Ministry of Planning
& International Cooperation
Economic Studies & Forcasting Sector

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Yemen Socio-Economic Update

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Yemen Economy in Lines

Public Finance Developments in Yemen

Situation ... Challenges... Priorities

Introduction

This edition highlights a very essential topic relevant to the previous one on the private sector. Both public and private sectors are key players in economic activity and generation of income and job opportunities.

The public sector plays a vital role in turning the wheel of economic activity in Yemen, where it contributes nearly 50% of GDP and provides employment for 31% the total employed population. Thus, the volatility of this sector reflects directly and indirectly on the lives of millions of citizens. The public budget faces several chronic challenges, in addition to the burden of the transitional period's additional expenditures and targeting the oil, gas and power infrastructure with acts of destruction.

The public revenues fell unprecedentedly in 2015, and expenditures have been reduced, including freezing the Public Investment Program and suspension of social welfare cash assistance disbursement. The public budget's deficit and domestic debt burden have exacerbated too. To overcome these challenges, appropriate options to finance the budget deficit from real resources should be considered, to ensure the continuous provision of inevitable expenditures, mainly wages and salaries, social welfare cash assistance and basic services' operational costs. Resumption of the crude oil and natural gas production and exports is undoubtedly the most essential option.

Searching for financing options, it's worth pointing out the importance of restoring the budget's role in stimulating economic growth through the Public Investment Program, which should be at a level allowing economic recovery and stimulating the economy and its various sectors.

Dr. Mohammed Al-Maitami
Minister of Planning and International Cooperation

Facts and Figures

- **The Gross Domestic Product (GDP) is expected to decrease by 34.6%, along with an escalating inflation rate by over 30% in 2015.**
- **The public budget's financing gap is estimated at $5.8 billion in 2016 without reconstruction needs.**
- **The exchange rate in the parallel market reached 270 YR/ USD in February 2016, compared to 214.9 YR/ USD in February 2015.**
- **Power supply through the public grid has been completely suspended in Sana'a and many other governorates for about 6 months.**
- **Fuel imports covered 89% and 16% of the local market needs during November and December 2015 respectively.** ***(OCHA, Shipment Snapshot, Jan. 2016)***
- **14.4 million Yemenis are food insecure, and 1.8 million children at risk of malnutrition** ***(OCHA, Humanitarian Bulletin, Issue 8, Feb. 2016).***
- **21.2 million Yemenis (82% of the population) are in need of humanitarian assistance, including 9.9 million children and 2.5 million IDPs (31% children).** ***(UNICEF, SitRep, 13-26 Jan. 2016).***

Highlights:

This edition highlights the public finance developments in Yemen during 2015 as follows:

- **Decline in total state's public revenues by 53.7% due to the suspension of the production and exports of crude oil and liquefied natural gas (LNG), suspension of donor support to state's budget and reduction in tax revenues.**
- **Decline in total state's public expenditures by 25% as a result of reducing most of the public expenditure items, which include freezing the capital expenditures, suspending the social welfare cash assistance disbursement and reducing the operational costs of basic service facilities.**
- **The public budget's net deficit reached 15.4% of Gross Domestic Product (GDP), exceeding the safe limits.**
- **Direct borrowing from the Central Bank of Yemen (CBY) is the most important source to finance the budget deficit by 84%.**
- **Increase in domestic public debt from $14.8 billion in 2014 to $19 billion in 2015, and the debt burden has reached an alarming level.**
- **The public budget's financing gap is estimated at $5.8 billion in 2016 (without reconstruction needs).**

First: The Role of Public Finance in Development (Pre-War)

The public sector plays a vital role in the economic and social development in Yemen. Key features of this role include:

Economically, the public sector contributed 46.3% of GDP in 2014, about 35% of the gross investment and 17.6% of the total final consumption in 2013. The public sector controls 45% of commodity exports (oil and gas) and 27% of commodity imports (fuel). The public sector is a key engine for the construction activities, air and maritime transportation. Additionally, the public budget absorbs a significant part of the banking sector resources through treasury bills.

Socially, the public sector provided employment opportunities for 31% of the working population during 2013-2014. The number of public sector employees is estimated at 1.1 million employees, with millions of dependants. The public finance also covers the cash assistance disbursed to about 1.5 million beneficiary cases of the Social Welfare Fund (SWF) up to the end of 2014. Moreover, the public sector is mainly responsible for the provision of basic services to population (education, health, water, electricity ...).

Generally speaking, fluctuations in the public finance undoubtedly have dramatic effects on the economic and social situations in Yemen, and the living conditions of millions of Yemenis as well.

Second: Current Situation of Public Finance

The public finance in Yemen is experiencing several chronic imbalances that have weakened its ability to perform its anticipated role in the development process and society. The public finance sustained several strong and unprecedented shocks both in terms of revenues and expenditures during 2015 as follows:

1- Decline in public revenues:

Preliminary data shows a decrease in the total state's public revenues by about 53.7% in 2015, compared to 2014. Since June 2015, the total revenues were unable to cover the salaries and wages due to the deterioration in most of the components of public revenues, the most important of which are:

1.1 - Interruption of oil revenues:

Oil revenues are the main contributor to the state public budget, but these revenues are dramatically decreasing as the government's share of the crude oil production has been continuously declining by 6.5% per year on average during 2001- 2014. In the light of the proven reserves, the decline is expected to continue in the future. `

The oil and gas revenues fell by 77.1% in 2015 due to the suspension of the activities of the foreign oil companies operating in Yemen, as well as suspending the production and exports of crude oil and LNG. This has deprived the public budget of resources that are desperately needed. As a result, the contribution of the oil revenues to the total public revenues decreased from 45.3% in 2014 to 22.4% in 2015.

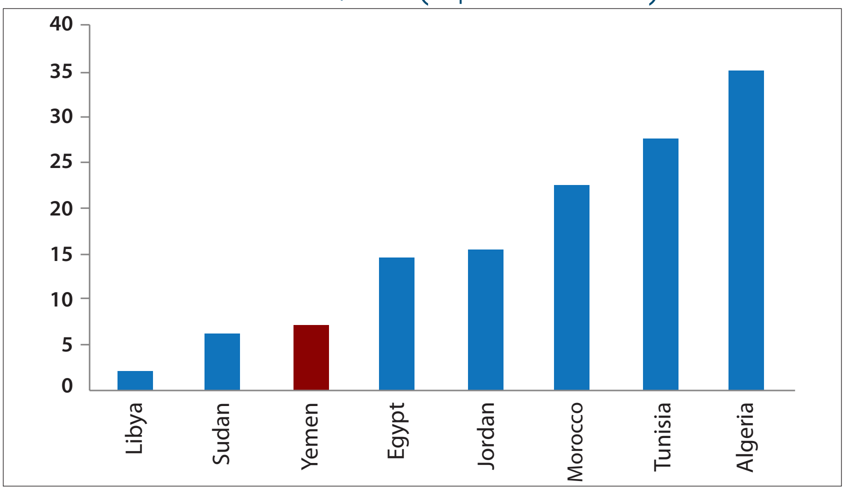
1.2 - Decrease in tax revenues:

Yemen is among countries with the lowest tax revenue, which accounted for less than 9% of GDP in the past, compared to an average of 17.7% in developing economies similar to Yemen. This is mainly attributed to the ineffective tax system in Yemen, weak tax laws and rampant corruption.

The tax revenues fell by about 19.2% in 2015 as a result of the lack of security in several areas, restrictions on the external trade, damage in custom ports in Aden and Hodeidah and the decline in economic activities.

Due to the decline in the crude oil revenues, the need is even more urgent to mobilize the tax resources (after economic recovery), that are sustainable resources.

Tax Revenue, 2013 (In percent of GDP)



Source: *IMF, 2014.*

1.3 - Suspension of external funding:

The total external grants and loans provided to the state public budget accounted for $4.8 billion (mostly grants) and constituted 14.4% of the total public revenues during 2012-2014. They played a key role in containing the budget deficit and improving the macroeconomic stability during the transitional period. However, the foreign grants and loans fell sharply by 93.5% in 2015 to YR10.6 billion (equivalent to $94.1 million) due to the suspension of donor funding to the state public budget. As a result, the contribution of the external grants and loans in the total state revenues has decreased from 13.5% in 2014 to 1.9% in 2015. In light of the limited local resources, government relies on external resources to finance the reconstruction projects and support the development efforts in the medium term

Budget Revenues 2015-2014	Total revenue (billion YR)		Growth rate %	% of Total revenue		% of GDP	
	2014	2015		2014	2015	2014	2015
Total Revenues	2293.0	1062.7	-53.7	100.0	100.0	31.4	18.0
1-Oil Revenues:	1039.2	237.6	-77.1	45.3	22.4	14.2	4.0
a. Exported Crude Oil	383.8	78.7	-79.5	16.7	7.4	5.3	1.3
b. Domestic Oil Revenues	444.8	46.4	-89.6	19.4	4.4	6.1	0.8
c. Gas Exports	158.3	54.5	-65.6	6.9	5.1	2.2	0.9
d. Gas Sales	52.3	58.0	10.8	2.3	5.5	0.7	1.0
2-Non-Oil revenues:	1253.8	825.2	-34.2	54.7	77.6	17.2	14.0
a. Tax Revenues, including:	586.4	474.0	-19.2	25.6	44.6	8.0	8.0
- Tax on Trade & Int. Transactions	111.5	66.8	-40.0	4.9	6.3	1.5	1.1
b. Non-Tax Revenues, including:	667.4	351.2	-47.4	29.1	33.0	9.1	6.0
- External loans	61.6	9.6	-84.4	2.7	0.9	0.8	0.2
- External grant	248.2	10.6	-95.7	10.8	1.0	3.4	0.2

Source: *Ministry of Finance, Government Finance Statistics Bulletin, Issue (62), the fourth quarter 2015.*

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2- Decline in public expenditures:

Preliminary actual data indicates a decrease in the total public expenditures by about 25% in 2015, leading to a reduction in the aggregate demand, income and employment in the economy. This is attributed to the decrease in various items of current and capital expenditures, except for the interest on public debt.

The current expenditures decreased by about 23.2% in 2015, mostly due to the removal of fuel subsidies and decrease in costs of goods and services, in addition to the total suspension of cash assistance provided to the SWF's beneficiaries; thereby, exacerbating the living conditions of the eligible poor households.

State Public Budget and Social Protection

The state public budget has encountered exceptional circumstances in 2015, and wasn't able to perform the minimum of its development and humanitarian functions. Projects of the Public Investment Program have been suspended and the expenditure items, including the operational expenses of basic social sectors such as education, health, water and electricity, have been reduced, making it difficult for the population to have access to basic services.

The poor have been directly affected due to the suspension of cash assistance disbursement to the SWF beneficiaries in 2015, despite the scant amounts of this assistance, between YR3000-6000 (equivalent to about $14 –28) for each household per month. Given that about 39% of the beneficiaries are disabled, orphans and women with no caretaker (divorced and widowed), this type of assistance is deemed among the humanitarian aid. This requires the adoption of urgent resolutions to resume the cash assistance disbursement to more than 1.5 million poorest cases.

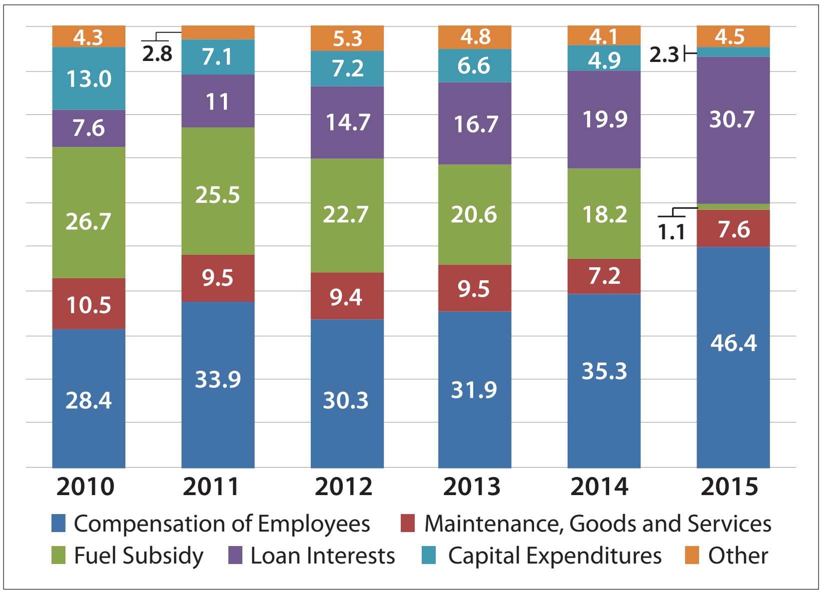
The capital expenditures (Section IV) have also declined from 4.05% of GDP in 2010 to 1.76% and 0.76% in 2014 and 2015 respectively. The absolute value of the capital expenditures decreased by around two thirds in 2015; thereby, negatively affecting the construction sector and the related activities and leading to lower economic growth despite the fact that increasing the investment expenditures is an effective tool to stimulate economic growth, generate employment opportunities and alleviate poverty (especially during economic recession).

The figure indicates sharp imbalances in the structure of public expenditures in 2015. The current expenditures have accounted for 93.3% of the total public expenditures, most of which was directed to wages, salaries and interests on public debt. Despite the reform of the fuel subsidy expenditures, which were hoped to provide larger scope for the capital expenditures, but the contribution of latter in the total public expenditures declined more to 2.3%.

Due to the reduction in the state's public revenues, the budget is currently focusing on paying wages and salaries of public employees, paying interest on public debt and covering a small part of the operational expenses of public institutions.

In brief, the dominance of the inevitable current expenditures and deterioration in the fiscal resources have made the budget spending policy uncontrollable and more complicated to be used, as a tool of the macroeconomic policy, to support the economic growth and employment.

Structure of Expenditure %



Budget expenditure 2015-2014	Total expenditure (billion YR)		Growth rate %	% of Total expenditure		% of GDP	
	2014	2015		2014	2015	2014	2015
Total expenditure	2629.0	1971.9	- 25.0	100.0	100.0	36.0	33.4
I. Current Expenditures, including:	2393.3	1839.0	- 23.2	91.0	93.3	32.7	31.2
- Compensation of Employees	927.8	915.0	- 1.4	35.3	46.4	12.7	15.5
- Maintenance, Goods and Services	189.6	149.8	- 21.0	7.2	7.6	2.6	2.5
- Loan Interests:	524.1	605.5	15.5	19.9	30.7	7.2	10.3
Domestic	507.6	590.3	16.3	19.3	29.9	6.9	10.0
External	16.5	15.2	- 7.7	0.6	0.8	0.2	0.3
- Fuel Subsidy	479.4	20.7	- 95.7	18.2	1.1	6.6	0.4
II. Capital Expenditures	128.6	44.9	- 65.1	4.9	2.3	1.8	0.8
III. Others	107.0	88.0	- 17.8	4.1	4.5	1.5	1.5

Source: *Ministry of Finance, Government Finance Statistics Bulletin, Issue (62), the fourth quarter 2015.*

3- Decline in public expenditures:

Preliminary actual data shows that the net deficit of the public budget exceeded the safe limits (15.4 of GDP) in 2015. Such a deficit provides a limited scope to the private sector lending and weakens the economic growth opportunities. More seriously, it's difficult to finance the budget deficit from real resources due to the loss of over 50% of the public revenues and the decrease in demand for treasury bills and government bonds.

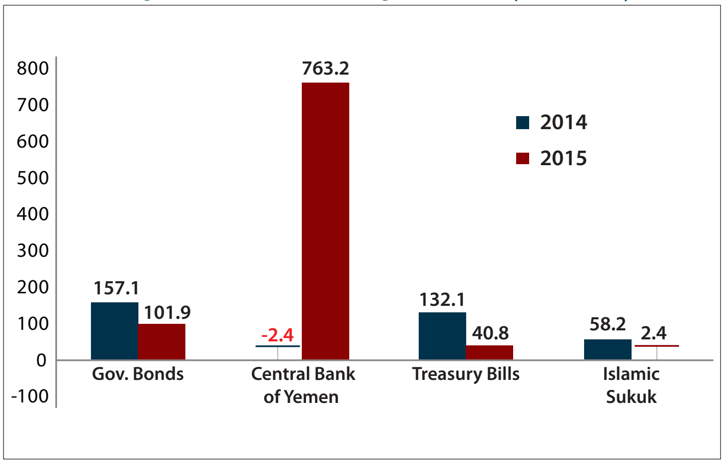
Therefore, the budget deficit was funded through overdraft from the CBY by 84% of the total deficit in 2015[1] . Overdraft from the CBY poses several threats to the economic situation, most notably: increase in pressure on the balance of payments, decline in the value of the national currency, higher inflation levels and lower living standards and increase in the public debt burdens. This makes it imperative to accelerate the mobilization of the real resources necessary to fund the inevitable expenses, most notably the resumption of crude oil and LNG production and exports.

Budget Deficit and Sources of Financing, 2014-2015

Budget Deficit and Sources of Financing	*2014*	*2015*
Net budget deficit (Billion YR)	- 344.9	- 908.3
Budget deficit percentage of GDP %	- 4.7	- 15.4
Structure of Budget Deficit Financing Sources %		
- Gov. Bonds	45.5	11.2
- Central Bank of Yemen	- 0.7	84.0
- Treasury Bills	38.3	4.5
- Islamic Sukuk	16.9	0.3
Total	100.0	100.0

Source: *Ministry of Finance, Government Finance Statistics Bulletin, Issue (62), the fourth quarter 2015.*

Budget Deficit Financing Sources (billion YR)

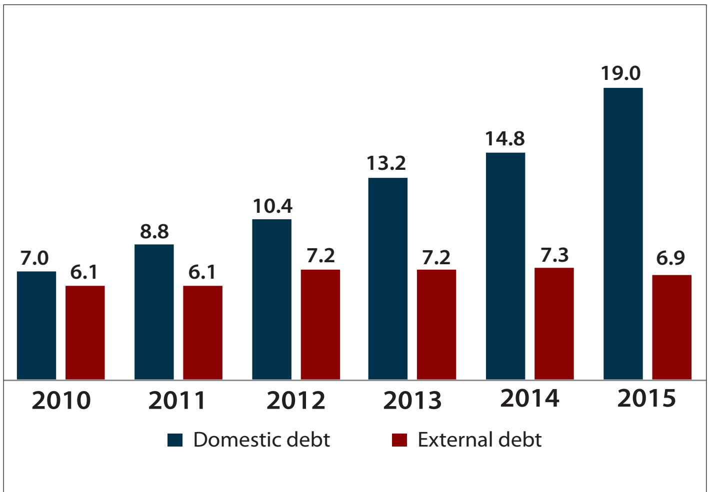


3- Increase in public debt:

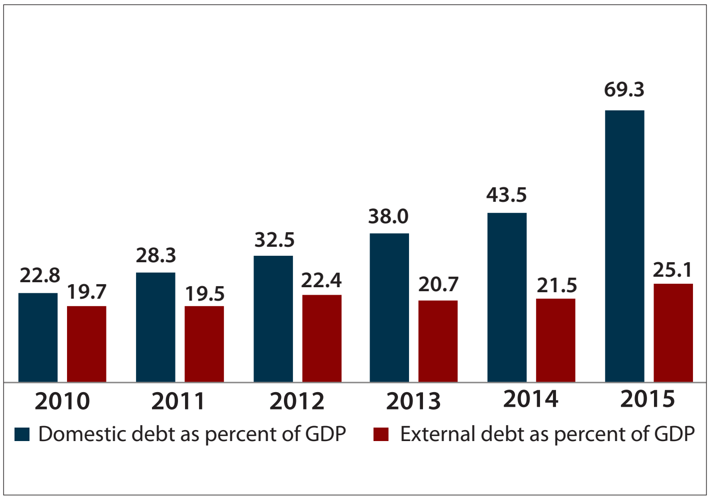
The total public debt has increased from $22.1 billion in 2014 to $25.9 billion in 2015, constituting 65.5% and 94.4% of GDP in 2014 and 2015 respectively. The figure indicates a decline in the external debt by about $400 million in 2015 due to the suspension of external loans and the CBY's payment of the due external debt. Yemen's external debt is almost wholly in the form of debt to international institutions, regional funds and organizations and sovereign countries. Therefore the external debt stock overwhelmingly concessional in nature. Given the erosion of the central bank's foreign exchange reserves, it would be better to negotiate with creditors to temporarily postpone the repayment of external debt.

The absolute value of the domestic debt and its percentage of GDP have significantly increased in 2015. Similarly, the debt burden has increased to alarming levels. The interest rates on the domestic debt are high (about 16% on the treasury bills). Therefore, payment of the public debt interest rates has consumed nearly one third of the public expenditures (29.9% of public expenditures) in 2015. Due to the weak fiscal sustainability, any additional non-concessional loans overburden the public finance and lay further burdens on the current and future generations.

Domestic and External Debts (billion USD)

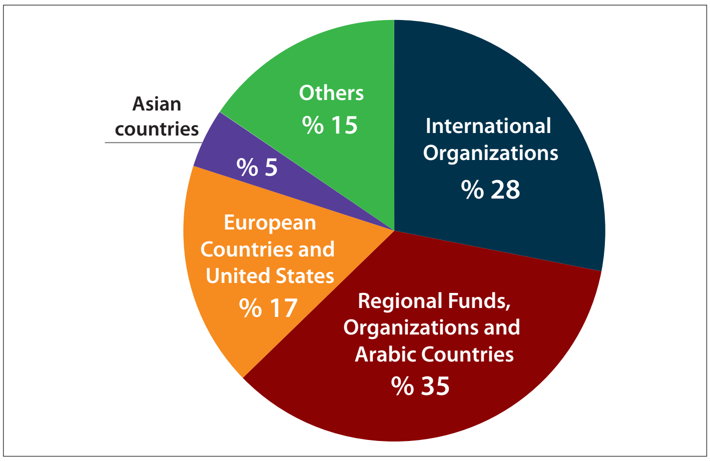


Domestic and External Debts as Percent of GDP %

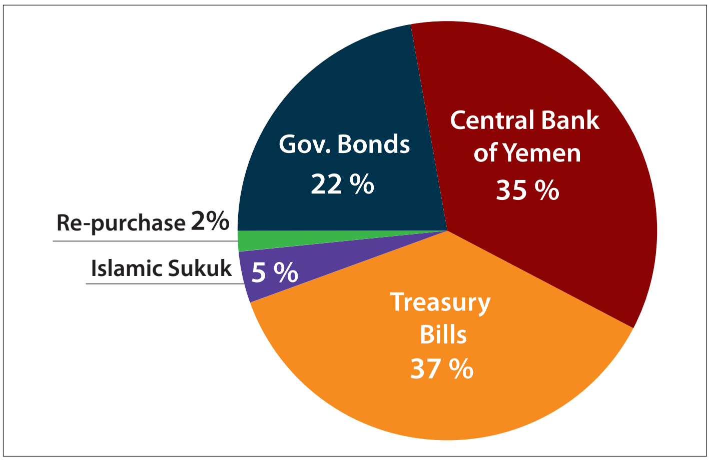


[1] *Currently, Islamic banks is demanding the Central Bank of Yemen to absorb its excess liquidity through issuing Islamic sukuk to finance some projects in the public budget or participate in financing fuel imports, for example.*

Structure of external debt outstanding %
until 31.12.2015



Structure of domestic debt outstanding %
until 31.12.2015

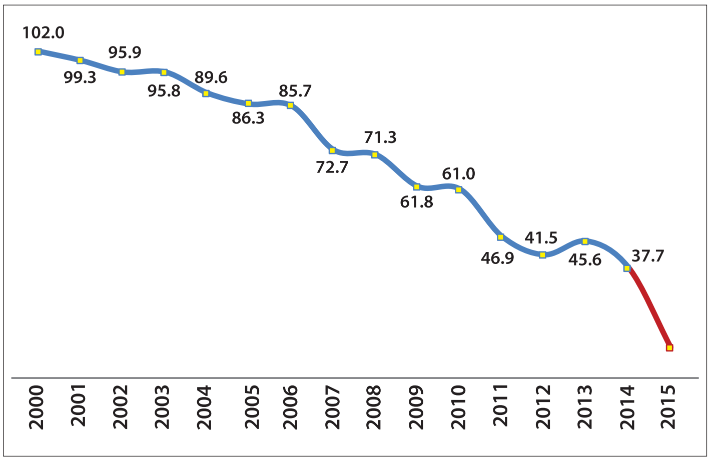


Third: Challenges and Risks

Public finance is facing profound challenges and high risks both in revenues and expenditures, most notably of which are:

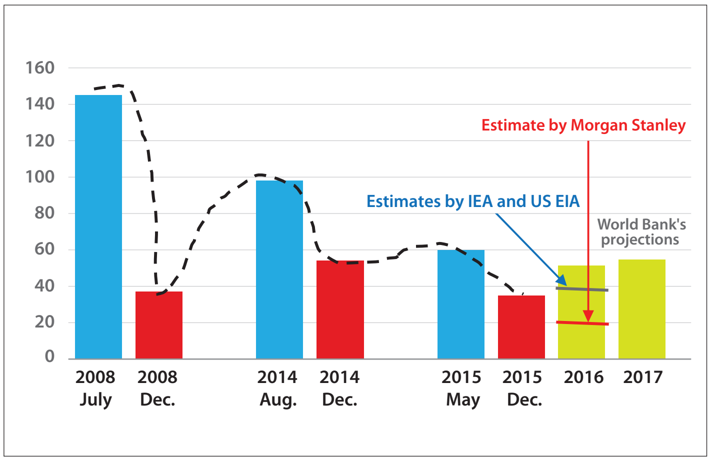
- Loss of the most essential resource of the public budget (oil revenues), due to:
  - Departure of foreign oil companies from Yemen and suspension of the production and exports of crude oil and LNG in 2015, in addition to the chronic decline in the government's share of the crude oil production since 2001.
  - A sharp decline in world crude oil prices; thereby, reducing the expected oil revenues and discouraging foreign companies from returning to Yemen to resume oil and gas production or invest in developing the existing oil fields, especially in light of the lack of security and repeated acts of sabotage on oil, gas and electricity infrastructure.

State's share of crude oil production (million barrel)



Source: *Ministry of Oil and Minerals, Oil and Minerals Statistics Bulletin, Various Issues.*

Oil prices (Brent, USD /barrel)



Source: *World Bank, Mena Quarterly Economic Brief, Issue (6), January 2016.*

- Expansion of areas affected by armed conflict and severity of the economic recession; thereby, weakening the tax revenues.
- Concentration of non-oil revenues in specific geographical areas, most notably Sana'a, Aden and Hodeidah. Therefore, the damages to Aden and Hodeidah ports have reflected negatively on public revenues, aside from the chronic inefficiency of the tax system.
- Suspension of the external funding (grants and loans) provided to the public budget in 2015.
- Loss of control over the fiscal policy due to the dominance of the inevitable current expenditures, providing no fiscal space for the fiscal policy.
- Suspension of the social welfare cash assistance, freezing the capital expenditures and the reduction of basic services' operational costs; thus, exacerbating the suffering of the population.
- Increase of overdraft from the CBY to finance the budget deficit and aggravation of the debt burden pose emerging and serious threats to the national economy.
- High costs of the reconstruction works and requirements of the economic and social recovery.

Fourth: Key priority interventions

To overcome the challenges and risks facing the public finance and financing the deficit from real resources, several key priority interventions should be taken, most notably:

Key issues	Urgent priorities	Mid-term priorities
Public revenue mobilization	- Resuming the production and exports of crude oil and gas and depositing the government's share of revenues in the CBY. - Stimulating the private sector enterprises to pay the tax arrears. - Strengthening the control over the revenues of public economic sector units. - Searching for external support (cash grants and in-kind assistance) to cover the inevitable expenditures of the public budget. - Studying the feasibility of imposing a temporary tax on fuel as an alternative option for the inflationary financing of the budget deficit that weakens the value of the national currency. - Raising the custom tariffs (temporarily) on luxury goods, which have local alternatives. - Raising the prices of government services (if any) to cover production costs. - Issuing Islamic Sukuk to make use of the excess liquidity of Islamic Banks in financing some projects in the budget or fuel imports.	- Providing effective security protection to oil companies, oil and gas pipelines and power transmission lines. - Intensifying efforts of oil and gas exploration, and stimulating the oil companies to improve the existing fields to produce oil. - Imposing the tax laws and improving the efficiency of the Senior Taxpayer Department at the Tax Authority. - Developing the public finance management and reforming the economic sector and public institutions. - Mobilizing the direct donor support to the budget to be able to perform its functions.
Public expenditure management	- Paying the inevitable expenditures, particularly wages and salaries, social welfare cash assistance and the operational costs for education, health, water and electricity. - Motivating the public sector employees to take long days off and get part of their salary (Ex. 50% of salary). - Considering the possibility of excluding ghost workers and double. - Reducing the diplomatic missions of Yemen's embassies abroad.	- Excluding ghost workers and double dippers in civil service, the military and security. - Ensuring the total liberalization of fuel prices. - Prioritizing spending on investment programs and giving priority to reconstruction programs and finalizing the stalled projects. - Restructuring the public expenditures in favor of social and developmental spending, as well as raising the maintenance and operational expenses. - Funding a strong investment program to stimulate the national economy.
Reduction of the debt burden	- Negotiating with external creditors to postpone the repayment of external debt obligations during the war period. - Considering the possibility of rescheduling the domestic debt.	- Holding an international conference to exempt Yemen from the external debt and reschedule it.

Main source of data:

Ministry of Finance, Government Finance Statistics Bulletin, Issue (62), the fourth quarter 2015.

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