

CHAPTER 1

PERFORMANCE OF THE NATIONAL ECONOMY

Introduction

The Poverty Reduction Strategy (PRS) includes a number of specific, general, and sector-based goals. This report considers the level of achievement for the PRS objectives, which varies across sectors and, in some cases, within a sector. The main objective is to reduce poverty by 13.1% during the term of the strategy 2003-2005. Achievement of this goal depends on an egalitarian economic growth that surpasses population growth.

The report addresses a number of important questions by monitoring the adopted measures and accomplished projects, reviewing the budget, and assessing implementation levels across the various sectors. The following questions were asked:

- Have the concerned authorities adhered to the policies and programs set out in the PRS?
- To what extent were these policies and programs suitable for the purpose?
- Were the financial resources sufficient to meet the needs?
- Were the financial resources optimally utilized?
- Have the policies and programs achieved their objectives?

Part I. Economic Development

Gross Domestic Product

One of the pillars for reducing poverty is sustainable economic growth. This is achieved through economic stability, development of sectors, and a healthy investment climate.

To raise income levels and create new employment opportunities, it is essential to continue implementation of the economic, financial, and administrative reforms; specifically, restructuring and strengthening local authorities. The PRS aims to raise gross domestic product (GDP) by an average of 4.7% per annum during 2003–2005, and non-oil GDP by 6.3%.

During the period covered by the report (2003–2004), GDP and non-oil GDP achieved average growth rates of 3.5% and 4.5%, respectively (3.3% and 4.5% during 2003, and 3.6% and 4.4% in 2004). Growth rates fell below targets for the period by 1.2 and 1.8 percentage points respectively.

Unfortunately, with a population growth rate of 3% to 3.5%, these GDP rates were not sufficient to reduce poverty. A modest 0.5% increase in per capita GDP was recorded during the period, well below the strategy target of 1.2%–1.7%.

Item	Average			Achievement			Target	
	2001	2002	Average	2003*	2004*	Average	2003	2004
GDP	4.9	4.7	4.8	3.3	3.6	3.5	3.7	5.3
Per capita GDP	1.4	1.5	1.4	0.1-	0.2	0.1	0.5	2.1

* Provisional

The national economy in Yemen relies heavily on the agriculture and oil industries, which are difficult to forecast or control because of their high sensitivity to natural and external factors. This makes the national economy vulnerable to sudden variations. Nevertheless, over the past few years, agriculture and manufacturing have been reasonably stable in their contribution to GDP. On the other hand, development of other potential sectors has fluctuated, and those sectors were unable to reshape the GDP or expand the country's economic base. GDP growth was also affected by the slow growth of the services sector, which makes up around one-third of the total economy.

Table 1.2: Real GDP by Sector

Item	Growth						Contribution to GDP			
	2001	2002	Average	2003	2004	Average	2001	2002	2003	2004
Crude oil	1.6	1.0	1.3	3.4-	1.6-	2.5-	15.3	14.8	13.8	13.2
Non-oil GDP	5.6	5.3	5.5	4.5	4.4	4.5	84.7	85.2	86.2	86.9
Agriculture, forestry, fishing	6.05	-0.1	3.0	3.8	3.5	3.7	21.6	20.6	20.7	20.6
Manufacturing	4.9	7	6.0	4.5	4.1	4.3	10.1	10.3	10.4	10.5
Building and construction	4.8	2.9	3.9	4.2	3.6	3.9	2.1	2.1	2.1	2.1
Trading, hotels, restaurants	4.8	12.1	8.5	5	5	5	8.5	9.1	9.2	9.3
Transportation and storage	6.1	9.3	7.7	4.8	4.2	4.5	11.2	11.7	11.8	11.9
Finance, insurance, real estate, business services	6.5	3.6	5.1	4.6	2.3	3.5	8.9	8.8	8.9	8.8
Government services	4.0	5.2	4.6	4.4	5.4	4.9	21.4	21.5	21.7	22.1

Low domestic savings and reliance on foreign financing, coupled with weak productivity and slow implementation of structural reforms, are contributing factors in the low national economy investments.

The average growth of the agriculture sector (excluding qat) for 2003–2004 was estimated at 3.6%, with an average contribution of 20.6% to GDP. Production of cereals increased by 16.8% in 2004 reaching 487,944 tons, vegetables by 7.8% and fruits by only 0.8%. Livestock grew by 1.3% in 2003 and by 10.5% in 2004. Consequently, production of red and white meat increased by 18.7% and 27.1% respectively in 2004. This has been due to augmented private sector investments in this field and concerted efforts to provide new seeds, combat epidemics, and improve veterinary services.

Box 1-1: The Seeds and Agriculture Services Project

The Seeds and Agriculture services project provided fertilizers at affordable prices. The project transferred considerable quantities of seeds to local companies as well as launched improved seeds. It also implemented qualitative programs to enhance traditional systems for seeds production in five districts, in addition to assisting local companies to reform budgets and management systems as well as to reduce its labor force. In the media field, the project produced and broadcasted T.V. and radio programs targeting farmers on the safety of imported agricultural inputs.

This increase followed the negative growth recorded during 2002, which was caused by the effects of droughts on rain-fed agriculture. Also, recent studies and surveys on soil and land productivity have shown continuous decline in rainfed agriculture and its

productivity due to several reasons including reduced fertilizers' use and abandoning terraces.

A number of factors in the internal structure of the agriculture sector also hamper its ability to contribute to economic development. Most important are the limited and scattered agricultural areas, the use of primitive production tools, and droughts that restrain the expansion of rain-fed production, which is 72% of total cultivated land. Although qat represents 31% of agricultural produce and contributes to a high percentage of employment in the sector and elsewhere, it has a negative effect on ground water overexploitation and to falling food production. Qat cultivated land increased by 4.3% in 2004.

The slow growth of the agriculture sector is a serious threat to poverty reduction efforts, and the weak implementation of sector-related strategies impedes its anticipated transformation. The implementation of Aden Agenda faces various obstacles, including shortage of financial resources, vague responsibilities, unqualified human resources, and weak field and extension services. In 2004, the Ministry of Agriculture and Irrigation in collaboration with the FAO initiated efforts to set a new program for restructuring the Ministry and the sector.

The sector employs over 50% of the total workforce and, along with fishing, is the main source of food. The livelihood of about 74% of the rural population relies on this sector; thus, supporting the agriculture sector would not only increase production and reduce shortages, it would also create new employment opportunities, decrease internal immigration, and increase related exports.

To improve agricultural productivity and sustainability of irrigated agriculture, the GoY supported by the WB and other donors concentrates on improving rain fed agriculture and livestock systems through promoting appropriate crop and seed technology for rain fed crops, and strengthening the capacity of organized farmers and village communities to access livestock related services. Rural Development Projects in collaboration with Agricultural Cooperative Union have encouraged planting in green houses, in particular in the governorate of Sana'a Taiz, Almahweet, and Albaida. Those methods increase agriculture productivity as well as rationalize water use.

The government is also considering exempting inputs to agricultural and fish production from customs, supporting small farmers by reducing irrigation costs, increasing the production and sale of seedlings and genetically engineered products at reduced costs, expanding loans to farmers and fishermen, supporting exports, and reducing air freight.

The average contribution of the oil sector to GDP over the two -year period was 31%, despite a decline of 3.4% in 2003 and 1.6% in 2004. The government's share of oil dropped from 96.2 million barrels (m/b) in 2002 to 95.9 m/b in 2003 and 91.1 m/b in 2004. Its share of oil exports fell to 63.2 m/b in 2003 and 55.7 m/b in 2004. On the other hand, international oil prices increased sharply following the American invasion of Iraq in 2003 and the growing demand for oil during 2004. The price of oil jumped from \$24.60 a barrel in 2002 to \$27.95 in 2003 and \$36.60 in 2004, compared with \$20.40 projected by the PRS.

Oil production of 431,000 b/day in 2003 and 404,000 b/day in 2004 has been higher than PRS projections (401,000 b/day and 390,000 b/day, respectively) as a result of procedures adopted by the Ministry of Oil to control the decline of oil production and preserve current levels. These efforts were coupled with marketing activities that resulted in the execution of production-sharing agreements and other memoranda of understanding with oil companies to broaden exploration in Yemen. Production of crude oil is expected to reach 139 m/b in 2005, based on a reduced daily production to 381,000, which is close to the strategy projection of 370,000. The government shares of exports and domestic consumption are expected to range between 80 m/b and 87.9 m/b, while oil revenues are expected to contribute \$2.5 billion to the budget (based on \$30.30 per barrel).

Although the oil sector plays a vital role in the national economy, the sector provides limited employment opportunities, especially for the poor. In 2004, the sector's workforce was estimated at 17,000. The sector relies on highly skilled and trained individuals and on foreign expertise. Also, the sector enjoys a number of privileges and exemptions that reduce its dependence on the local market for goods and services.

In addition to crude oil, natural gas is a very promising sector. Current production of gas stands at about 2.8 billion cubic feet per day; only 5% of this is used, and the rest is reinjected. Gas reserves are estimated at around 16 trillion cubic feet. Although a gas-related agreement was executed in 1997 and renewed in 2002 for another four years, production and exporting of gas have so far not been realized. The delay in implementation is supposedly due to saturation of international markets and unavailability of new export markets.

The non-oil production sectors include fishing and manufacturing, which, along with tourism, are the major potential sectors to achieve sustainable economic growth, as well as to diversify sources of income and create employment opportunities to reduce poverty. However, average growth of the manufacturing sector recorded a drop from 6% in 2001–2002 to 4.3% in 2003–2004, 1.9 percentage points below the target. The sector's contribution to GDP during the two periods (from 10.2% to 10.4%) indicates that PRS targets were not met and the sector's potential was not used to change the structure of the national economy, create job opportunities, and reduce poverty. The manufacturing workforce in 2004 was estimated at 155,000.

In 2003, the cabinet issued a decree to draft legal frameworks to implement and regulate the three industrial zones, with comprehensive plans to promote the sector and update the feasibility studies concerning the zones. But significant efforts are required to develop the manufacturing sector, especially in improving the investment climate. Current efforts and financial incentives (customs and tax exemptions) have not yet achieved their investment goals. The sector also suffers from weak infrastructure, government bureaucracy, reliance on imports, conservative family businesses, and undeveloped banking facilities. The small manufacturing enterprises that constitute 95% of the sector face great difficulties in obtaining financing.

The government aims to strengthen forward and backward linkages between various industries and with other sectors through appropriate customs and tax policies, increasing the added value and enhancing the role of the banking sector and its related

investment activities. The government is also adopting measures to encourage small enterprises and high-employment manufacturing because of their suitability to the national economy and their potential role in reducing poverty.

Other minerals, construction, and manufacturing of raw materials may also contribute to economic growth. In 2004, the Ministry of Industry and Commerce and the Ministry of Oil and Mineral Wealth submitted draft bills to develop the organisational, institutional, and technical structure of an authority for geological survey and mineral wealth. They included a proposal to establish a “mixed” mining company, a marketing plan to promote minerals and industrial and construction materials, and investment incentives for the sector. The Ministry of Oil and Mineral Wealth conducted a number of surveys and studies during 2003 and 2004, including a survey of stone mines for construction in 2003 and a detailed study of sand and soil in Hadhramout and Dammar in 2004. Promotion of investment opportunities was also undertaken via a number of exhibitions, including one on industrial and construction minerals and stones and one on metallic minerals and stones.

Despite the rise in production and exports of fisheries, the fishing sector constitutes less than 1% of GDP. Sector's growth is estimated at 5.8% in 2003 and 9.5% in 2004. Policies and measures taken by the Ministry of Fish Wealth and other agencies contributed to increasing production from 179,600 tons in 2002 to 256,300 tons in 2004, and exports from \$ 141 million to \$ 212 million over the same period. Conventional fishing is about 90% of total production. The sector would require significant support to develop its potential; the country's 2,200 km of coastline could provide great employment opportunities to the poor in coastal areas. Despite this potential, the sector employs only 60,000 people. The government is currently reviewing all laws, regulations, and procedures that relate to this promising sector. It is working on reforming the sector and involving the private sector in enhancing fishing activities, trading, and fish processing; enhancing resource management; and protecting reserves by delegating responsibility to local authorities.

Tourism-related services witnessed some growth over the past two years. Hotels and restaurants achieved an average share of 0.9% of real GDP, compared with 0.8% in 2001–2002. The number of tourists increased sharply by 58% during 2003, to 154,000, of whom 60% were from Arab (mainly GCC) countries. The percentage continued to rise and is estimated at 77.3% for 2004. The increase is attributed to improved infrastructure, implementation of security plans, promotion of tourism and investment, and simplified immigration procedures at entry ports. It should also be noted that the rigid entry procedures adopted by some countries following September 11 encouraged Arab tourists to turn toward Arab destinations. Returns from tourism during 2003 amounted to \$139 million, an increase of 31% over 2002. The number of people employed by tourism also increased, from 55,000 in 2000 to 61,000 in 2003. Tourism is considered to be a very promising sector in Yemen because of its ability to affect economic growth, provide significant employment opportunities, and reduce poverty. Long-term and ambitious vision are required if tourism is to achieve its potential and play its anticipated role.

The contribution of the service sector during 2003–2004 averaged 31.4% of GDP, with an average growth rate of 5.5%. Personal and community services are estimated to have increased by 11.7% during 2004, while shares of other services remained

relatively stable, and real estate and construction services had negative growth of 2.3%. The service sector accommodates a large workforce, estimated in 2004 at around one million, which is 23.5% of the total workforce. Supporting the growth of this sector will lead to significant new opportunities and overall development of the economy.

Obstacles to Growth

The Yemeni economy is tenuous and vulnerable to shocks and external factors. The events experienced during 2001–2004 had a tangible impact on the economy and economic forecasts. Nevertheless, despite their importance, external factors cannot always be blamed; internal factors that hamper growth should also be addressed.

Failure of the promising non-oil sectors to achieve their potential is attributed to their weak infrastructure and the inappropriate environment in which they operate. Economic, financial, and Administrative reforms have not resulted in tangible enhancements in the production and service sectors, because they focused on stabilizing the financial and monetary aspects. Structural reforms have been slow in coming, which has slowed improvement in the investment climate.

The economic, financial, and administrative reform program faces major challenges that call for serious measures. Challenges are apparent in weak administration (privatisation), lack of a clear vision (exporting natural gas), weak capacity for implementing projects that hampers their execution (civil service), and lack of focus and prioritisation (Aden Free Zone/accession to the World Trade Organization).

The lack of progress may be attributed to the time-consuming nature of reforms, the relatively poor driving force for reform, and the resistance to it, as well as obstacles that hamper implementation of reforms. Nevertheless, the government endeavors to overcome these challenges and pursue the reform programs through integrated strategies and efforts, enhancing the political will in this respect.

Box 1-2: Accelerating Growth

The government acknowledges that accelerating economic growth is an economic and social necessity, and that it is obligated to implement any measures necessary to enhance the investment climate in order to raise comparative and competitive advantages. The government cannot rely on the financial and other incentives provided by the investment law, because these incentives have failed to attract the required investments. Developing infrastructure and government services, and reducing bureaucracy will provide a better climate for the development and growth of the non-oil sectors. Therefore, the government will embrace economic and investment policies that support potential and promising sectors, such as fishing and tourism, in addition to producing natural gas for domestic consumption and exploring international export markets. The government also continues to explore new strategic opportunities for projects in the fields of natural gas, minerals, fertilizers, manufacturing and transport, in addition to completing strategic coastal, mountain, and desert roads.

Consumption, Saving, and Investment

To reduce poverty, it is necessary to achieve high economic growth and general macroeconomic balance, as well as adopting economic policies that enhance investment and mobilize resources. Average domestic consumption during 2003–2004 stood at 76.8% of total GDP, 3.3 percentage points below the average for 2002–2003, and 8.8 percentage points below the target.

Private consumption declined from 65.7% in 2001 to 60.1% in 2004. On the other hand, public consumption was relatively unchanged in that period, despite an increase to 16.1% in 2003 that was due to parliamentary elections and related expenditures. The steady decline in consumption denotes weak purchasing power resulting from low real incomes in general and low wages and salaries in

Table 1.3: GDP according to Spending (%)

Item	Actual		Achieved		Target	
	2001	2002	2003	2004	2003	2004
Total consumption	80.2	80.0	79.5	74.1	84.9	86.3
- Private	65.7	64.4	63.4	60.1	67.2	68.6
- Public	14.5	15.6	16.1	14.1	17.7	17.7
Total investment	18.9	20.8	22.1	23.0	24.6	25.8
Domestic Consumption	99.2	100.8	101.6	97.2	109.5	112.1
Balance of goods and services	0.8	0.8-	1.6-	2.8	9.5-	12.1-
Exports of goods and services	36.6	38.4	38.1	39.0	32.1	28.6
Imports of goods and services	35.8	39.1	39.7	36.2	41.6-	40.6-

particular. This implies that food needs absorb the largest portion of incomes, which impedes poverty reduction efforts.

The decline in total consumption resulted in raising average gross investment share to 22.5% of GDP for 2003–2004, compared with 19.9% for the preceding two years. Nevertheless, total investments remained below targets by an average of 2.7 percentage points. Government investments made up most of this and represented 7.5% of GDP on average for 2003–2004; they are expected to remain at this level during 2005. These figures do not vary significantly from previous years; they raise concerns about the inability to raise investments to the required levels and, thus, reduce poverty.

The country seems unable to attract enough private domestic and foreign investment, largely because of the distorted image of security in Yemen. In addition, the Aden Free Zone suffers from poor investment efforts and lack of a long-term vision to make the most of its strategic geographic location. And finally, low incomes in the country prohibit saving and investment. The government plans to enhance investment through a well-thought-out plan based on the measures listed in the policy matrix.

Investment Climate and the Private Sector

The PRS aims to create an attractive investment environment for local and international investors, including Yemeni expatriates. The PRS also aims to enhance the involvement of the private sector and strengthen its role in the non-oil sectors to increase and sustain economic growth.

Investment and the Business Climate

The reform program and other measures undertaken by the government have contributed to enhancing investment opportunities in Yemen. The number of registered investment projects has increased since 2000, as illustrated in a rise in investment indicators in international publications. During 2003–2004, the Investment

Authority carried out a number of legislative and legal procedures to enhance the environment. It enacted the executive bylaws of Investment Law No. 22 for 2002 and Cabinet Decree No. 1 of 2003, providing more power to the authority's branches in Ibb, Al Mahara, and Hadhramout, and simplifying registration procedures. Registration now requires only eight days at the main office and nine days at the branches. The length of time to obtain commercial registration has been reduced to five days.

Table 1.4: Indicators of Business Environment

Indicators	2002	2003	2004	Region's Average for 2004
1- Start-up activities				
- Number of procedures	-	13	12	10
- Number of working days required	95	96	63	39
- Cost of accomplishing procedures (% of per capita income)	317	24	269	51
- Minimum capital required (% of per capita income)	2,803	1,717	1,561	856
2- Registration of ownership				
- Number of procedures	-	-	6	6
- Number of working days required	-	-	21	54
- Cost of registration (% of per capita assets)	-	-	3.9	6.8
3- Executing contracts				
Number of procedures	-	27	37	38
Number of working days required	-	240	360	437
Cost (% of per capita income)	-	0.5	10.5	17.9
4- Liquidation of business				
Liquidation time (years)	-	2.4	3	3.9
Liquidation cost (% of assets)	-	4	8	13

The monthly *International Country Risk Guide for 2003*, published by the Political Risk Services, indicated that Yemen falls into the moderate risk category, with a recorded increase of 1 point to 67 points during the period from December 2002 to December 2003. Yemen maintained its rank of 81. The annual *World Bank Report on Doing Business* also recorded a relative increase in 2004, particularly in comparison with the regional average. *Indicators of Economic Freedom*, published by Freedom House, also recorded a rise to 3.7 in 2004.

Overall, the delay of implementing reforms and governance measures had a negative effect on the improvement of the investment climate. The role of the Investment Authority as the responsible agency is still limited to following up on registered investment projects, collecting statistics, and supervising investors' compliance with executed agreements. The number of government agencies involved in investment activities and issuance of project licences (General Investment Authority, Free Zones Authority, Tourism Promotion Council, and General Authority for Island

Development) contributes to an investment climate that is not reaching its potential. The government should reconsider the responsibilities and jurisdictions of the various bodies involved, with a view to simplifying procedures and enhancing the role of local authorities.

The investment climate suffers from a number of geographic and sector-based challenges. The industrial and service sectors constitute over 56% of licensed investment activities, and these activities are concentrated in limited areas. Their contribution to economic growth and employment opportunities is limited. Despite the relative improvement in the implementation of investment projects, the rates are still low.

The government is currently working with the private sector to develop a strategic plan to enhance the business and investment environments. It will provide more incentives than those provided by the Investment Law, accelerate Yemen's accession to the WTO, execute free trade agreements with the west, and encourage privatisation, particularly in the fields of telecommunications and infrastructure.

In 2004, the government held a workshop for ministries and other government agencies, business organisations, and the private sector. Workshop participants explored the challenges facing investment and drew up specific recommendations and procedures to enhance the business and investment climate in Yemen.

Private Sector Activities

The private sector's contribution to total investments during 1996–2000 averaged 42%. It is expected to average 39.7% for 2001–2004, compared with a target of 58% for the period 2001–2005. Statistics show a retreat in private sector investment compared with levels achieved in the years preceding the implementation of the reform program, because the business and investment climates have not developed sufficiently. About 338 investment projects were registered in 2003 and 362 projects in 2004, at a cost of YR106 billion and YR114 billion, respectively. The most important of these projects were the building of an oil refinery in Hadhramout, two cement factories in Lahj and Hadhramout, the Saudi German Hospital in Sana'a, and other factories and mills.

Law No. 28 for 2003 on the Federation of Chambers of Commerce and Industry was enacted, and the administrative board of the federation was reformed after long suspension of its activities. A Yemeni Businessmen and Investors Council was also established, and a number of small businesses in the governorates of Taiz and Aden established professional associations to look after their interests.

The Privatization Program

The privatisation program aims to privatize 61 public enterprises by the end of 2005. During 2003, eight entities were privatized; seven were auctioned and one was assigned to the Yemeni Economic Corporation to manage the government's share, as a first step toward reaching consensus with shareholders on a privatisation mechanism. By the end of 2003, 37 entities were fully privatized; 60% to the private sector and 40% to the Yemeni Economic Corporation and the Ministry of Defence.

Only five entities continued production, while the majority were transformed to pursue other economic activities. Employees' salaries continued to create a liability for the national treasury. Privatisation efforts declined in 2004. Of five targeted public units, only Awsan Biscuit Corporation and Automatic Bakery in Mansoura was sold to a local investor. The Salt Company in Salif and the Paint Company in Aden were transformed into joint stock companies and shares were transferred to the employees. The Mareb Poultry Company and the General Potato Seeds Company in Dammar are currently being considered for privatisation.

In 2004, Parliament decided to merge public and mixed banks into a Bank of Development. This decision has resulted in a number of challenges owing to the nature of the banks' activities, objectives, and financial liabilities. Other obstacles stand in the way of accomplishing the privatisation programs: the fact that the liquidation committee takes anywhere from four months to over a year to render a decision, the lack of interested buyers, the geographically scattered nature of the assets, and ownership-related disputes.

Effect of Economic Development on Poverty

The economic growth that has been achieved has failed to reduce poverty in the presence of a 3.5% population growth. To reduce poverty, create job opportunities, and reduce unemployment, the government must meet targets for economic growth by supporting non-oil sectors and must continue with efforts to lower population growth.

In the absence of a household budget survey in 2005, it is

Item	Urban	Rural	Total	Percentage Change 1998–2003		
				Urban	Rural	Total
Food poverty	8.4	21.3	18.3	-16.0	7.0	3.3
Absolute poverty	21.1	45.7	40.1	-31.5	1.6	-4.1

difficult to accurately measure poverty indicators. The World Bank estimated poverty levels through two mechanisms that gave similar results.¹ The estimates indicated a slight drop in poverty during 1998–2003, from 41.8% to 40.1%. Although this trend is considered to be quite slow.

The data showed a tangible reduction in poverty levels among urban areas to 21%-28% in 2003 versus 30.8% in 1998. On the other hand, poverty levels in rural areas did not change much, from 45% to between 44% and 46% at best. The government plans to provide more resources over the next few years for the social safety net to reduce poverty.

Labor and Unemployment

Economic growth, imbalances in the GDP structure, and restrictive financial and monetary policies were reflected in the labor market. The number of workers

¹ The first mechanism relied on a consumption function based on the 1998 household budget survey and applied to the 2003 health survey; thus, personal spending was used to project poverty estimates. The second mechanism estimated poverty through a simulation model based on the 1998 household budget survey and assuming that personal spending increases at the rate of economic growth.

increased from 3,942,000 in 2002 to 4,051,000 in 2003 (a 2.7% growth rate) and to 4,134,000 in 2004 (a 2.1% growth rate). Both rates fall below workforce growth, which is estimated at 4% per annum. The rates are low considering the size of the population, especially for women, whose participation (estimated at 22.7%) is the lowest among all developing countries. GDP growth has not kept up with workforce growth, which reduces employment opportunities. It is estimated that unemployment rose from 13.2% in 2002 to 14.8% in 2004.²

The Yemeni labor market suffers from significant segmentation and leading to a disparity in wages among the different economic sectors, between males and females, and between locals and expatriates. This situation exists despite the ambitious plans that accompanied implementation of the reform program. In 2003, the government workforce represented 10.9% of the total workforce. Reducing the public workforce will cause a rise in the nonformal sector that constitutes 60% of the total workforce. The nonformal sector controls agriculture and construction, and is the most important component of private sector activities that favor the employment of male laborers.

Providing employment opportunities is one of the major challenges facing the government. The industrial sector may not in the near future replace the agriculture sector, which accommodates about 52% of the total workforce and 89% of female workers. To increase employment opportunities outside of agriculture, the government will have to enhance the investment climate, develop the production sectors, and support the economy through financial and monetary policies that accelerate growth. Economic policies should not be biased to local production at the expense of exports or to capital-intensive projects at the expense of labor-intensive projects, and skilled labor should not be driven to neighboring countries.

Monetary and Banking Policies

Monetary Developments

Money supply increased by 20% in 2003, compared with 18% in 2002, as a result of the rise in government spending and the reduced issuance of treasury bills that failed to neutralize over liquidity. This resulted in high inflation, reaching 12.1% (excluding qat), compared with 4.5% in 2002. In 2004, the rise in the government's share of oil exports contributed to increasing the foreign assets of the banking sector by YR146 billion and reducing net local assets by about YR26 billion. The local liquidity growth rate fell to 15% and inflation to 10%.

In 2005, the money supply is expected to grow by about 18%, based on the continued relationship between money supply and non-oil GDP and the impact of the real interest rate. The expansion effect of net foreign assets is expected to drop against local liquidity to 7%, compared with 18% in 2004, as a result of a decline in the amount and prices of exported oil (government share). The rise in public spending in the absence of a similar rise in public revenues caused a shift in the budget position of the banking sector from a surplus of 2% of GDP in 2001 and 0.6% of GDP in 2002 to a deficit of 4.1% in 2003. This created excess liquidity in the economy. The deficit

² Estimate is based on the human resource balance approach.

was transformed into a surplus of 0.8% of GDP in 2004 as a result of a rise in government revenues from oil exports.

Interest on loans and deposits remained constant at 15%–22% on loans, 10.5% on savings, and 12%–15% on deposits, for an average of 13%. The current interest rates contribute to supporting the monetary policy; specifically, to controlling inflation. The ratio of circulated currency to broad money supply dropped from 54% in 2002 to 51% in 2003 and 47% in 2004. The ratio of deposits of quasi-money to broad money supply rose from 31% to 34% to 38% in the same period. Real interest rates remained at positive values and supported relative stability of the exchange rate. Interest on the local currency exceeded that on foreign currencies. Nevertheless, the Monetary Authority continues to review real interest rates for consistency with the financial and monetary objectives, to support the production sectors, and to control the “dollarization” phenomenon.

The Central Bank pursues a flexible exchange rate policy and intervenes to calm sharp fluctuations in the market resulting from noneconomic factors, while adopting a liberalized exchange system on payments and transfers relating to international transactions. The increase in foreign reserves at the Central Bank by 10% in 2003 and 14% in 2004, in addition to procedures adopted by the bank, contributed to achieving relative stability in the exchange rate, especially during 2004. The value of the rial against the dollar dropped by about 3% during 2003 as a result of pressures resulting from the turmoil in the region. On the other hand, the rial fell by only 0.26% against the dollar during 2004 because of the depreciation of the dollar against other currencies. The euro and the pound fluctuated against the rial.

In a small and open economy like that of Yemen, changes in the exchange rate affect variables of the macroeconomy in general and inflation in particular. Imported inflation also affects the Yemeni economy. The value of imports rose 23.4% in 2002 and 31.4% in 2003.

Banking Developments

The unified budget of commercial banks recorded a rise of 21% and 22% in 2003 and 2004, respectively, compared with 24% in 2002. It reached over YR686 billion (equivalent to \$3.7 billion) in December 2004, of which \$889 million in foreign assets represented 24.1% of the total assets of commercial and Islamic banks. Rial deposits in commercial banks increased 24.8% in 2003, from YR189 billion in 2002

Item	2002	2003	2004
Total deposits	388	475	574
Local currency deposits	189	236	309
Foreign currency deposits	199	239	264

to YR236 billion; and then by 31.1% in 2004, to YR309.4 billion. Foreign currency deposits increased by 18.2% in 2003, from YR198.8 billion (equivalent to \$1.1 billion) to YR238.6 billion (equivalent to \$1.3 billion). The growth rate dropped to 11.3% in 2004; deposits amounted to about YR267 billion (equivalent to \$1.4 billion) by the end of the year. The rise in local currency deposits is attributed to relative stability in the exchange rate and the continued high interest on rial deposits compared with low interest rates on foreign currencies.

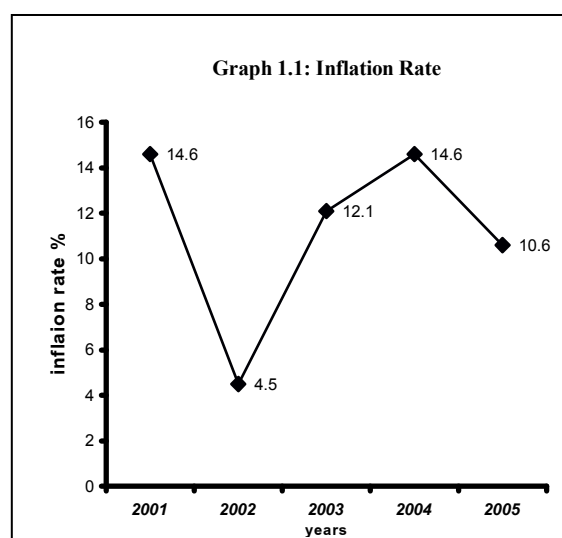
Credits offered to the private sector rose from YR109 billion in 2002 to about YR138 billion in 2003 and YR184 billion in 2004. They are expected to grow by 35% during 2005 to 9% of GDP as a result of the improvement of the commercial courts. However, the development and investment roles of banks are still limited. Banking credits accounted for less than 24% of the banks' total assets at the end of 2003 and about 27.9% in 2004. Banks invest 70% of their assets in low-risk assets and investments such as foreign assets (28%), stocks and deposit certificates (27%), and accounts at the Central Bank (15%).

The private sector took out the largest share of bank loans: 55.2% in 2003 and 54% in 2004, compared with 59.2% in 2002. The remaining loans were taken out by the public sector. Short- and long-term commercial bank loans and investments of Islamic banks were directed to financing trading in manufactured goods, to the industrial sector, and to financing other imports. The share of construction stood constant at 8%, and agriculture and fishing was only 1% during 2002–2004. This illustrates a decline in the share of the production sectors that can contribute to accelerating economic growth, especially in the promising sectors.

Banks' reluctance to use surplus funds is attributed to many factors, such as high interest rates on loans, concerns about sudden exchange rate fluctuations, and concerns about judicial and investment infrastructure, including the difficulty of recovering loans and the long time frame for recovering capital in the production sector. In early 2004, the cabinet decreed that the banks of the public and mixed sectors would be merged in order to finance development projects, and most shares would be offered to the public. Also, at the end of 2004, the Central Bank decided to raise the capital of operating banks to YR6 billion, to strengthen their financial standing and increase their economic capacities. This will be gradually enforced before 2009.

Inflation and Prices

Achieving economic stability and controlling inflation are two of the most important objectives of the PRS because of the inverse relationship between inflation and living standards. Inflation (consumer price index excluding qat) rose from 4.5% in 2002 to 12.1% in 2003 and 14.6% in 2004. Thus, inflation rates exceeded target rates by 3.1 percentage points in 2003 and 9.6 percentage points in 2004. Food and beverage indexes of 16.6% in 2003 and 19% in 2004 also contributed to rising inflation as they represent 43.8% of the consumption basket. Inflation is expected to reach 15.6% in 2005 as a result of the lifting of the subsidy on oil derivatives, which will increase prices by 5%. This will seriously affect the competitive position of exports.



Foreign Sector

The PRS emphasizes the importance of liberalising trade, encouraging exports, and attracting foreign investment to increase job opportunities, enhance incomes, and reduce poverty. The strategy also stresses the importance of economic integration with GCC countries, establishing the Arab Free Trading Zone, and completing measures to access the WTO, in addition to improving management of the public debt and foreign reserves. The balance of payments continued to record a surplus, reaching \$336 million in 2003 and \$532 million in 2004, which constituted 3% of GDP in 2003 and 4.1% in 2004, compared with \$597 million in 2002 (5.8% of GDP). The current account contributed toward the surplus despite declining from \$434 million to \$176 million before rising to \$471 million in 2004 (3.7% of GDP). The trade balance also continued to achieve a surplus over the same period despite its decline to \$367 million in 2003, followed by a rise to \$937 million in 2004 (7.3% of GDP).

	2000	2002	2003	2004
Current account	13.8	4.3	1.6	3.7
- Trade balance	13.8	5.8	3.3	7.3
- Services balance	-6.5	-6.6	-4.8	-5.3
- Income balance	-8.2	-7.9	-9.1	-9.5
- Transfer balance	14.7	13.0	12.2	11.2
Capital account	-2.4	-0.1	1.2	0.7
- Direct investments	0.1	1.0	0.1	-0.2
- Other investments	-2.5	-1.1	1.2	0.9
- Errors and omissions	3.0	1.7	0.2	-0.2
- Balance of payments	14.4	5.8	3.0	4.1

Oil exports are the backbone of the trade balance and the balance of payments. Government's share of oil revenues rose from \$1,600 million in 2002 to \$1,828 million in 2003 and \$2,259 million in 2004, which contributed to the balance of payments and the current account. This rise is attributed to a rise in export prices that compensated for the drop in quantity. Nonetheless, the trade balance suffers from a structural deficit caused by poor non-oil exports and the increase in imports to meet the need for most goods and services.

At the end of 2003, the outstanding balance of external debt stood at about \$5,377 million, compared with \$5,044 million in the previous year. The balance remained almost unchanged in 2004 at \$5,381 million. Thus, its share of total public debt was reduced to 87% at the end of 2003 and 85% at the end of 2004. In 2003, an increase in drawing on loans compared with loan repayment, as well as the appreciation of lending currencies, contributed to increasing the outstanding balance by about 6.7%. This includes all long-term scheduled debts, new loans, and facilities executed following Paris Club arrangements in 1996, 1997, and 2001.

The outstanding balance declined from 48.9% of GDP at the end of 2002 to 47.7% in 2003 and 41.7% in 2004. Yemen ranks ninth among Middle Eastern countries in terms of debt size, with a share of about \$258 per person.

Part II. Assessing the Budget

Performance of the Budget

The budget is one of government's major instruments to achieve economic and social objectives; this is especially true in Yemen, where the budget accounts for 30%–35% of GDP. Sound management and channelling of public spending to development projects, basic social services, and financially viable enterprises play a vital role in economic development and reduction of poverty. Prudent fiscal and monetary policies lead to economic stability, fair distribution of income, stabilisation of the exchange rate, and control of inflation. Fiscal policy is also the basis for achieving other economic goals, including the creation of growth and job opportunities.

Box 1.3: Enhancing the Impact of the PRS Mechanism on the Budget

The PRS mechanism was only fully operational in the second quarter of 2003; thus, it was not involved (as required) in the preparation of the 2004 budget. Other institutional and technical factors require better organisation to support the role and create the required relationship between the PRS and the budget. The timing of decisions is one important factor; in 2003, decisions were made late, with insufficient time to discuss them with the authorities or submit recommendations. PRS subunits were not effectively involved in the preparation of the budgets of ministries and government agencies, or even in raising the awareness of the local committees that were responsible for assisting in the preparation of local budgets. The incomplete status of databases and of the poverty monitoring system, as well as the lack of fiscal information, further weakened the role of the PRS in its early phase.

Status of the Budget

The budget has been affected by growing public spending; in particular, current expenditures. Public expenditures grew by 30.8% in 2003 and 13.9% in 2004, compared with public revenue growth of 18.7% in 2003 and 21.9% in 2004. The net deficit rose from about YR14.3 billion in 2002 to YR88.8 billion in 2003 and YR46.4 billion in 2004. The deficit increased from 0.8% of GDP in 2002 to 4.3% in 2003, then dropped to 1.9% of GDP in 2004. The net deficit remained within the safe bounds set by the PRS.

The gross deficit rose from YR9.1 billion in 2002 to YR90.5 billion in 2003 (rising to 4.4% of GDP), then dropped to YR65.7 billion in 2004 (2.8% of GDP). The deficit is expected to rise in final accounts to YR188.6 billion at the end of 2004 as a result of the inclusion of supplementary allocations. In

2003, the gross deficit was financed through local means (98.2%), mostly by treasury bills to avoid the inflationary effects of financing. This helped stabilize the value of the rial against foreign currencies. The contribution of local resources to the total deficit declined in 2004 to about 70.7%. The 2005 budget is expected to show a rise in

Table 1.8: Budget Status and Financing Resources (% of GDP)

Item	Actual			Proposed Budget 2005	PRS Target	
	2002	2003	2004*		2003	2004
Surplus/deficit (net)	-0.8	-4.3	-1.9	-3.0	--	--
Surplus/deficit (gross)	-0.5	-4.4	-2.8	-4.3	3.0	4.0
Net foreign financing	-0.3	0.1	0.8	3.0	1.3	1.3
Net local financing	0.8	4.3	1.9	1.3	1.7	2.7

the deficit to YR106.8 billion (about 4.3% of GDP); 32.2% of this deficit will be financed by net foreign loans, so the net deficit will be YR74.6 billion (3% of GDP).

Public Revenues

Data indicate that local revenues and grants grew by 18.4% in 2003 and constituted 23.5% of GDP. Provisional data for 2004 estimate revenue growth of 19.5%, resulting in revenues and grants amounting to 33.7% of GDP. The 2005 budget proposal expects a decline in revenues and grants to 28.4% of GDP as a result of a drop in oil prices and the government's share thereof.

Oil Revenues

Despite the fiscal and monetary reforms undertaken by the government since 1995, the budget still suffers from a number of imbalances; mainly, dependence on oil revenues, which were 61% of total revenues in 2002 and 72.3% in 2003, and are estimated at 72% in 2004. On the other hand, the share of tax revenues declined from 24.3% to 22.7% during the same period, and is estimated at 22% in 2004.

Item	Actual			Proposed Budget 2005**	PRS Targets	
	2002	2003	2004*		2003	2004
Total revenues and grants (1+2+3)	31.3	32.5	33.7	28.4	-	-
Total revenues (1+2)	30.9	32.1	33.6	17.7	-	-
1. Current revenues	30.9	32.1	33.6	27.6	31.4	29.7
A. Oil and gas revenues	18.8	19.8	24.3	18.1	20.3	17.9
- Exported oil	14.6	14.8	15.6	9.0	11.3	9.2
- Locally sold oil	3.9	4.7	8.5	8.3	-	-
- Gas sales	0.3	0.2	0.2	0.7	-	-
B. Tax revenues	7.6	7.4	7.4	7.7	8.8	9.5
- Direct taxes	3.4	3.3	3.3	-	3.6	3.8
- Indirect taxes	4.2	4.1	4.1	-	5.2	5.8
- Customs	2.1	2.0	2.2	2.1	2.5	2.8
C. Other non-tax current revenues	4.4	4.8	1.9	-	2.3	2.3
2- Capital revenues	0.0	0.1	0.0	0.1	0.0	
3- Grants	0.4	0.4	0.1	0.7	0.8	0.8
Revenues from loans and sales of equity	0.1	0.0	0.0	-	-	-
Lending	0.6	0.8	1.5	-	-	-
Total revenues	32.0	33.3	35.2	-	-	-

* Provisional. ** Estimated.

The 2005 proposed budget continues to depend on oil and gas revenues amounting to YR449.2 billion, based on lifting the subsidy on oil derivatives in the local market, against an expected decline in government's share of oil exports to 41.7 million barrels at \$2.3 billion (equivalent to YR225 billion).

Non-Oil Revenues

Direct and indirect taxes are the main source of non-oil revenues. Non-oil revenues constituted 22.2% of total revenues and grants during 2003–2004. They grew by 10.8% in 2003 and by 15.5% in 2004, but the increase did not meet PRS targets of 8.8% and 9.5% of GDP, respectively; rather, the percentage remained constant at 7.4%. Direct taxes averaged 3.3% for the two years, compared with targets of 3.6% for 2003 and 3.8% for 2004. Indirect taxes accounted for 4.1%, compared with targets of 5.2% for 2003 and 5.8% for 2004. The 2005 budget estimates total tax revenues at YR191 billion, compared with about YR176 billion in 2004, according to provisional data.

The government must introduce a comprehensive policy to mobilize tax revenues, based on enforcing the general sales tax (GST) as a sustainable revenue source that could provide 3%–5.4% of GDP. Tax system reforms will continue in order to build the capacity of the Tax Authority and enable it to collect other taxes estimated at 4%–6% of GDP. Preparations for restructuring the Tax Authority were finalized in 2004 as part of the Civil Service Reform Program.

Some related procedures were deferred, including the enforcement of Law No. 19 of 2001 with respect to the GST Law; the enactment of Law No. 14 of 2004 (postponed to July 2005); and the imposition of new taxes on some goods and services previously exempted by Law No. 70 of 1991 and its amendments.

Enforcement of the GST law has been deferred because of wide criticism from business owners, especially in the industrial sector. The proposed law was referred to the Shura Council; it will be discussed by representatives of the government and the Federation of Chambers of Commerce and Industry to reach agreement and achieve the economic, financial, and social objectives of the law while avoiding damage to the interests of the private sector.

Customs revenues increased from 11.7% in 2001–2002 to 13.2% in 2003 and 22.7% in 2004, increasing its ratio to GDP to 2% in 2003 and 2.2% in 2004 compared with the PRS targets of 2.5% and 2.8%. This improvement is attributed to steps taken to enhance the Customs Authority and simplify its procedures; implementation of Phase II of the electronic system; and enforcement of the ban on cars that enter the country illegally. The new electronic system is operational in the five main ports of Hodaidah, Haradh, Sana'a Airport, Aden Port (Mualla), and Aden Airport, in addition to the authority headquarters. The system is expected to be implemented in all branches and main ports by the end of 2005. Restructuring of the Customs Authority will commence in early 2005.

The 2005 budget estimates customs revenues at YR51.1 billion. However, the government plan to reduce customs tariffs on most imported goods will initially reduce revenues. It is possible to overcome the decline of revenues and, in fact,

increase them by 1%–2% of GDP by adopting strict legal and regulatory measures to combat direct and indirect smuggling, in addition to optimising customs exemptions for cars, machinery, and tools. Collection efficiency can also be enhanced by building the capacity of personnel and the ongoing development of customs administration, especially relating to dues, value, and classification.

Other nontax revenues increased from 4.4% in 2002 to 4.8% of GDP in 2003, then dropped to 1.9% in 2004, compared with the 2.3% PRS target. In 2005, an executive program will be put in place to reform and activate all non-oil resources and proposals will be submitted to amend laws relating to the fiscal policy package, especially the finance law, public tenders, and customs and tax laws.

Foreign grants increased by 8.2% in 2003 and remained constant at 0.4% of GDP, compared with the target of 0.8%. They dropped to 0.1% during 2004. Total grants amounted to YR1.8 billion during 2004 and are expected to increase to YR18.5 billion in 2005 (0.7% of GDP). External lending increased from YR10.7 billion in 2002 to YR15.6 billion in 2003, for a growth rate of 46.6%. It is expected to increase by 125.6% during 2004 to about YR35.3 billion; this is the equivalent of 4.2% of public revenues, compared with 2.3% in 2004.

Public Expenditures

The PRS fiscal framework incorporated a number of measures and policies relating to controlling the growth of public spending, especially current expenditures, while increasing development expenditures by an annual rate of 13.3% during the PRS years. Public expenditures grew by about 30.8% in 2003 and declined by an estimated

Item	Actual		Proposed Budget		PRS Targets	
	2002	2003	2004*	2005**	2003	2004
Current Expenditures	24.4	25.5	26.3	23.4	28.2	27.1
1-Salaries and wages	10.4	9.8	9.5	10.7	9	9.2
2-Goods and services	3.6	3.6	3.5	3.4	2.8	2.9
3-Maintenance	0.6	0.6	0.3	0.5	0.4	0.4
4-Interest payments	1.9	1.8	2.3	2.1	2.2	2.4
5-Current subsidy and transfers	7.2	9.0	9.9	6.0	6	4.9
a- Subsidy	3.1	5.3	6.2	-	2.2	1.2
– Electricity	0.2	0.3	0.3	-	-	-
– Petroleum products	2.9	5.1	6.0	-	-	-
b-Current transfers	4.1	3.6	3.7	-	3.9	3.8
6-Other current expenditures	0.6	0.7	0.7	0.8		
Capital and Investment Expenditures	6.2	9.6	8.7	7.9	7	7.4
Government Lending and Equity	1.4	1.9	1.5	1.5	-	-
Debt Repayment	0.9	0.7	0.7	0.8	-	-
Total of Expenditures	32.8	37.6	37.1	33.6	35.2	34.5

13.9% in 2004. Public spending (excluding foreign finance) in January–August 2004 amounted to YR529.3 billion, which amounts to 77.3% of the allocations for the fiscal year, exceeding budget estimates for the period by about YR72.8 billion (16%). The percentage of public spending to GDP rose from 32.8% in 2002 to 37.6% in 2003, exceeding PRS targets by 2.4 percentage points. This increase was due to the 19.3% growth in current expenditures (compared with 12% in 2002) and the rise in average capital and investment expenditures to 9.6% (compared with 6.2% in 2002). Also, despite the decline of average public spending to 13.9% in 2004, provisional data indicate its rise to 37.1% of GDP, exceeding the target by 1.9 percentage points.

Current Expenditures

Current spending makes up the largest share of public expenditures. It rose from 67.7% of public expenditures in 2003 to 70.7% in 2004, despite relatively constant growth rates of 19.3% in 2003 and 19% in 2004. This represented an increase to 25.5% of GDP in 2003 and 26.3% in 2004. The government took a number of measures to control spending on wages and salaries, which grew by 7.1% in 2003 and 12.5% in 2004 as a result of civil service salary increases of 20%–40%. Wages and salaries as a percentage of GDP declined from 10.4% in 2002 to 9.8% in 2003 and to an estimated 9.5% in 2004. The PRS targets for 2003 and 2004 were 9% and 9.2%, respectively. Spending on wages and salaries as a percentage of total public spending declined from 31.5% in 2002 to 26% in 2003 and an estimated 25.7% in 2004.

Spending on wages and salaries is expected to increase to 16.4% in 2005 due to continued demands from government agencies, reaching 32% of total public expenditures. This increase will offset the rise in prices resulting from lifting subsidies on oil derivatives. The government plans to enact a strategy and law on wages and salaries during 2005 as part of the economic, financial, and administrative reforms. The implementation of the strategy will coincide and integrate with other structural reforms to improve public services.

The budget suffers from increased current transfers and subsidies, which continued to rise during 2002–2004 because of the growing oil subsidy. Spending rose from YR131 billion in 2002 to about YR186 billion in 2003 and YR236 billion in 2004. The growth rate was 41.9% in 2003 and 26.9% in 2004. Transfers and subsidies amounted for 7.2% of GDP in 2002, 9% in 2003, and 9.9% in 2004, exceeding PRS targets by 3 percentage points in 2003 and 5 percentage points in 2004. The 2005 budget projects a YR87 billion (36.9%) drop in these allocations to 6% of GDP as a result of price reforms for oil derivatives.

The subsidy for oil derivatives grew from 2.9% of GDP in 2002 to 5.1% in 2003 and 6% in 2004. The electricity subsidy remained relatively low at 0.2% in 2003 and 0.3% in 2004. Subsidies are a large burden on the budget. Price reform is an economic necessity in light of growing domestic consumption of oil derivatives and a decline in oil production. The government has carried out broad political and media campaigns regarding the risks of continued oil subsidies and offered a package of reforms before the joint meeting of Parliament and the Shura Council in September 2004. The 2005 budget proposal included a significant reduction in the subsidy on oil derivatives. The

government will abolish the subsidy gradually to avoid negative political consequences of the decision.

The government is reviewing administrative and technical reforms in electricity to increase efficiency and capacity. Reforms are aimed at reducing the cost of generating electricity, reducing waste, and increasing financial returns. Gas-based electricity stations such as the Mareb Power Plant, expected to be completed in 2007, are an essential step in this direction.

The government is trying to control current spending as part of improving the efficiency of public spending management; this includes not resorting to supplementary allocations at the end of the year, which weakens the government's ability to achieve financial control and the role of the budget in determining priorities. The most important efforts are using indicative ceilings to set budgets based on a medium-term expenditure framework and enhancing internal control and audit on public spending.

Development and Social Spending

Capital and investment spending increased by 77.9% in 2003, up to 25.5% of total expenditures and 9.6% of GDP, and exceeding the PRS target by 2.6 percentage points. The increase in such spending declined to 4.7% in 2004, to 23.5% of public expenditures, and its ratio to GDP declined to 8.7%, compared with the 7.2% PRS target. Majority of the increase went to central allocations, in particular transfers and subsidies that grew by 59% in 2003. Diesel subsidy took up the lion's share%. Projects financed by government retained YR 65,675 million, allocated to roads, electricity and others.

Development spending targets sectors closely related to poverty reduction, to provide basic social services and enhance the livelihood of the population. Social and community spending in education, health, and social welfare grew 11.2% in 2003 and 23.3% in 2004, for a ratio 8% of GDP in 2003 and 8.2% in 2004. However, these ratios remain below PRS targets by 4.1 percentage points for 2003 and 4.2 percentage

points for 2004, indicating low levels of spending on social sectors.

The PRS aims to raise spending on education by an annual average of 12.9%. The actual increase was

Table 1.11: Public Expenditures According to Functional Classification

Item	Actual			PRS Targets	
	2002	2003	2004*	2003	2004
Public services	6.7	9.0	8.1	-	-
Defense	7.1	6.6	4.9	6.5	6.3
Safety and public order	2.4	2.7	2.4	-	-
Economic affairs	5.0	7.1	3.5	-	-
Environment protection	0.0	0.6	0.8	-	-
Housing, local community affairs	1.9	2.2	1.6	-	-
Entertainment, culture, and religion	0.5	0.6	0.7	-	-
Community social services	8.2	8.0	8.6	12.1	12.8
-Health	1.3	1.5	1.6	1.9	2.1
-Education	6.8	6.4	6.8	9.1	9.4
-Social protection	0.1	0.1	0.1	-	-

* Estimates

8.5% in 2003 and 22% in 2004. The sector's share of GDP was 6.4% in 2003 and 6.8% in 2004, below the PRS targets by an average of 2.7 percentage points. Current spending accounts for the largest share of the sector's spending: 87.2% in 2003, estimated to drop to 76.8% in 2004. The average increase in the health sector was relatively stable at 28%, bringing the sector's share of GDP to 1.5% in 2003 and 1.6% in 2004. The gap between spending and PRS targets widened from 0.4% to 0.6%.

Social protection spending declined from YR2.6 billion in 2002 to about YR1.7 billion in 2003, and is estimated at YR3.2 billion for 2004. The increase fluctuated from minus 9.8% in 2003 to 33.8% in 2004; the ratio to GDP remained constant at around 0.1% in both years. The government also spends on social sectors through the Social Fund for Development (SFD), the Public Works Project (PWP), and other mechanisms. The SFD executed 640 projects in 2003 and 669 projects in 2004, estimated at a total cost of \$123.2 million. The focus was on education (365 projects) and water (543 projects). The PWP contributed toward executing 211 projects in 2003 and 151 projects in 2004.

The government intends to increase the allocations for social and investment spending in light of the available resources to support economic growth and reduce poverty, and to provide additional resources to the social safety net. The government also enhances the selection, implementation, and monitoring of investment and social projects and programs in the following ways:

- Including financial and technical data relating to the projects in the annual investment program, to ensure that projects reflect the priorities, objectives, and strategies of the sectors.
- Adopting scientific standards in assessing project costs, controlling tender procedures, and technically supervising projects to ensure compliance with specification and delivery schedules.

Public Debt

Treasury bills through public offering (initial market) were the main source of internal borrowing. The treasury bills' share of total internal public debt rose from 65.7% in 2002 to 73.2% in 2003 and 81% in 2004. The value of traded treasury bills in the initial market increased by YR55 billion in 2003 and YR92 billion in 2004, and their stock rose from YR129 billion at the end of 2002 to YR276 billion at the end of 2004. There was no notable change in repurchasing transactions in this period; they remained steady at YR65 billion. The net public debt continued to rise from YR49 billion in 2002 to YR151 billion in 2003 and YR174 billion in 2004 despite government deposits at the Central Bank. The increase in internal public debt is explained by the rise in public spending and the ongoing budget deficit.

The government is seeking other financial tools to mobilize domestic savings and serve development needs, such as issuing medium- and long-term government bonds and completing the establishment of the Sana'a Stock Exchange.

Yemen continued to repay instalments and interest on its loans; interest amounted to YR7.5 billion in 2003 and rose to YR10.7 billion in 2004. Repayment of foreign debts increased from YR14 billion to YR16 billion during the same period. The government works toward improving external debt efficiency by overcoming the delays in tender

procedures and in the implementation of projects, as these delays cause wastage of grace periods and impose significant financial liability on the country. In 2005, the government will submit an external debt bill to regulate the operations and execution of loan-related policies. It is intended that foreign loans would only be contracted when necessary and only to serve development.

Yemen's foreign debt management system (DMFAS), currently at the Yemen Central Bank, will be linked to concerned ministries and government agencies, especially the Ministry of Planning and International Cooperation and the Ministry of Finance.

Fiscal Decentralization

Local Authority Law No. 4 of 2000, along with its executive bylaws and related laws, triggered comprehensive reforms in the administrative and financial systems of the country, with respect to administrative and fiscal decentralisation. Granting local authorities the right to prepare and execute their own budgets is an important step toward enhancing public services, especially basic social services, and reaching the poor. The performance and development role of local authorities in reducing poverty is linked to the available financial resources and the authorities' ability to mobilize independent resources.

Financial Resources for Local Authorities

Available data on decentralisation indicate that since its implementation in 2002, financial resources for local authorities continue to be modest, with insignificant improvement, despite efforts to increase them. Developing decentralisation and its sustainability

are linked to gradually enhancing its financial capacity and independence. Financial resources at the district level and those shared

Table 1.12: Local Authority Fiscal Resources (in YR millions)

Item	2002	2003	2004 provisional	2005 Proposed
Local revenues	4,121	5,288	5,838	7,163
Shared revenues	5,325	4,540	6,455	8,221
Total local revenues	9,446	9,828	12,293	15,384
Shared public revenues	398	1,004	3,227	3,074
Central capital support	3,851	3,851	3,850	4,000
Total local authority revenues*	13,695	14,683	19,370	22,458

* Excluding current central support and carried-over surplus.

with governorates are important to finance development and social projects. Data illustrate that those resources are not proportional to the volume envisaged by the Local Authority Law of 29 local resources and 28 shared resources. Increases in those resources in the 2005 proposed budget are meagre, especially considering the decline in collection of local authority resources from 97.4% in 2002 to 85.1% in 2003.

The government provides local authorities with funds from the Agriculture and Fishery Production Promotion Fund, the Road Maintenance Fund, and the Youth Care and Sport Fund. Revenues from the Municipality and City Improvement Fund are transferred to administrative units. The budget classification will be revised to accommodate all resources outlined in the Local Authority Law and special classifications will be drafted for the local authority budgets. MoF and MoLA will

enhance the monitoring and supervisory role in collecting local and shared revenues to ensure that they are collected and deposited in the right accounts.

Local Authority Expenditures

Current spending took the major part of local authorities' allocations, exceeding 86% of spending during the period 2002–2004 and in the 2005 proposed budget. This implies that local authorities' budgets are essentially operational and that development spending is very low, even compared with the needs of local administrative units or with total local authority spending. Capital and investment spending constituted 0.6% of GDP in 2002 and 0.8% in 2003. This spending represents about 14% of total local authority spending during 2002–2004 as well as in the 2005 proposed budget. The government is considering increasing operational spending for local councils and executive bodies to enable them to play their role and accomplish their duties. It is also looking into increasing annual capital support for these units to enable them to meet minimum levels of services and development projects for local communities and to reduce the gap between local and central investment programs, beginning with the 2006 budget.

Efforts to Enhance Fiscal Decentralisation

In 2003 and 2004, a number of measures were introduced to transfer the preparation and execution of budgets to local authorities. The Ministry of Finance set up a program for this purpose in 2003. Cabinet Decree No. 113 of 2003 was issued to assist districts in the preparation of their 2004 budgets. In 2004, local administrative units prepared their own budgets; the central authority had no role beyond setting indicative ceilings. Planning and budget committees

Table 1.13: Local Authority Expenditures (in YR millions)

Item	2002	2003	2004	Proposed 2005
Current expenditures	89.3	112.3	116.4	137.9
% of total local authority expenditures	85.1	88.5	84.8	84.5
Capital and investment expenditures	15.7	14.7	20.8	25.3
% of total local authority expenditures	14.9	11.5	15.2	15.5
Total	105	126.9	137.3	163.2

in governorates allocate funds according to local conditions; along with other expenses and revenue estimates, these allocations reflect the operational needs of the local authorities and their priorities in terms of programs and projects.

In 2004, 114 accounting units were established at the various administrative units (second and third levels); these were added to the 139 units established in 2002. The units provide and develop local financial resources under the supervision of the Ministry of Finance offices in the districts. During the report years, Cabinet Decision No. 286 of 2001, regarding local and shared fees, was reviewed, resulting in a proposed Financial Resources Law for local authorities. This law, together with amendments to the Zakat Law, is awaiting cabinet approval. The low financial resources directed at development and the lack of ability to collect local and shared resources make it necessary to take the following measures:

- Establish databases at the governorates relating to available resources and their collection and development; these databases will be replicated later in the districts.
- Enhance the capacity of the executive to follow up and collect taxes and fees.
- Amend laws and bylaws that conflict with the Local Authority Law and its executive bylaws, including the Finance Law and the Tender and Procurement Law.