 per cent in the third quarter of 2019.

THE MACROECONOMIC IMPACT

Based on the above analysis, if the Israeli and US measures are implemented in full in 2019, the PA may face an annual budget deficit after external financing of about $800 million in 2019–2020. Given that the PA cannot raise more funds by borrowing from local banks or through arrears in payments to suppliers, it can cover the gap only through increased donor aid

17 Ibid., table 7a.

18 Ibid., table 3.

and/or a sharp reduction in expenditures in the West Bank and/or Gaza.

Considering the decline in donor aid over the years, the likely course of action is that the PA will need to reduce substantially its public expenditures by up to 20 per cent of total 2018 expenditures. This would require large-scale cuts in salaries and in social transfers.

Reducing PA public expenditures in the West Bank and the Gaza Strip, in addition to receiving emergency aid, may help delay the impact of the Israeli and US measures until the second half of 2019. This would allow parties—the Palestinians, donor states, Israel and others—time to devise a plan to avoid economic collapse and potential deterioration into violence.

Should most expenditure cuts be applied to Gaza, the PA would likely have to cut more than half of its 2018 financing of the public sector in Gaza, itself much reduced from previous years. This would result in:

- a cumulative additional decline in Gaza's 2019–2020 GDP of 10–15 per cent, depending on the availability of additional donor aid to Gaza and application of easing measures by Israel to mitigate the impact of the cuts;
- an increase in unemployment in Gaza to 60–65 per cent, from about 50 per cent;
- a further deterioration in infrastructure and basic services; and
- possible additional cuts in public-sector expenditures in the West Bank, probably by around 5 per cent in 2019 and 2020, causing West Bank GDP to decline by about 2 per cent a year and unemployment to rise by about 0.5–1 percentage points a year, to about 20 per cent in 2020.

If the PA applies most of the expenditure cuts in the West Bank, this would cause West Bank GDP to decline by a cumulative rate of about 5 per cent in 2019 and 2020, and unemployment to increase by about 3–4 percentage points, to around 22–23 per cent in 2020.

Should the PA refuse to receive the monthly transfers of the remaining clearance revenues from Israel, this would lead to an even more severe and rapid deterioration in both the West Bank and the Gaza Strip. In Gaza, unless donors increase their funding and Israel introduces significant easing measures to offset the impact of cutting PA public expenditures in Gaza, GDP will decrease by 25 per cent compared with 2018. Unemployment will initially increase to 65 per cent and reach 75 per cent by the end of the third quarter.

In the West Bank, GDP will fall by around 10 per cent in the second quarter and by an additional 5–10 per cent in the third quarter. By the end of 2019, West Bank GDP would fall by 15 per cent. Unless employment of Palestinian workers increases dramatically in Israel, unemployment in the West Bank will start to increase rapidly by the end of the second quarter, reaching 30 per cent by the end of 2019. If the PA maintains its refusal to receive the remaining clearance revenues from Israel for a short time, until the end of the second quarter of 2019, most of the negative impact in the West Bank associated with the initial refusal can be reversed in the third quarter.

Recent counter-terrorism legislation introduced by Israel and the US could lead to a doubling of the Palestinian Authority's budget deficit to about $800 million a year, and a fall in tax revenues of 13 per cent.

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