

## Financing the Palestinian Authority

A Paper by Geoffrey Aronson Prepared Under a Grant by Canada's  
International Development and Research Center (IDRC)

May 25, 2006

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### Executive Summary

The boycott of the reconstituted PA, lead by the Quartet and Israel, has resulted in a massive reduction in funds made available not only to the PA, but to the Palestinian economy as a whole. This engineered impoverishment of Palestinian governing institutions is reverberating throughtout the economy, threatening "one of the worst depressions in the history of capitalism," in the words of one international official intimately familiar with the issue. Starved of aid funds by donors and tax transfers by Israel, having few remaining financial resources to collateralize, and boycotted by commercial financial institutions fearing the legal implications of doing business with organizations proscribed by US and EU laws, the PA may not be able to mobilize the resources necessary to perform its core functions.

The Hamas victory is yet another indication, along with the intifada, Israel's disengagement from the Gaza Strip, and its incremental noncompliance with the Paris Protocols, that a new, post-Oslo framework governing relations between Israel and Palestinians is being created.

The PA's current financial crisis, and the depression in the Palestinian economy that accompanies it, is a function of struggle over the viability, legitimacy, and purpose of the institutions of Palestinian self-rule in the post-Oslo era.

Before money ever became an issue, Palestinian institutions were plagued by a loss of power and authority. Today, the issue is not only their viability, but rather the question of whether as a consequence of decisions made by donors and Israel they will be rendered illegitimate instruments of Palestinian self-rule.

A Hamas decision that the value of participation in democratic elections and subsequent administration of the institutions of Palestinian self-rule have been undermined by external forces will have implications not simply for the composition of the next PA government, but whether there will be a government at all. The Hamas leadership has made it clear that the organization will not permit the reconstitution of the PA – via elections or through any other vehicle – if it is forced to fail. In such an environment it believes that it will emerge as the only Palestinian organization capable of mobilizing popular support. In this sense, the Hamas leadership, while preferring to work through established institutions it now leads, is fully prepared to profit from its ability to mobilize popular support in their absence.

The government of Israeli Prime Minister Ehud Olmert government must decide if it wants to maintain its unspoken but nonetheless effective partnership with Hamas, a partnership that established the basis for the pacific disengagement from Gaza in September 2005 and the subsequent Hamas victory. While Israel has no interest in legitimizing the PA under Hamas leadership, it need not conspire in the PA's collapse. Were it to do so, Hamas would be compelled to conclude that it has nothing to gain from continuing the related policies of cease-fire and supporting the institutions of the PA. These are the two pillars of a policy needed by Israel to create enough space for the implementation of disengagement on the West Bank – the heart of the current Israeli government's political program. As one Israeli official noted, "At the

end of the day, we would rather deal with a rogue entity near us than with a failed entity.”

The critical point is whether or not Israel and major donors decide to maintain Hamas as a partner in maintaining stability – i.e. in an environment in which the Israel’s ability to implement Israel’s disengagement policy is maximized and Hamas’ rule tested. It is likely, however, that a policy choice of such clear-cut dimensions will not be reached, even in Israel. Just enough resources – labor permits, border openings, fund transfers, aid and development funds – will be offered in the hope of maintaining Hamas’ interest in preserving the PA’s minimal functionality.

## Financing the Palestinian Authority

A Paper by Geoffrey Aronson Prepared Under a Grant by Canada's International Development and Research Center

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The results of the January 2006 elections to the Palestinian Legislative Council (PLC) have sparked a wide ranging reassessment in the international donor community as well as in Israel about the continuing provision of economic assistance to the Palestinian Authority (PA) and the maintenance of agreements and institutions created during the Oslo era. Donor concerns about unsustainable budgetary obligations incurred by the PA have been exacerbated by the January 2006 election results. Entirely new considerations relating to the political and institutional legitimacy of Palestinian representative bodies have appeared at the center of the political and economic agenda as a consequence of the parliamentary victory of the Islamic Resistance Movement (Hamas).<sup>1</sup> The reassessment among donors, aid and international development and humanitarian agencies and Israel is occurring in a highly charged atmosphere not always conducive to effective and well-considered policymaking. The boycott of the reconstituted PA, lead by the Quartet and Israel, has resulted in a massive reduction in funds made available not only to the PA, but to the Palestinian economy as a whole. This engineered impoverishment of Palestinian governing institutions is reverberating throughout the economy, threatening "one of the worst depressions in the history of capitalism," in the words of one international official intimately familiar with the issue.

This paper, prepared on behalf of Canada's International Development and Research Center (IDRC), will review and assess the various options for financing obligations of the PA under consideration by donors and Israel and look at how each is managing the transition, already well underway, from a policy and political framework based upon the political and economic assumptions underpinning the Oslo era to a successor framework whose defining outlines are quickly evolving.

## Introduction

The PA is a hybrid institution, nominally invested with administrative, security, and policymaking powers that are usually the province of sovereign entities. But it is constrained from exercising independent policies by its status as a creature of an occupying power that retains and often exercises its overarching authority across a wide administrative and security spectrum.

This contradiction at the heart of the PA's institutional and political existence was managed, not without difficulty, from its inception in 1994 until the outbreak of the second Palestinian Uprising, or *intifada*, in September 2000. The PA's anomalous situation was accommodated by the international donor community, which believed that the PA's awkward status was merely a temporary way station on the road to sovereignty and a two state solution. During this period, the institutions of limited Palestinian autonomy represented by the PA were defined by their growing dependence upon an unprecedented amount of external funding. This aid, however, was unable to compensate for the loss in national income resulting from Israeli decisions limiting Palestinian economic intercourse with Israel and restrictions on Palestinian movement within and between the occupied West Bank and Gaza Strip. The defining trend was to establish and consolidate Palestinian governing institutions as a mechanism for the distribution of aid and transfers rather than as a vehicle for regulating and promoting national sovereignty and sustainability.

This system, and the all-important Israeli assumptions that defined it, collapsed in September 2000 with the outbreak of the Palestinian rebellion against continuing occupation. Israel, in defining the PA in December 2002 as an "entity that supports terror," signaled its intent to reassess core security and political assumptions that sustained the 1994-2000 era. Israeli policies growing out of this new environment, both in the security and economic spheres, worsened the impoverishment of Palestinians and further reduced the functionality of PA institutions and the financial resources at their command, while cementing their primary role as conduits for international humanitarian assistance and transfers.

It is this limited role that is now in question as a consequence of the legislative victory of Hamas in January 2006. In the eyes of the Western donors and Israel there is an aversion to support institutions now led by forces that their policies during the last decade aimed to

marginalize. Donor nations now cannot avoid the fact that unprecedented aid transfers – some USD 10 billion since 1993 – not merely failed to consolidate the political ends believed to be promised in the Oslo agreements but became part of a framework that has impoverished a generation of Palestinians. Their aid is now locked into a cycle of at best managing a deliberate, ongoing humanitarian crisis, presided over by a rejectionist, Islamist government whose recent election victory symbolizes the failure of past policies. Starved of aid funds by donors and tax transfers by Israel, having few remaining financial resources to collateralize, and boycotted by commercial financial institutions fearing the legal implications of doing business with organizations proscribed by US and EU laws, the PA may not be able to mobilize the resources necessary to perform its core functions. This crisis threatens a cascading implosion not only of PA institutions, the last institutional remnant of the Oslo era, but of the everyday fabric of Palestinian life.

The Hamas victory is yet another indication, along with the intifada, Israel's disengagement from the Gaza Strip, and its incremental noncompliance with the Paris Protocols, that a new, post-Oslo framework governing relations between Israel and Palestinians is being created.

Hamas' win removes the fundamental rationale underlying much of the international support for Palestinian self-government. The PA, and particularly its security agencies, were creations of the Oslo era. The PA was the key to the effort to institutionalize the power of Palestinian movements opposed to Hamas and to reach a final status peace agreement with Israel on the basis of two states. Indeed, the PA's central mandate, at least in the eyes of Israel and many international supporters, was to crush the Islamists, who, unlike the PLO, were not partners with Israel and the international community.

Certainly the victors view Hamas' success at the polls as a mandate to reinvent Palestinian institutions – from parliament to the PLO – to reflect not only Hamas' new status as the democratic choice of Palestinians under Israeli occupation, but also to lead Palestinians in the post-Oslo era. The victory also compels the international donor community to consider the new political and security context of their contributions, financial and otherwise. Some of those in the international community who were prepared to support the long moribund “peace process”

see no reason to support an effort by terrorists, albeit democratically elected, to consolidate power over institutions conceived to do the very opposite. Nor are they yet ready to see beyond the horizons defined by the now defunct Oslo era in order to actively participate with Hamas and Israel in the refashioning of new “rules of the game” that will define the coming era. Yet there remains among most parties a reluctance to acquiesce in the deliberate creation of a humanitarian catastrophe in Palestine in the service of the political aim of dethroning the preeminent and democratically elected Palestinian representative institution. A far more popular and comforting assumption is the belief that a denial of funds to the PA can be managed in such a way as to register opposition to the Hamas victory and compel the new government to affirm support for the pillars of the *passé* Oslo framework, or peaceably give way to those who do, while not fomenting a humanitarian disaster.

#### The PA’s Perilous Economic and Fiscal Environment

Despite positive growth rates during 2003-2005, Palestinian incomes remain considerably lower than their pre-intifada levels, with real GDP per capita in 2005 (USD 1,152) about 31 percent lower than in 1999.<sup>2</sup> Palestinian unemployment in 2005 was almost 25 percent, underlying a poverty rate of 44 percent.

In 2005, imports and exports totaled USD 3.4 billion (USD 2.8 billion imports, USD 600 million exports) equivalent to an extraordinary 83 percent of GDP, highlighting the extent to which the Palestinian economy has been dependent upon reliable access to and transfers from Israel.<sup>3</sup>

During 2005, a daily average of 44,800 Palestinians (excluding those from East Jerusalem) worked in Israel, divided almost equally between those with and without valid work permits.<sup>4</sup> This employment is approximately one third pre- “closure” era rates.

The PA budget for 2005 totaled USD 2.15 billion (USD 180 million/month): USD 1.232 billion in tax revenues comprised of USD 476 million in domestic revenues and USD 757 million in Israeli transfers as per the Paris Protocols; USD 349 million from donors; USD 173 million in PIF profits<sup>5</sup>; an additional transfer from Israel of USD 137 million from previously

withheld revenue; and USD 254 million in commercial borrowing.<sup>6</sup> Expenditures on health and education comprise 70 percent of the non-security budget.<sup>7</sup>

In 2005, foreign support totaled USD 1.3 billion – USD 350 million for direct budget support, USD 500 million humanitarian assistance, and USD 450 million for development programs.<sup>8</sup> Support at a similar level continued during the first quarter of 2006, but was all but terminated with the installation of the new Palestinian government in March 2006.

PA salaries cost USD 1.2 billion (more than 60 percent of the budget), or approximately USD 118 million/month for 172,000 public employees, of whom 70,000 are in various security services, 39,000 in the ministry of education, and 12,000 in the ministry of health.<sup>9</sup> The current government believes 60,000 of the 150,000 (including 77,000 in the security forces ) on the PA payroll are not formally employed. Included in this number are 20,000 belonging to Fateh militias.<sup>10</sup>

In the months before the January 2006 elections, the PA was running a monthly deficit of USD 70 million, leading the IMF to report to the Ad Hoc Liaison Committee in December 2005, that is, *before* the election and the decision by Israel and donors to boycott the PA, that “the PA faces an unfinancable fiscal deficit in 2006.”<sup>11</sup> Any PA government emerging from the January 2006 election would have been confronted with the necessity to cut expenditures, salaries, or fire PA employees.

The World Bank estimates the following maximum revenues available to the PA budget for 2006:

Monthly tax revenues and fees

\*USD25-35 million in domestic revenues,

\*USD 50-55 million in clearance revenues transferred by Israel

\*USD 25 million in donor contributions from Arab, Islamic, and OECD sources

\*USD 15-25 million in PIF investment liquidations.

Total potential revenue: USD 115 million - USD 150 million

Monthly 2005 revenues of USD 180 million have been reduced to USD 130 million during the first quarter of 2006. The World Bank reports that April 2006 revenues may be reduced to USD 50-55 million, less than one half what the World Bank estimates to be the PA’s



monthly “real income” during 2005 – revenues, transfers, and donor contributions – of USD 120 million.<sup>12</sup>

### Responding to the Hamas Victory

In crafting the response to the Hamas victory it is sobering, and perhaps also instructive to note that policies promoted during the last decade by the international community and Israel aiming at Hamas’ isolation produced exactly the opposite result. There is no reason to assume that this serial inability to relate appropriate means to preferred ends has been successfully addressed by policymakers.

### Israel

Israel’s approach to the Hamas victory is conditioned by a number of considerations, some of which are not necessarily shared by all members of the Western donor community. Flexibility, imagination, and a continuing reliance on impoverishing its neighbors as a tool in crushing a Palestinian rebellion against occupation and settlement distinguish Israel from other parties. Israel however, is also more mindful than many donors of the implications for its own security and well-being of the total collapse of Palestinian institutions and the endemic instability that would result. It is this concern that is likely to compel the government of Israel to enable the provision of sustainable economic resources to the PA, and thus the Palestinian economy as a whole, to keep it just on the right side of functionality.

Israel has a less than stellar record in gauging the political pulse of Palestinians under its rule. It was stunned by the victory of Palestinian nationalist forces affiliated with the PLO in municipal West Bank elections in 1976. In an effort to undue the results, it eventually deported most of the winners. Others were maimed in failed assassination attempts by Israeli rightists. Israel created the organized thuggery of some Palestinian groups like the Village Leagues and supported others like the inward looking Islamist forerunner of Hamas in an effort to stem the rising fortunes of secular nationalists of the PLO, whose program was then anathema. The one option Israel never considered was to recognize the connection between continuing occupation

and settlement in the West Bank, East Jerusalem, and the Gaza Strip and the growing power of those Palestinian groups embodying the popular hope for liberation and sovereignty. The PLO under the leadership of Yasser Arafat's Fateh movement, which once claimed leadership of these hopes, has now lost it to Hamas.

Since the inception of occupation in June 1967 Israel has searched for a Palestinian partner prepared to accommodate its security and settlement objectives in the occupied territories. The disengagement from the Gaza Strip inaugurated an entirely new phase in this process – one in which the existence of a Palestinian “partner” – at least in the commonly understood sense – is no longer deemed critical. Both Israel, in its decision to withdraw from Gaza and to plan to implement similar policies in the West Bank, and the Palestinians, by electing Hamas, have chosen paths inconsistent with past practice. Each in its own way is looking forward. A convergence of interests between Israel and militant Palestinian factions led by Hamas produced a successful and pacific Israeli withdrawal from the Gaza Strip and an election season in which Hamas and Israeli prime minister Ehud Olmert's Kadima Party emerged victorious. The Hamas victory confirmed the new direction of Israeli and Palestinian policies even as it signified the de facto if unacknowledged partnership binding them.

The new PA nevertheless poses a dilemma for Israeli policymakers. Its existence is both a repudiation of a decade of policies aimed at crushing Hamas' power as well as a reflection of a new policy direction that implicitly accommodates the creation of a hostile Palestinian government such as the one now in power. Israel's “aim is to delegitimize this government and to signal that we cannot remain indifferent to a terror organization that has come to power.”<sup>13</sup> In operational terms, Israel is removing the PA as the institutional address for numerous day to day aspects of occupation in a manner not dissimilar to the policies implemented after the mayoral victories of members of the PLO's National Guidance Committee after 1976 elections.<sup>14</sup> UNRWA too is being viewed in a new, more positive light as an alternative to the provision of donor aid through existing PA ministries and other Palestinian institutions.<sup>15</sup> But both in broad policy terms and in operational actions Israel may be compelled – by Hamas' power to confound Israel's creation of a new security-settlement paradigm in the West Bank as well as by hard-headed self-interest – to provide the financial resources necessary for the PA to function, if only

barely.

The current focus on conditions established by Israel and the Quartet that Hamas in some fashion must concede in order to be admitted to polite diplomatic company obscures the fundamental character of the relationship now being fashioned between the antagonists. These demands represent far less a standard that Israel expects Hamas to endorse or Hamas views as a necessary way station on the road to liberation or even productive diplomatic engagement, than an engineered obstacle that preserves Israel's freedom of action and a diversion from the far more decisive and substantive relationship now evolving on the ground.

### Funding Palestinian Self-Rule

Israel, not the international community, holds the key to the PA's ability to mobilize the necessary financial resources for its continued operation. Its control over Palestinian trade and labor access to the Israeli market, and its control over VAT and other tax receipts, are both qualitatively and quantitatively different from the international aid transfers that now preoccupy the international community, and far more important to Palestinian fortunes.<sup>16</sup> While the provision of aid is the focus of donor diplomacy and most international attention, a concerted effort by the international community to assure the transfer of Palestinian assets blocked by Israel would provide more immediate and effective relief to the Palestinians' predicament.<sup>17</sup>

Israel's decision to suspend the transfers, along with other actions, has placed it in the position of "gatekeeper" over the general diplomatic agenda, a position it will not easily concede. The creation of this crisis has dominated the international and to a large extent the Palestinian agenda as well, leaving little time or energy to address core issues relating to the conflict and deflecting the new Palestinian government from much of its vaunted and popular internal reform agenda. This environment well suits Israel. The Olmert government would like to maintain control not only over its own decisions regarding the PA, but also over the policies of the international community, where legal and legislative restrictions on aiding terror entities have been allowed to dominate a political and legal environment antagonistic to continuing assistance.

Ironically, Israel's success in mobilizing an international boycott of the new government, preserves the flexibility Israel itself enjoys to modulate its own more nuanced efforts to manage

the PA's economic crisis. This is an advantage Israel is loathe to surrender. Donor governments need be aware that such Israeli considerations may well be reflected in demands for a more draconian and inflexible donor policy than Israel itself feels free to pursue.

While legal and political constraints on donor governments create a favorable environment for maintaining a boycott of the new Palestinian government, they need not be decisive. In the view of one official participating in the policy debate, the views of the Israeli government play an important role in this process.<sup>18</sup> An Israeli decision to support the provision of donor aid to the PA communicated to Washington and donor institutions like the World Bank could instigate the political will necessary to counterbalance these constraints and enable an international funding mechanism to begin work within weeks instead of months. Israel is well aware of its power in this regard, but remains concerned about losing its ability to manage both funding and political initiatives related to the PA.

As is often the case, the internal Israel debate is a critical factor in shaping the larger policy environment. There are two basic competing policy directions – one favoring an unbending policy of hostility toward the PA – now viewed by some as a “terror entity” itself<sup>19</sup> – with little regard for its collapse and the attendant implications; and another view which while equally hostile to the rejectionist nature of the government, feels compelled to acknowledge, at best, an Israeli interest in its continued existence, and at least a reluctance to adopt special measures above and beyond its already draconian policies to promote its demise. The former attitude is prominent in the IDF, which has little regard for PA president Mahmoud Abbas (Abu Mazen) and the security arms connected with him and Fateh, but is concerned to defeat Hamas, whose policies towards Israel are viewed as a threat that can only be confronted with force.<sup>20</sup> A more pragmatic trend agrees that Abu Mazen-Fateh era is over, at least insofar as it is represented in the presidency and security organs, but is concerned about the implications for Israel attending a collapse of PA institutions. It is particularly concerned about the ability of Hamas to complicate and perhaps even undermine the new government's core interest – to implement some sort of disengagement and settlement evacuation from the West Bank. The Olmert government must decide if it wants to maintain its unspoken but nonetheless effective partnership with Hamas, a partnership that established the basis for the pacific disengagement from Gaza in September 2005

and the subsequent Hamas victory. While Israel has no interest in legitimizing the PA under Hamas leadership, it need not conspire in the PA's collapse.<sup>21</sup> Were it to do so, Hamas would be compelled to conclude that it has nothing to gain from continuing the related policies of cease-fire and supporting the institutions of the PA. These are the two pillars of a policy needed by Israel to create enough space for the implementation of disengagement on the West Bank – the heart of the current Israeli government's political program. As one Israeli official noted, "There is a serious and sincere Hamas effort to be in the government and to control the security apparatus. At the end of the day, we would rather deal with a rogue entity near us than with a failed entity."<sup>22</sup> Hamas officials recognize this assessment. "More than America, Israel understands (the cost of Hamas's loss of interest in stability), explained Deputy Prime Minister Nasir Shaer. "It has a more rational policy."<sup>23</sup>

#### Israel and The Transfer Fund

Israel and the PA, under the terms of the Paris Protocol (1994), agreed to establish a customs union administered by Israel including seamless trade and labor exchange through "soft borders." Israel collects a duty on imports destined for the Palestinian market in the West Bank (excluding East Jerusalem) and Gaza Strip as well as a VAT on Israel merchandise and services provided to these areas. In 2005, these revenues totaled USD 740 million, USD 60 million/month, two thirds of total Palestinian revenue, or approximately 50 percent of minimal PA requirements.<sup>24</sup> (Monthly internal tax revenues and fees amounted to USD 34 million. These may be reduced to USD 25 million in 2006.<sup>25</sup>) Denying these transfer funds to the PA has created a new dimension to the structural crisis in PA finances. The effective end to the era of efficient, transparent, and nondiscriminatory trade, particularly between Israel and Gaza, has made the crisis endemic. Making the transfer funds sequestered by Israel available to the PA "is the key to countering" it.<sup>26</sup>

Unlike discretionary donor funds, the receipts currently held by Israel belong to the PA. Israel's role, according to the Paris Protocols, was meant to be purely administrative – as a collection and transfer agent, and its refusal to transfer funds or to condition their transfer on Palestinian performance is a violation of the understandings.<sup>27</sup> All parties recognize this fact.

Even the Palestinian prime minister, Ismail Haniyeh, has called upon Israel to honor its commitment to the Paris Protocols<sup>28</sup>, an ironic demand in view of the government's otherwise ambivalent attitude towards this agreement. Deputy Prime Minister Nasir Shaer has suggested that Israel make direct deductions for Palestinian payments for electricity, fuel, and water – all provided to the PA by Israeli state or private concerns – and use a third party to disburse the remaining balance.<sup>29</sup>

Donor nations are unanimous in their assessment that Israel's sequestering of this account is insupportable, which does not mean that they are prepared to do anything about it. In closed Congressional hearings, some members of Congress even termed the policy of withholding these funds "immoral."<sup>30</sup> Beyond formulaic statements, however, there has yet to be any meaningful engagement by donor nations on this critical issue, or on the moribund November 2005 agreement on access, another of the key obstacles to the PA economy's rehabilitation placed by Israel for both security and policy reasons.<sup>31</sup>

In the absence of an Israeli decision to make these funds available to the PA, the World Bank notes that "no mechanism (for donor assistance) is likely to restore fiscal predictability and stability. . . . It would thus make little sense to establish a [donor transfer] mechanism unless GOI (Government of Israel) is prepared either to resume transfers direct, or to route the clearance revenues through the bypass (funding mechanism)" for donor aid, christened the Temporary International Mechanism (TIM) in early May 2006.

Israel is viewing its options for these funds not only in the context of the short term issue of determining how much of these monies should be returned to the PA but also in the broader context of changing Israeli perceptions of the decreasing attractiveness of the overall economic relationship enshrined in the Paris Protocols.

Concerning the latter, one option Israel is considering is to remove itself entirely from the collection of such monies – by limiting use of its import facilities for use by Palestinian importers, bonding such shipments for direct transport to the PA at the "hard" borders governing entrance from Israel to Gaza and the West Bank where such duties will be collected.

In the more immediate term however, decisions must be taken in the next days, weeks, and months to respond to Palestinian needs. In light of the Quartet's decision to postpone a

decision on provision of aid until July at the earliest, the available funds held by Israel, itself capable of deciding and moving quickly to disperse funds, gain even more importance.

While efficiency, transparency, and regularity are understood to be vital for the creation of a more normal economic life, such attributes are inconsistent with policies Israel has long adopted towards the PA. It is unlikely therefore that Israel will present the PA and the international community with a clear policy decision regarding disbursement of these funds. Far more likely is a stance permitting Israel to act on an *ad hoc* basis, preserving both its freedom of action and its role as “gatekeeper” over donor policy, as well as maintaining the sense of emergency in the PA.

There are indications, however of the uses to which these balances will and will not be put. Unless Israel is compelled by external (the U.S.) or internal pressure (a High Court decision for example), it is unlikely that funds will be made available directly to the PA, as Israel is obligated by agreement to do, for its unrestricted use. It is more likely that Israel will agree, as it has in the past, to use the fund balances to directly pay Israeli concerns supplying the PA with water, electricity, hospitalization, and perhaps fuel as well.<sup>32</sup> In April 2006, payments totaling USD 25 million were indeed transferred for such items.<sup>33</sup> This source could also be used to pay outstanding PA debts to local Palestinian suppliers totaling USD 370 million, or other debts totaling NIS 130 million owed by the Palestinian private sector to Israeli businesses.<sup>34</sup> Israel is also considering using the yet-to-be organized TIM (or a similar mechanism) as a vehicle for the transfer of the sequestered funds, although it is reserving judgement pending the clarification of the TIM’s parameters. “Recognized and agreed upon projects and salaries,” the latter paid directly into individual accounts, would appear to be parameters enabling Israel’s use of this yet-to-be-devised facility.<sup>35</sup> PA officials have noted their support for such an arrangement. It is unlikely, however, that Israel would support such a mechanism if it were to contribute funds directly to ministerial accounts. Israel’s considered use of this new institution may also be reflective of the overall reconsideration of the Paris Protocol mechanism noted above. Its support for UNRWA as a conduit for donor aid is also reflective of the new policy direction.

Israeli Banks Disengage

Dramatic decisions announced by major Israeli banks since the Hamas parliamentary victory reflect both a tactical and strategic realignment of Israeli economic interests in the occupied territories. The World Bank reports that “on April 4, 2006 Bank Hapoalim and Bank Leumi announced that they would “terminate all banking transactions with Palestinian banks as follows: all non-shekel transactions within two weeks and all shekel transactions within three months.”<sup>36</sup> Bank Hapoalim and Bank Leumi’s decisions will further complicate trade and increase the cost of Palestinian/Israeli business transactions. Although too early to predict clearly, third party banks could in time fill this void and enable Palestinian-Israeli traders to make US dollar-denominated transactions (the US dollar is already used widely in West Bank and Gaza).” Without access to letters of credit, the vital supply of Israel food products on a commercial basis to Palestinian concerns would have to depend upon unwieldy and inefficient cash transfers. Israeli trade with Palestinians totaled NIS 9 billion in 2005.<sup>37</sup>

Some view this decision, although opportunistic in the sense that it was prompted by legal concerns throughout the private banking sector of running afoul of US laws regulating business with the new PA, as indicative of the strategic Israeli intention to disengage from intercourse with the Palestinian economy.<sup>38</sup> This development would end Bank Hapoalim’s role as intermediary to clear checks to and from all Palestinian government and private sector accounts, disadvantage all IS transactions, and speed the effective end of the use of the Israeli Shekel as the territories’ effective reserve currency, a key element of the Paris Protocols.

#### The Donors

The capacity of the donors – the US, EU, and Arab/Islamic world – to compensate for the engineered crisis in the Palestinian economy pales in contrast to the financial and related tools at Israel’s disposal. Assuming a transfer mechanism is established and that agreement is reached among donors, Israel, and the PA for its use, the funds made available could not, in and of themselves, maintain the viability of PA institutions or prevent unprecedented Palestinian economic contraction. In 2005, aid from all sources comprised 16.9 percent of the PA’s budget, half as much as customs revenue.<sup>39</sup> EU officials estimate, for example, that EC contributions will total no more than EU 86 million in the May-December 2006 period, barring an



extraordinary appropriation .<sup>40</sup> During 2005 EU aid of all types and sources – budget support, development, and humanitarian assistance by EU and member states – totaled EU 500 million.<sup>41</sup> US officials have noted an intention to increase humanitarian aid over last year's levels while stopping development assistance. The level of US and EU support for Abu Mazen's security forces and other security arms remains unclear.<sup>42</sup> The Arab League reaffirmed in April 2006 its monthly subsidy of USD 55 million (USD 660 million annually), a pledge it has habitually failed to honor. Russia has broken with the Quartet consensus, meeting with Hamas officials and promising USD 10 million aid to the PA.<sup>43</sup> Hamas leader Khalad Mishaal noted on Al-Jazeera on April 21, 2006 that "Iran has committed up to USD 50 million, Saudi Arabia USD 92.5 million, and Qatar USD 50 million." In these latter cases, banking restrictions have made the transfer of available funds problematic.<sup>44</sup> Arab states contributions totaling USD 70 million are currently blocked at the Arab Bank in Cairo, which is refusing to transfer funds to the PA's Single Treasury Account. Russia has been successful in placing its contribution in a new Arab Bank account under Abu Mazen's authority, with the added stipulation by the Arab Bank that the funds would not be used for PA salaries.<sup>45</sup>

### The Quartet's Conditions

The policy environment surrounding US and EU decisions is defined by the three conditions noted in the Quartet statement of January 26, 2006 – "A two-state solution to the conflict requires all participants in the democratic process to renounce violence and terror, accept Israel's right to exist, and disarm, as outlined in the Roadmap"<sup>46</sup> – as well as legal constraints imposed by legislative prohibitions in the US and elsewhere on funding so-called terror entities.<sup>47</sup>

These conditions governing the Quartet's relations with the PA reflect both the sense of power members feel to dictate the agenda with the Palestinians and confidence in their ability to accommodate the failure of the PA to respond as demanded. A British official, for example, has acknowledged that "a possible consequence (of stalemate on the Quartet demands) is collapse not only of the Hamas-led PA government but the PA as a whole."<sup>48</sup> In addition to registering a principled refusal to engage democratically elected Palestinian representatives unless its

conditions are met, the Quartet's conditions are noteworthy for three reasons:

1. They are inartfully and imprecisely conceived and phrased
2. There is no quid pro quo stated for satisfaction of the demands.
3. There is no mechanism for engagement to make them operational.<sup>49</sup>

There may be merit and advantage in the PA (or Hamas or the PLC) subscribing to these commitments in a manner acceptable to the Quartet. It is far less certain, however, that the formula and framework set forth by the Quartet represent a sincere effort to accomplish this objective.<sup>50</sup> It is not the purpose of this paper to analyze the Quartet's conditions and the PA's or Hamas' reaction.<sup>51</sup> It is sufficient to note two points. First, this framework reflects the degree to which donor objectives have evolved since the inception of the Madrid process after the first Gulf war. The initial focus on developing Palestinian institutions and the economy in anticipation of statehood has given way to establishing unclear standards for political engagement that are all but meant to fail and conditioning humanitarian assistance on a mechanism that attempts to circumvent Palestinian representative governing institutions the donors have spend billions and more than one decade nurturing. Second, insofar as the PA – the presumed address of the Quartet conditions<sup>52</sup> – has not satisfied the terms put forward for donor engagement with it, an assessment most recently noted in the Quartet's statement of May 9, 2006, current donor efforts to craft a mechanism for the provision of aid (TIM) represent an incremental failure of Quartet policy.<sup>53</sup>

Supporters and opponents of the Quartet's conditions alike have been compelled to consider measures to reduce the costs, primarily in humanitarian terms, of a PA starved for resources in part as a consequence of the donor boycott.<sup>54</sup> As Special Envoy James Wolfensohn noted on May 1, 2006, "it would surprise me if one could win by getting all the kids out of school or starving the Palestinians. And I don't think that anyone in the Quartet believes that to be the policy, although sometimes it is made to appear that that's what it is."<sup>55</sup>

To the extent these resources are provided without reference to the PA and in the expectation that such aid will not accrue to the political benefit of Hamas– itself a dubious

proposition operationally no matter what the mechanism, and questionable politically as well—donor aid nonetheless enhances the ability of the current government to survive, maintain Hamas’ evident interest that it do so, and permit the PA to allocate scarce resources elsewhere. Donors currently searching for a donor mechanism which bypasses the PA and from which Hamas will not be able to profit from politically might as well be looking for the Holy Grail. The formula they are now constructing to parse distinctions between humanitarian aid, development assistance, and budget support, or to distinguish between “allowances” and “salaries” to employees will go further towards assuaging their refusal to engage the new government unless it conforms to their agenda than it will in achieving the political marginalization of Hamas they are seeking.

#### The Bush Administration

The views of the administration of President George W. Bush are widely acknowledged to be critical in the formulation of the Quartet’s policies and in the activities of multi-lateral institutions like the World Bank. The policy debate in Washington sparked by the parliamentary victory of Hamas ended before it even began. The decision – U.S. support for what is effectively a “soft coup” against the democratically elected government of Palestine.

U.S. policymakers believe that within a matter of months, financial pressures orchestrated by the U.S. and Israel, together with the former’s support for the expansion of the security, economic, and administrative powers of PA chairman Mahmoud Abbas will result in controlled economic and social disintegration calibrated to generate public demands that will force the Hamas-lead government to fail while maintaining the integrity of Palestinian institutions and society. In its place, through elections or some other means, a new Fateh-led legislature will be seated, capable of marginalizing the whatever residual power and popularity Hamas retains.<sup>56</sup>

"We've advised our mission in Jerusalem, as well as other missions around the world that . . . there should be no contact between U.S. government officials and PA officials who are under the authority of the prime minister or any other minister in the Hamas-led government. This includes working-level officials in those ministries," deputy State Department spokesman Adam Ereli told reporters on April 1, 2006. “If they're working in a Hamas-led ministry, no matter what

their affiliation is, we're not going to have contact with them. We will work with individuals and organizations who are not affiliated with Hamas. There are a lot of people we can speak to now.”

There is logic to U.S. refusal to engage the new Palestinian government, rethink assumptions underlying the Oslo era, and refashion U.S. policy towards Palestinian self-rule. The Hamas victory removes the fundamental rationale underlying US support for Palestinian self-government. Not only was the U.S. investment in the Palestinian institutions created by the Oslo process predicated on their ability to defeat Hamas, its victory, albeit in a democratic election certified by U.S. agencies, cannot be easily accommodated by a legal and political environment hostile to empowering Islamic forces generally, particularly those defined, like Hamas, as terror entities.

The inflexibility that characterizes U.S. policy towards the Hamas victory, however, cannot be attributed solely to matters of principle. These criteria have not been permitted by policymakers to define policy towards governments in Iraq led by Islamists allied with Iran and that maintain private militias, refuse to disarm, are no less tainted than Hamas by terror and ideological hostility towards Israel.<sup>57</sup> This U.S. attitude is distinguished not only from other donors, but also from Israel, which, notwithstanding its public campaign against the PA, is recognized to be pursuing a far more nuanced, sophisticated, and less ideological effort. The origins of U.S. policy lie in an assessment that Washington wields the power necessary to impose its preferences upon Palestinians, and failing that, can easily accommodate its failure to do so.

The policy adopted by the Bush administration will not work, both because its main assumptions are flawed and also because the standard of success it has defined – the demise of Hamas as a leading force in the PA and its replacement by Fateh – is unachievable. Even top Fateh activists consider it to be a fantasy.

It should not be the least of Washington’s concerns that “it is doubtful that Abu Mazen and Fateh elements can bring about a regime change by legal means.”<sup>58</sup> The deliberate impoverishment of Palestinians at the heart of this policy is also at odds with Washington’s once-central belief that the economic rehabilitation of the occupied territories where Palestinian GDP is today 30 per cent less than it was on the eve of the intifada in September 2000, is vital to peace and stability. The immediate cost of the PA’s ouster will be the end of Hamas’ interest in

supporting the “tadiya” and the associated interest in contesting control of PA representative and administrative institutions, decisions which will make impossible the reconstitution of the PA under any leadership, let alone one acceptable to the U.S.. Indeed the policy favored in Washington, whether it succeeds or fails, is more likely to strengthen Palestinian Islamists of all stripes and continue the political emasculation of secular Palestinian nationalists. In other words, the exact opposite of what is intended. This dynamic is sadly consistent with past U.S. policies in this arena.

The turn to Fateh as the default option is at odds with the conclusions so famously reached by Secretary of State Condoleeza Rice, who declared not long ago that the U.S. policy supporting the generation of autocratic secular nationalists – Saddam Hussein and Yasser Arafat among them – and the movements they lead for the last 60 years has failed.

In a speech at the American University of Cairo, the secretary remarked, “For 60 years, my country, the United States, pursued stability at the expense of democracy in this region here in the Middle East -- and we achieved neither. Now, we are taking a different course. We are supporting the democratic aspirations of all people.”

This strategic reassessment, reaffirmed during an April 2006 visit to Blackburn, England<sup>59</sup> was preceded by a “reform” policy initiative towards the PA aiming at “empowering the prime minister” and “unifying the security services” under an interior ministry reporting to the prime minister. Each of these elements of US policy since September 2000 has now been turned on its head.

Notwithstanding Rice’s disappointment with Arab secular nationalists, Washington continues to invest its hopes in the widely discredited Fateh Party and more particularly Abu Mazen, a remarkably short-term strategy in the event he maintains his decision not to contest the presidency when his term ends in 2009. To the extent that Fateh is seen as America’s choice, particularly in an environment when US policy is explicitly hostile to the choices Palestinians themselves have made, Fateh’s rehabilitation in the public’s eye and also in terms of much-needed internal reform becomes even less likely.

U.S. policy in the aftermath of Hamas’s victory in the PLC has been to select the PA presidency it once reviled and undermined as the vehicle for assuring the failure of Hamas.

Ironically, this was the assumption originally underlying U.S. support for Yasser Arafat at Oslo's inception. Since the Hamas victory Washington has supported efforts of the president's office to retain, assume, and enhance its powers in both the security financial realms at the expense of the PA's legislative authority as represented by the PLC, the prime minister, and his cabinet. Both Egypt and Jordan support the U.S. policy of maintaining Abu Mazen as a power, notwithstanding more keenly felt reservations about the utility of boycotting Hamas. The central constant in US policy since September 2000 is support for the person of Mahmoud Abbas, whether as prime minister or president, rather than the institutions of Palestinian political life. In the security realm, U.S. security coordinator General Keith Dayton, whose original mandate has been compromised by the election results, suggested at donors meeting at Canada House in London in early May 2006 to bring the Rafah border crossing up to international standards under the control of a newly established Border Agency subject to presidential control, to develop the presidential guard, and to transform the president's security forces into a national security force. Sufficient funds to realize these preferences do not appear to be available.

#### Finance

In the U.S. view, the Palestinian Authority, starved of cash by Western donors, will either be compelled to accommodate to the Quartet's conditions and thus render itself an acceptable interlocutor, or Palestinians will desert an unreconstructed Hamas for secular elements in Fateh more deserving of Washington's approval. To further this policy in the financial and economic realms, Washington demanded that the PA return to the U.S. USD 50 million granted for reconstruction projects, and stopped new and most existing aid and development programs amounting to more than USD 400 million, except those associated with the president's office, and championed the criminalization of financial intercourse with the prime minister's office, the PLC, and individual members of parliament associated with Hamas.<sup>60</sup> This boycott represents the moderating of an effort, lead by the U.S. Treasury Department in inter-agency discussions, to criminalize dealings with the PA in its entirety, including the president's office and the PLO.<sup>61</sup> According to one U.S. official involved in the debate, maintaining an aid pipeline to Abu Mazen's office "was seen as a way of saving the situation."<sup>62</sup> Treasury however, retains control

of the all-important licensing requirement for transacting business or assisting those Palestinian agencies identified by Office of Foreign Assets Control (OFAC). The standard for PA is said to be even more stringent than those applied to state sponsors of terrorism – Iran and Syria – where license exemptions are more flexible.<sup>63</sup>

This policy has had the unintended but not unwelcome (at least in the U.S.) effect of spooking the international banking sector, which fears the criminalization of its dealings with institutions or person targeted by US anti-terror law. The Arab Bank, for example, which manages the PA's "Single Treasury Account," refuses to transfer funds from any external source to the account or to disburse funds to all payees, including PA employees.<sup>64</sup> The result has been to add another layer of complexity and uncertainty to the PA's ability to mobilize, transfer, access, and distribute both its own and donated financial resources.

The U.S. remains the most adamant in its hostility towards the new PA, restrictive in defining the limits of humanitarian assistance to which Palestinians might be eligible if circumstances warrant, and insistent that the PA salaries not be paid. Together with Israel, the Bush administration has distinguished itself in its skepticism of the dire economic analysis provided principally by the World Bank, which has otherwise focused international attention on the perilous effects of the money crunch engineered by the PA's past profligacy and galvanized by the post-election boycott. These doubts were conveyed by top US officials at the Canada House conference in London in early May 2006 and during the Washington visit of Prime Minister Ehud Olmert later in the month. At the Quartet meeting in New York on May 9, 2006, Washington offered grudging acceptance of an EU-led effort to plan the establishment of a Temporary International Mechanism (TIM), although it opposed directing U.S. assistance through such a mechanism. Former Quartet envoy James Wolfensohn has noted in Congressional testimony that four to eight weeks would be necessary in order to establish a "delivery mechanism ... not utilizing the Hamas leadership which meets the humanitarian needs of the Palestinians."<sup>65</sup> In the U.S. view, the provision of aid through such a mechanism, if it is approved, could not be used for salaries for PA officials, to fund agencies affiliated with the PLC or PA, or for large development projects like sewage treatment facilities. The U.S. list of permissible uses of funds includes: in-kind support for health and education; food security;

private sector initiatives; democracy building; support for Fateh and Abu Mazen, the security arms under his authority, and quasi-independent agencies such as the Palestinian Election Commission and the Palestine Investment Fund; avian flu; and infrastructure such as water projects.

The preferred delivery vehicles for U.S. humanitarian assistance are international aid NGOs and other organizations with an already extensive presence in the West Bank and Gaza Strip, principally UNRWA, which is to receive USD 51 million from Washington this year for its emergency appeal, more than double the USD 20 million allocated in 2005,<sup>66</sup> notwithstanding the fact that the UN organization is not curbing its contacts with PA officials<sup>67</sup>; the World Food Program; UNDP; and UNICEF. Washington is reportedly coordinating its list of acceptable delivery institutions with Israel.<sup>68</sup> A DFID paper presented at the Canada House meeting proposed a stand alone fund licensed by OFAC to pay monthly health ministry costs (including salaries for 12,000 employees) of USD 14 million.<sup>69</sup> It was suggested that this mechanism could also be used to transfer Israeli-held funds.

An EC paper on the structure of the TIM presented in Brussels on May 24, 2006 was conditioned upon the parameters presented at Canada House. Salaries would not be paid from the fund, but rather pensions, other transfers, and “allowances to PA employees working in selected sectors.” The commercial banks’ liability concerns need to be addressed. And the PA President’s office would be the interlocutor and executor of the fund.

The TIM Window I fund would “provide essential supplies in health and education and payment of fuel and other energy bills.”<sup>70</sup> employing the existing World Bank-administered Emergency Services Support Program (ESSP) to support the non-wage costs (i.e. no salaries) incurred by the PA ministries of Health and Education -- estimated at USD 6.3 million month. The TIM’s anticipated annual expenditures of USD 75 million comprise less than two months worth of transfer payments to the PA now halted by Israel. The ESSP, currently located in the Ministry of Finance, was identified as a potential mechanism for payment of non-salary expenditures in the areas of health, social services, and education, while the EC’s existing Interim Emergency Relief Contribution would be expanded to pay for fuel (TIM Window II). The most problematic issue for the donors is payment of PA employee salaries. Only salaries in



ministries of health and education – at a monthly cost of USD 31.4 million – were discussed.

Implementation of such a scheme requires the endorsement by the Quartet and the approval of relevant Palestinian bodies, including the President’s Office, which has an explicit role in the mechanism’s execution, the commercial banks, relevant international institutions like the World Bank, and, last but not least, the PLC, which, in line with the Quartet’s boycott, is formally if not operationally excluded from the structure.

#### Non-US Donors

USD 142 million (EU 120 million) was released by the EU on February 27, 2006 during the post-election “transition.” EU 64 million was sent to UNRWA, USD 43 (EU 40 million) million went to pay debts owed to Israeli energy and utility companies, and the remaining USD 20.7 million (EU 17.5 million) was used for PA salaries paid through the World Bank Reform Trust Fund. Also in February, Saudi Arabia was to provide the PA with USD 20 million, while Norway and Russia were to each give USD 10 million by the end of March.<sup>71</sup> Kuwait has offered USD 40 million; the UAE USD 20 million, Iran USD 50 million, Qatar USD 50 million, Saudi Arabia USD 92.5 million.<sup>72</sup> Japan has offered USD 106 million in humanitarian aid to be distributed through UNRWA and the World Food Program.<sup>73</sup> Canada, like the U.S., has suspended all financial assistance.

The EU has distinguished itself as the principal source of donor assistance to the PA, at an average of EU 500 million (USD 615 million) annually. Generally speaking, it supports the broad policies set out by the Quartet under U.S. leadership, while lacking its conviction. This view is in contrast to Norway and Russia, for example, and of course the Arab and Islamic nations, which have not criminalized relations with Hamas.<sup>74</sup> On April 6, 2006, the EC announced a halt to aid transfers to the PA, including direct budgetary assistance and salary support through the World Bank. There nevertheless appears to be a more articulate concern in the EU than is heard in Washington about the humanitarian effects of the financial boycott. This concern attempts to distinguish between humanitarian assistance and development, infrastructure, and budget support. Although not as inflexible and restrictive as U.S. policy, operationalizing these distinctions adds yet another degree of complexity and arbitrariness to the

situation. An operational policy based on these concepts cannot but be subjective in its choice of “acceptable” candidates for funding – supporting purchase of medicines but not syringes for example – further balkanizing the PA’s capability to act in a coherent manner.

French foreign minister Philippe Douste-Blazy told French radio that while the European Union had cut funding to the Hamas-led Palestinian Authority it had no plans to end relief aid. "It is absolutely out of the question ... to cut off humanitarian aid to the Palestinian Territories," he told RMC radio. "That would be a major political mistake. If we don't help the Palestinian Territories, others like Iran will do so. And, on the other hand, we risk pushing the Palestinian people towards radicalism and that's not what we want and that's why we should continue to help them."<sup>75</sup>

“We view the U.S. willingness to promote pain among Palestinians as counterproductive,” noted another European diplomat. There are doubts about the core US view that a humanitarian crisis will increase pressure upon Hamas to accede to the Quartet’s conditions, along with the belief that PA ministries can be bypassed in the provision of critical services. Abu Mazen’s ability to recreate the president’s office as an alternative to the PA is viewed skeptically, as is the prospect for a continuing diplomatic boycott of the PA. “I anticipate that some form of engagement will begin between Hamas and other parties,” the diplomat observed. On the day the EC announced a suspension of budget support and development aid to the PA, EU envoy Marc Otte suggested that working relations with PA officials are appropriate in the context of the provision of humanitarian assistance, if not in the context of a political dialogue, which, like the US, he excluded.<sup>76</sup> As British foreign secretary Straw intimated before his removal, however, there is an as yet unrealized readiness to engage with the PA in an effort to establish an agreed upon framework for resolving the Quartet’s demands.

EU or member states are unlikely to adopt policies regulating assistance to the Palestinians that directly confront or contradict US preferences, which to a large degree they share, even if not with the same degree of enthusiasm. Rather, they are more likely to show greater empathy with both Palestinian humanitarian suffering and the need to engage the new PA leadership by broadening the range of acceptable destinations for aid.

“We leave the door open to positive change but at the same time we also have to make

clear we cannot go soft on our principles,” explained EU external relations commissioner Benita Ferrero-Waldner.<sup>77</sup>

## The World Bank

The World Bank emerged as a principal player in mobilizing and coordinating donor support throughout the last decade. From 2004 until March 15, 2006 the World Bank transferred USD 293 million in donor funds for direct PA budget support, conditioned by financial performance standards. It is unlikely that the institution would support policies aiming unambiguously at undermining Palestinian representative and administrative institutions that have been the Bank’s principal Palestinian interlocutors.

“The World Bank is not inclined to bypass the PA just to provide humanitarian assistance, even if we had the money,” noted a close observer of Bank policy. “There is no discussion in the World Bank of creating (alternative) avenues for funding because in the Bank’s experience, there is a correlation between weak institutions and conflict. Undermining Palestinian institutions will not take us down the road to the Roadmap for peace.”<sup>78</sup>

Concerns about interaction with terror entities as defined by both US and EU law have impeded the Bank’s interaction with the PA. These concerns are now being resolved. Recent exemptions provided by OFAC have enabled the Bank to resume disbursements from its existing project portfolio. These disbursements do not include the budget support fund which is constrained from providing aid because of the PA’s failure to fulfill longstanding budget-related conditions, and the Quartet boycott.<sup>79</sup> While current projects are being implemented as per agreement there are no new projects on the horizon, with the possible exception of a USD 13 million project on containing avian flu.

The World Bank maintains transfer mechanisms (like the ESSP) that could be adapted to meet the donors’ political and financial requirements. Like others that became engaged at the inception of the Madrid process over a decade ago, the World Bank has seen its mission transformed by the changing political and security environment. “For a long time, the international donor community has not been engaged in promoting economic development and post-conflict reconstruction,” noted a close observer, “but in accommodating to the consequences

of political and security decisions. Now not only are we not putting out fires, we're watching others light them.”<sup>80</sup>

## Conclusion

The PA's current financial crisis, and the depression in the Palestinian economy that accompanies it, is a function of struggle over the viability, legitimacy, and purpose of the institutions of Palestinian self-rule in the post-Oslo era. Hamas has an agenda premised in part on the rehabilitation of all Palestinian institutions whose purpose and functionality have been compromised by the failure of Oslo process. Its program includes greater job creation in the private sector, public sector reform, rehousing refugees, promotion of trade and commerce with Jordan and Egypt while recognizing the centrality of Israel to Palestinian economy.

These elements are not dissimilar from those championed by the international community, and in some respects (refugee rehabilitation) they represent a conceptual advance over previous policies. However they are part and parcel of a world view and a liberation strategy which neither the donors nor Israel sees any value in accepting, let alone facilitating. For many years, through active and passive measures, and not without a measure of Palestinian complicity, they have promoted the enfeeblement of Palestinian institutions. Before money ever became an issue, Palestinian institutions were plagued by a loss of power and authority. Today, the issue is not only their viability, but rather the question of whether as a consequence of decisions made by donors and Israel they will be rendered illegitimate instruments of Palestinian self-rule.

Hamas by virtue of its decision to contest elections in the aftermath of an Israeli decision to evacuate the Gaza Strip, was almost alone among Palestinians in seeing the end of the Oslo era as an opportunity to institutionalize its power on the ruins of the foundation established during the previous decade. As long as the institutions it now leads are capable of being reinvented, that is, as long as have the financial wherewithal to exist, the new Palestinian leadership will see in them useful instruments for its own strategy and as a vehicle for cementing its popularity. Donors would be willfully deceiving themselves if they premise their donations on an assumption that this is not the case. But unlike the leadership of Fateh, Hamas does not yet view these institutions of Palestinian self-rule as vital for its own existence or its public support. It is

not wedded to their continued existence, particularly in an environment where Israel, the international community, and even some Palestinians are seen as conspiring in their demise.

A Hamas decision that the value of participation in democratic elections and subsequent administration of the institutions of Palestinian self-rule have been undermined by external forces will have implications not simply for the composition of the next PA government, but whether there will be a government at all. The Hamas leadership has made it clear that the organization will not permit the reconstitution of the PA – via elections or through any other vehicle – if it is forced to fail. In such an environment it believes that it will emerge as the only Palestinian organization capable of mobilizing popular support. In this sense, the Hamas leadership, while preferring to work through established institutions it now leads, is fully prepared to profit from its ability to mobilize popular support in their absence.<sup>81</sup>

The process supported by Israel and the major donors “can be a tool for this government,” acknowledges PA Deputy PM Shaer. “People will start to become hungry. Then they become angry. Against whom? The government or someone else? If you make the government lose interest in maintaining stability, then you will lose too. More than the Americans, Israel understands this.”<sup>82</sup>

Walking such a tightrope is for acrobats, not policymakers. A decision or a miscalculation by either of the principal antagonists could spark the dissolution of Palestinian self-rule, either by design or as a consequence of a cascading implosion of institutions.

The critical point, as Shaer noted, is whether or not Israel and major donors decide to maintain Hamas as a partner in maintaining stability – i.e. in an environment in which the Israel’s ability to implement Israel’s disengagement policy is maximized and Hamas’ rule tested.

It is likely, however, that a policy choice of such clear-cut dimensions will not be reached, even in Israel. Just enough resources – labor permits, border openings, fund transfers, aid and development funds – will be offered in the hope of maintaining Hamas’ interest in preserving the PA’s minimal functionality.

The EU and Israel are each engaged in such a process. Policymakers in the Bush administration find themselves compelled to increase allocations for humanitarian assistance and to watch, ever so carefully, as the EU considers making the hard choices they believe their

principles entitle them to ignore.

## Endnotes

1. Officials in the new government have surrendered their membership in the Hamas organization.
2. “West Bank and Gaza – Economic Update and Potential Outlook” (WBG), World Bank, March 15, 2006, p.1; “The Impending Palestinian Fiscal Crisis, Potential Remedies” (IFC), World Bank, May 7, 2006, p.7.
3. WBG, p.2.
4. WBG, p.2.
5. The Palestine Investment Fund is valued at approximately USD1.5 billion. A large proportion of this amount (perhaps 60 per cent) however, is mortgaged or sold. Interview with World Bank official.
6. IFC, p.3.
7. Interview with World Bank official.
8. WBG, p.3.
9. “Assessment of the future humanitarian risks in the occupied Palestinian territory,” United Nations, April 11, 2006, p.4.
10. *Ha’aretz*, March 27, 2006.
11. “Macroeconomic Developments and Outlook in the West Bank and Gaza,” IMF, December 14, 2005.
12. IFC, p.3.
13. Israeli foreign ministry official.
14. For example, Israel will now co-ordinate the travel of Palestinians in need of Israeli medical attention directly with Palestinian hospitals rather than the PA.
15. “Israel Asks UNRWA to Expand its Humanitarian Program,” Reuters, April 1, 2006.
16. IFC, pp.8,9; WBG, p.1.
17. “We took into account the fact that during the election campaign it was hard for the [Israeli] government to transfer the tax money to the Palestinians, says [EU special representative Marc] Otte, but according to the [Oslo II] agreement this money belongs to them, and we made it clear

to the Israeli government that they cannot keep the money, *Ha'aretz*, April 25, 2006.

18. Interview with author.

19. See comments by then Minister of Defense Shaul Mofaz, *Ha'aretz*, March 20, 2006.

20. See, for example, "Senior security Officials: Beware of Hamas' 'Honey Trap', Itamar Eichner, *Yediot Aharonot*, February 2, 2006, p.2; "Buying Time," Ze'ev Schiff, *Ha'aretz*, April 7, 2006.

21. See, for example, the views of outgoing Israeli NSC advisor Giora Ireland, "Head of the NSC: Let Hamas Fail without Sanctions," *Yediot Aharonot*, February 20, 2006.

22. Interview with author. See also "And Thank You To Hamas," Aluf Benn, *Ha'aretz*, April 27, 2006.

23. Interview with author.

24. WBG, p.2

25. "Palestinian Economic Dependence on Israel," Elizabeth Young, Washington Institute for Near East Policy, March 23, 2006; IFC, p.3.

26. IFC, p.8.

27. Israel withheld funds from this account for two years during the intifada. Payments were resumed in 2003 and arrears are still being paid to the PA. During the embargo of funds, the shortfall was made up by Arab donors.

28. Interview with author.

29. Interview with author.

30. Interview with US official.

31. See for example the statement by EU external relations commissioner Benita Ferrero-Waldner to the European Parliament, reported by Reuters, "EU Says Israel Key to Resolving Palestinian Crisis", April, 26, 2006. Because of the closure at Karni, daily export income of USD 500,000 is lost. Exports through Karni have for practical purposes ceased, with a daily average of only 4.5 truckloads during April 2006. Hisham Awartani notes that exports to Israel are 50 percent below the 2000 figure. Israeli exports have fallen by 34 percent during the same period.

32. In early April, 2006 the PA was reported to owe the Dor-Aon petroleum company, the exclusive Israeli fuel supplier to Gaza, USD 45 million. Dor-Aon planned to cut off additional



fuel supplies pending payment, Middle East Mirror (Israel section), April 10, 2006.

33. IFC, p.3.

34. Interview with former PA minister of economy Mazen Sonocrot.

35. Interview with Israeli official.

36. *Ha'aretz*, April 5, 2006.

37. *Ha'aretz*, April 11, 2006.

38. Interview with Mazen Sonocrot.

39. Interview with U.S. official.

40. Interview with EU official.

41. EU contributions totaled approximately EU 300 million. Member state contributions comprised the remainder.

42. The president's office has reportedly submitted a \$50 million proposal to the EU to enable it to enhance security forces under its control., *Al Quds Al Arabi*, April 27, 2000.

43. *The Observer*, April 16, 2006.

44. A Hamas representative carrying more than EU 500,000 in donations through the Rafah terminal after a visit to Qatar was intercepted by Palestinian customs agents (working under Abu Mazen's direction) and the funds confiscated.

45. Interview with EU official.

46. This statement was followed by a more detailed January 30, 2006 statement noting, "It is the view of the Quartet that all members of a future Palestinian government must be committed to nonviolence, recognition of Israel, and acceptance of previous agreements and obligations, including the Roadmap. . . . the Quartet concluded that it was inevitable that future assistance to any new government would be reviewed by donors against that government's commitment to the principles of nonviolence, recognition of Israel, and acceptance of previous agreements and obligations, including the Roadmap."

47. See regulations issued on April 12, 2006 by the US Office of Foreign Assets Control.

48. Interview with author.

49. See, for example comments made by British foreign minister Jack Straw to the *Telegraph*, on April 19, 2006, and reported in *Ha'aretz* on April 20, 2006, shortly before his firing, and reports

of an Egyptian diplomatic plan. See also statements by Russian special envoy Alexander Kalugin, reported in *Yediot Aharonot*, February 28, 2006.

50. Palestinian foreign minister Mahmoud al-Zahar spoke out for the first time Thursday on the possibility of negotiations with Israel, saying he does not rule out holding a dialogue with Jerusalem via a third party.

"It is possible to consider holding peace negotiations with Israel, as long as they lead to actual results and are not held for the sake of negotiation alone," al-Zahar told Al Jazeera television during his visit to Qatar. "How the negotiations are held and which parties mediate is not important, only the contents and goals matter."

Al-Zahar added that "we are still holding to resistance (a term al-Zahar used solely in a military context up to now - AR), but in its wider meaning, including resisting the occupation and banishing it with any means necessary."

Al-Zahar did not rule out the recognition of Israel, but added that "Arafat and Abbas recognized Israel without receiving anything in return."

"There is no reason to recognize a state with unknown borders, presently occupying the Golan Heights, Shabaa Farms and Palestinian land, [a state] that does not recognize Palestinian refugees' right of return to homes they were driven out of," he said., "PA Foreign Minister Does Not Rule Out Negotiations with Israel," Arnon Regular, *Ha'aretz*, April 27, 2006.

51. See, for example, comments of Mohammad Nazzal, member of Hamas' political bureau on Al Jazeera, March 21, 2006, in [www.mideastwire.com](http://www.mideastwire.com); PM Haniyeh in *Ha'aretz*, March 30, 2006 as well as the ministerial statement read by PM Haniyeh before the PLC, March 27, 2006.

52. It is not clear if the donors consider the address of their demands the Hamas Party, the Change and Reform list, the PLC, or the PA.

53. "The Quartet reiterated its grave concern that the Palestinian Authority government has so far failed to commit itself to the principles of nonviolence, recognition of Israel, and acceptance of previous agreements and obligations, including the Roadmap. The Quartet noted the absence of a commitment to these principles has inevitably impacted direct assistance to that government and expressed its deep concern about the consequences for the Palestinian people. The donor members noted their willingness to work toward the restoration of international assistance to the Palestinian Authority government once it has committed to these principles."

54. French foreign minister Philippe Douste-Blazy told French radio that while the European Union had cut funding to the Hamas-led Palestinian Authority it had no plans to end relief aid. "It is absolutely out of the question ... to cut off humanitarian aid to the Palestinian Territories," he told RMC radio. "That would be a major political mistake. If we don't help the Palestinian Territories, others like Iran will do so. And, on the other hand, we risk pushing the Palestinian people towards radicalism and that's not what we want and that's why we should continue to help them," *Reuters*, April 19, 2006.

55. Remarks at the U.S. State Department, May 1, 2006.
56. According to one mid-level U.S. official, “If Fateh staged a coup, the aid would flow back in a minute.”
57. See comments by Iyad Allawi regarding US support for dialogue with Sunni rebels, *Al Watan*, April 27, 2006.
58. “Buying Time,” Ze’ev Schiff, *Ha’aretz*, April 17, 2006.
59. “The Curious Disconnect In U.S. Foreign Policy,” James Mann, *Financial Times*, April 16, 2006.
60. Interview with U.S. official. “The Department of the Treasury’s Office of Foreign Assets Control (OFAC) has determined that Hamas, a terrorist entity whose property and interests in property are blocked under three separate OFAC-administered economic sanctions programs, has a property interest in the transactions of the Palestinian Authority. Accordingly, pursuant to the Global Terrorism Sanctions Regulations, 31 C.F.R. Part 594, the Terrorism Sanctions Regulations, 31 C.F.R. Part 595, and the Foreign Terrorist Organizations Sanctions Regulations, 31 C.F.R. Part 597, U.S. persons are prohibited from engaging in transactions with the Palestinian Authority unless authorized, and may not transfer, pay, withdraw, export or otherwise deal in any assets in which the Palestinian Authority has an interest unless authorized. Consistent with current foreign policy, certain transactions otherwise prohibited pursuant to the Regulations are being authorized by general license to facilitate limited transactions by U.S. persons with the Palestinian Authority. General licenses or statements of licensing policy will be issued as appropriate to authorize additional transactions with the Palestinian Authority or to indicate limited circumstances under which other transactions may be considered for favorable licensing treatment on a case-by-case basis. Information on complying with specific aspects of these general licenses, including a list relevant to compliance with General License No. 4(b), is available on OFAC’s website.
- “The above restrictions with respect to the Palestinian Authority do not bar general transactions between U.S. persons and non-governmental actors within the West Bank or Gaza and do not prohibit transactions with private sector banks within the region.”,  
<http://www.ustreas.gov/offices/enforcement/ofac/actions/20060412.shtml>
61. Interview with U.S. officials.
62. Interview with the author.
63. Interview with U.S. official.
64. *Reuters*, April 11, 2006.

65. Testimony of James Wolfensohn, Quartet special envoy, before the US Senate Foreign Relations Committee, March 15, 2006.
66. The U.S. contribution to UNRWA's regular 2006 budget is USD 84.15 million.
67. "UN Agency Says Won't Scale back Hamas Government Contacts," *Reuters*, April 12, 2006.
68. *Ma'ariv*, March 3, 2006, p.3.
69. Interview with European official.
70. EC working paper, May 24, 2006. no title, p.1.
71. "Envoy Says Palestinians Face Financial Collapse," Adam Entous, *Reuters*, February 27, 2006.
72. "Palestinians in Financial Crisis Despite Arab Aid Promises," *AFP*, April 12, 2006; *Al-Jazeera*, April 21, 2006.
73. "Japan decides to extend humanitarian aid to Palestinians," Iris Georlette, *YNET*, March 18, 2006.
74. Dr Musa Abu-Marzuq, the vice chairman of the (Hamas) Political Bureau, noted that the "Russian stand is ideal in terms of how to deal. The Russians do not consider Hamas a terrorist movement while the Europeans placed it on the list of terrorist organizations. The Russians also believe in dialogue with us while the Europeans cut it off. Russia opposed stopping the aid while the European cut it off because the Palestinian people exercised their democratic choice," *Al Hayat*, May 1, 2006.
75. *Reuters*, April 19, 2006.
76. *Reuters*, April 7, 2006 as reprinted in *Americans for Peace Now: Middle East Peace Report Vol. 7, Issue 36, April 7, 2006.*
77. "Hamas Faces Daunting Solo Government Challenge," *AFP*, March 20, 2006.
78. Interview with the author.
79. USD 60 million was withheld in December 2005 for the PA's failure to abide by agreed upon conditions related to budget discipline. USD 40 million of this amount was disbursed in February 2006.
80. Interview with author.

81. "It now appears that the Hamas government may fall, but that will not greatly harm the Hamas movement. Just the opposite. It will increase support for the movement among Palestinians. PA Foreign Minister Mahmoud Zahar said last weekend that the international blockade of his government will only intensify the people's rallying around it. Apparently he is correct. The more the world refuses to accept the results of the democratic election in Gaza and the West Bank, the greater the sense of insult and the greater the anger of the Palestinian public. They believe they are being given a raw deal: the international community demanded that they hold elections, but refuses to accept the results.

"The only candidates for replacing the Hamas government are the Fatah activists, who might be able to find a way to regain control of the government. But the clear impression in the territories today is that the public will not let them do so. The large number of Hamas voters have been joined by many more whose support for Ismail Haniyeh, Mahmoud Zahar and their persecuted colleagues has only increased as a result of the pressure on the elected government, together with the Israeli bombings, the siege and the collective punishment. All this will only increase the hostility for and hatred of Fatah," "Rallying Around Hamas," Danny Rubinstein, *Ha'aretz*, April 17, 2006.

82. Interview with author.