

**Testimony of James D. Wolfensohn
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To the Foreign Relations Committee
United States Senate
March 15, 2006**

Mr. Chairman and members of the Committee, thank you for inviting me today to share with you my assessment of the current economic situation in the Palestinian Territories, and my thoughts about how the international community might usefully proceed from here. The Palestinian Legislative Council elections on January 25 were free and fair, with a high turnout, good security and results that have been respected by all political factions. The Palestinian people sent a clear message that they want a clean government that meets their needs and is accountable.

At the same time, the election of a group that is designated a Foreign Terrorist Organization by the United States and the European Union, and that advocates the destruction of Israel in its charter presents serious challenges that we all must now address. The Quartet has made clear that Hamas must commit to nonviolence, recognize Israel, and accept previous agreements and obligations of the Palestinian Authority (PA), including the Roadmap. I agree with this position unequivocally. These are fundamental commitments, and set the basic parameters under which the PA can be a partner in the peace process. Israel cannot be expected to negotiate with a PA government that does not accept its existence and openly calls for its destruction.

In the event that a new PA government refuses to accept the three conditions set by the international community, then it is right for all those engaged in attempting to bring peace to the region to review their assistance efforts to the PA. While the future should be left to the citizens and leadership of the Palestinian community, international assistance remains a powerful tool that can be used to affect the policy debate in the right direction—we do this in developing countries around the world to ensure that aid money is used effectively and to promote strong economic growth. We have been targeting our assistance to the PA to elicit the kinds of reforms and policies consistent with Oslo. Hamas faces a clear choice to either fulfill the mandate given it by the Palestinian people to eliminate corruption and pursue their desire for peace, or maintain its support of terror and untenable stand against Israel at the cost of international censure.

The mechanisms we use to encourage Hamas to commit to the Quartet's three principles should be very carefully selected and targeted, with the goal of retaining open political space. It is essential, therefore, to ensure the continued humanitarian and economic welfare of the Palestinian people in a way that is predictable and clear to the population. We must appropriately target our message to Hamas at those responsible for terrorism and those responsible for making decisions about the future direction of the PA. To cast too wide a net and punish ordinary Palestinian citizens for Hamas' failures—those working for the health and well-being of the Palestinian people, those pursuing moderate political causes, or elected officials who are not associated with Hamas—sets the stage

for our intentions to be misread. We risk blame being cast at the international community and increased radicalization of Palestinian society should Palestinian suffering increase.

In the nearly eight months since my last appearance before the Committee, I have continued to work on behalf of the Quartet to pursue its original mission to coordinate the international community's efforts in support of Israel's disengagement from the Gaza Strip and parts of the northern West Bank. This has meant working with both sides to establish the prerequisites for a successful Palestinian economy, and working with the PA to develop a program of reforms and steps to promote economic recovery, good governance, transparency, job creation and improved living standards. Above all, my goal was to facilitate economic hope for the Palestinians in an environment of security for both sides.

Planned changes in assistance will affect the efforts we, and the rest of the international community, have made thus far to build the economy, institutions and efficacy of the PA. I have noted to the Quartet that such changes require careful examination against the long-term development goals we have pursued. Key measures in this area have included: the establishment of a single treasury account at the Ministry of Finance; increased transparency of financial accounting including external auditing and submission of financial statements to parliament; stronger anti-corruption measures including passage of a law on illicit earnings and passage of a judicial authority law, and the successful formation and functioning of the Central Elections Commission. There remains a great distance yet to go in PA reform, and abandoning the project now across the board risks setting back our goals and interests in the region. I have been greatly impressed by many Palestinians working for these same goals, and we should not let them down.

Coordinated leadership during this time will avoid hasty decisions that could jeopardize many years of democratization and institution building processes. We could inadvertently foster a situation where there truly can be no partner for peace. The international community is working now to address many of these difficult questions. I recognize the complexity of the task and am hopeful there will soon be a convincing strategy addressing the PA's financial and short- and long-term development needs.

The Fiscal Crisis

The current fiscal situation in the Palestinian territories is dire and unsustainable and may have wide-ranging consequences for the Palestinian economy, and for security and stability for the Palestinians and the Israelis. And it comes at a time when Israel prepares for elections. The PA needs \$115 million to pay salaries and essential benefits for the month of February. The size of the wage bill has ballooned over the last 8 months, largely due to substantial wage increases granted to both civilian and security personnel mid-year, and more recently due to significant increases in the number of PA security services personnel (to return to a path of fiscal sustainability, the PA must shed at least 30,000 security sector employees). Additional costs, including payment to Palestinian and Israeli vendors, social transfers, and utility payments to Israel result in a monthly deficit of roughly \$70 million. Israel's decision to withhold tax and customs revenue

transfers of roughly \$60 million per month expands this deficit to \$130 million per month and severely increases the PA's reliance on external financing.

With generous contributions of budget support from donors such as the EU, Saudi Arabia, Norway, and the United Kingdom, the financing gap for February has narrowed significantly. However, the PA continues to face shortfall of some \$30-40 million and therefore has not yet paid February salaries. Hamas has asked President Abbas for a two week extension to form a cabinet, meaning that we will have a caretaker government through most of March. There are no plans in place for how to finance the March deficit.

The majority of donor assistance directly to the PA budget is from Arab states. According to the PA Ministry of Finance, in 2005 \$210 million of the PA's over \$360 million in budget support was provided from the Middle East. Saudi Arabia, Algeria, Kuwait and Qatar were the lead Arab donors. It is possible but by no means certain that Arab donors would increase assistance to the PA if Western donors reduce funding through other channels. While I have no personal knowledge of the subject, we have already seen rumors that Iran is considering assistance, though Hamas itself has disputed some such stories. It is also not clear the degree to which Iran is capable of funding the PA. What is clear is that the PA has a consistent and chronic budget deficit the new government will be responsible for addressing.

Non-payment of salaries to some 150,000 PA civilian and security employees would have a major impact on the economy and increase levels of poverty, but again, I cannot endorse external budgetary assistance once a new government is formed absent the new government's accepting the three Quartet principles. PA employees make up 37 percent of those in employed in Gaza and 14 percent in the West Bank, with more than 940,000 Palestinians (about one quarter of the population) directly dependent on a PA wage earner in the family. This dependence is particularly high among the poorest segments of the population. The private sector, already experiencing a severe slump, has only a limited capacity to absorb new unemployed, leaving the population even more vulnerable.

Non-payment of salaries to some 73,000 security staff risks rising criminality, kidnapping and protection rackets. This has led already to UN international staff being reduced from 76 to six currently, and kept UN operations in Gaza at a heightened level of alert. As we saw yesterday from the terrible events in Jericho that spread rapidly throughout the West Bank and to Gaza, the already highly charged environment needs no additional fuel for a spark to ignite.

Development and Humanitarian Assistance Issues

Donors have long been engaged in the broad process of building Palestinian institutions, infrastructure and capacity to govern. In 2005, donors spent over \$700 million in projects and programs to help the Palestinian people build water lines and housing, create jobs, develop small businesses and strengthen their elections system. The EU COPPS program helped build the Palestinian security sector, while donors worked together through the World Bank Financial Reform Trust Fund to strengthen PA financial management.

Donors were planning further increases in assistance to the PA in the wake of disengagement and in the run-up to January PLC elections. The EC proposed doubling aid to €500 million if meaningful progress in security and access policy were achieved; Japan was moving forward with provision of \$100 million in disengagement-related assistance; the U.S. provided \$200 million in supplemental assistance in 2005, in addition to \$75 million annual budget, and doubled 2006 budget to \$150 million; UAE pledged \$100 million to build 3,000 new housing units in Gaza, and Canada doubled their 2005-06 commitment to \$58 million. This assistance was to have largely been implemented during the first half of 2006.

The suspension of all such activity would have important consequences for Palestinians. Sewage running in the streets will continue to do so. Jobs that would have been created through road building and other infrastructure projects will not exist; the UN notes that 100,000 jobs need to be created in 2006 just to maintain the current rate of unemployment. Removing assistance for political reform programs is especially counterintuitive when we recall that 55 percent of the Palestinian population voted for parties other than Hamas. This again speaks to the need for a careful, thoughtful approach to the current situation that reinforces our long term goals while preserving our interests.

When Israel announced its planned disengagement from Gaza and parts of the northern West Bank, the international community, including me, spoke of a return to the Roadmap and of building hope for the Palestinians. We recognized then that the best way to bring calm and security was to improve the Palestinian economy. At the same time, we recognized that if we failed to seize this moment to increase prosperity, the likelihood of rising discontent and violence would increase. The same issues face us now, and we must very carefully consider how we design the next phase of donor activity.

Part of building PA institutions has been building their capacity to provide for the basic needs of the Palestinian population. More than 50,000 Palestinians work in the health and education sectors. To halt financing of the PA would mean that basic and essential services, such as education, health care, water supply, and sewage treatment would be significantly reduced or cease to be provided altogether. For example, the PA Ministry of Health currently operates about 60 percent of basic health care clinics and hospital beds in the West Bank and Gaza and administers 85 percent of vaccinations in the West Bank (and 25 percent in Gaza). NGOs account for 30 percent of the remaining facilities and UNRWA for 8.5 percent. Donors currently fund 87 percent of the non-salary operating budget of the PA Ministry of Health. A collapse of health services and the education system, which addresses the needs of one million children, would be a total failure for the new government, and would have tragic consequences for the Palestinian people. This should not be permitted under any circumstances.

In order to avoid a total failure of the healthcare system in the Palestinian Territories, we are looking at the prospects for provision of services through NGOs, UNRWA, and other agencies outside the PA. According to the UN, while a number of organizations—including UNRWA—are active in the provision of basic health care and education,

international humanitarian agencies may not have the capacity to take over the running all of the PA services. A World Bank survey shows that 47 percent of respondents utilized government health services for regular health care services; 25 percent used UNRWA; 16 percent utilized private sector providers and 11.5 percent used NGOs. It is unclear how much NGOs can fill the gap that would left by the PA.

In education, the IMF reports that about 75 percent of the schools are public, with the remaining 25 percent equally divided between UNWRA and private institutions. UNRWA schools are already overcrowded and operating on shifts. UNRWA has indicated it could expand its primary health and education services to a portion of the non-refugee population if its mandate were expanded. If, however, the PA Ministry of Education were to fail, and in the worst case scenario thousands of school children were sent home, there could be the potential for increasing instability and violence.

Seeking to engage international and non-governmental organizations in the provision of basic services to the Palestinian people may be useful in helping some donors address legal issues that impede providing assistance to or through a new Hamas-led PA government, while enabling their continued support of the Palestinian people. There are questions, however, about the time needed to establish acceptable new mechanisms for delivering assistance, the willingness of these groups to participate, and their capacity to do so. Any new such mechanisms should be designed with the clear intent to dissolve them once their function is no longer needed.

Agreement on Movement and Access

As Quartet Special Envoy, I worked to create the preconditions for a viable Palestinian economy. A major result of this effort was the Agreement on Movement and Access (AMA) that I helped Secretary Rice secure with both sides on November 15, 2005. If fully implemented, this agreement would have addressed major impediments to a successful Palestinian economy: the ability to efficiently move people and goods into and out of Gaza—to Egypt, Israel and the West Bank; reduced trade-restrictive barriers to movement within the West Bank; and facilitated work on a sea and airport for Gaza.

While some success was achieved at Rafah, and for a time at the Karni crossing, the overall implementation of the AMA has been poor. Each side is culpable for this situation, which has ultimately meant that the benefits we had hoped would accrue to the Palestinian economy have not materialized. There could have no reasonable expectation of progress on these issues after the Palestinian elections, but it is regrettable that the parties did not work harder to reach a conclusion to the issues in the intervening period between signing of the AMA and the elections.

One of the most alarming issues in this context is the prolonged and repetitive closure of the Karni crossing point between Gaza and Israel; the only operating cargo terminal in and out of Gaza. The latest prolonged closure from February 22 to March 8 followed a previous closure from January 15 to February 4. Karni was closed again on March 14

until further notice. The periods of closure represent 51 percent of the total amount of time the crossing should have been open since the beginning of the year.

The closures at Karni have been devastating and severely harmed the Palestinian agricultural sector which was at the height of its season. The AMA set the benchmark of 150 export truck loads a day by December 31, which has not yet been attained. In the last normal operating period in February, daily exports averaged 62 truck loads. There has been a significant decrease in the agricultural crops productivity due to delayed harvesting resulting from the inability to export the produce out of Gaza.

Severe shortages in dairy products, wheat, fruit and chemical items had been reported from Gaza in the week of March 6. Accordingly, prices for many goods, if available at all, rose significantly (sugar by 150 percent, fruit by 40 percent). UNRWA reported yesterday that despite the opening of Karni for imports March 9-13, flour supplies remained insufficient. UNRWA furthermore estimates running out of fuel by March 17.

Progress on establishing convoys for people and goods between Gaza and the West Bank has also been stalled. The AMA stipulates the former were to have been started December 15, 2005 and the latter January 15, 2006. Movement within the West Bank also remains problematic. The number of obstacles identified by the UN Office for the Coordination of Humanitarian Affairs climbed from 376 in August 2005 to 487 as of March 3.

There is not yet a detailed assessment of how the above issues will affect the Palestinian economy. It is reasonable to assume, however, that GDP expansion will fall well short of the previously predicted 8.7 percent for 2005. The IMF estimates real growth will instead be 6 percent—not nearly what is needed after the devastating years of recession during the intifada. Unemployment, which the World Bank estimated at over 22 percent in 2005 (and disproportionately affects young Palestinians), will also increase dramatically, especially if the PA undertakes badly needed reforms to reduce public sector payrolls.

The pressure on the new Palestinian government is therefore intense. Even had Fatah won the majority of PLC seats, the international community would have had to engage intensively with the PA on a set of economic and political reforms. Hamas now faces a huge challenge simply in managing the existing issues in front of the PA, and has made big promises to deliver quickly. Fatah failed to do so and was voted out of power in free and fair elections. It will be incumbent on Hamas to provide a peaceful and prosperous future for Palestinians—this can begin with its acceptance of the Quartet's conditions.

There is a great deal of good will motivating the realignment of international assistance to the Palestinians, as all major international donors have stated their commitment to supporting the humanitarian needs of the Palestinian people. The burden, however, rests squarely with Hamas. The current scenario demands a thoughtful, prudent and measured response based on the steadfast goal of returning both sides as quickly as possible to the Roadmap, and finally bringing about a two state solution. I believe the best way to

achieve this is through A clear set of requirements for Hamas, matched with strong, multilateral support for the Palestinian people over a predictable timeframe. The period after the installation of the PA cabinet, as the international community hopes for Hamas to determine whether or not it will make the required policy changes, will be dangerous and difficult. All of us—the Quartet, the Israelis, the Palestinians and the rest of the international community, but first and foremost the Palestinian leadership—need to consider carefully how this is handled.