Economic Monitoring Report to the Ad Hoc Liaison Committee

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WORLD BANK GROUP
THE WORLD BANK IBRD • IDA | IFC International Finance Corporation | MIGA Multilateral Investment Guarantee Agency

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Acronyms

AHLC	**Ad Hoc Liaison Committee**
AML/CFT	**Anti-Money Laundering and Combating Financing of Terrorism**
CBRs	**Correspondent Banking Relationships**
CPI	**Consumer Price Index**
ESRAF	**Energy Subsidy Reform Assessment Framework**
FAO	**Food and Agriculture Organization of the United Nations**
FATF	**Financial Action Task Force**
FCDO	**Foreign, Commonwealth and Development Office**
FCV	**Fragility, conflict, and violence**
FFPI	**Food and Agriculture Organization of the United Nations Food Price Index**
FISIM	**Financial Intermediation Services Indirectly Measured**
GDP	**Gross Domestic Product**
GoI	**Government of Israel**
GNI	**Gross National Income**
GRM	**Gaza Reconstruction Mechanism**
HCPPP	**High Council for Public Procurement Policies**
IAA	**Israeli Airport Authority**
IEC	**Israeli Electricity Company**
IFMIS	**Integrated Financial Management Information System**
IFRS	**International Financial Reporting Standard**
IPI	**Industrial Production Index**
IPP	**Independent Power Producer**
LGUs	**Local Government Units**
LWSC	**Land Water Settlement Commission**
MENA	**Middle East and North Africa**
MENAFATF	**Middle East and North Africa Financial Action Task Force**
ML/TF	**Money Laundering and Terrorism Financing**
MoF	**Ministry of Finance**
NCTP	**National Cash Transfer Program**
NDC	**Nationally Determined Contribution**
NPL	**Non-Performing Loans**
OECD	**Organization for Economic Co-operation and Development**
OMR	**Outside medical referrals**
OQ	**Office of Quartet**
PA	**Palestinian Authority**
PCBS	**Palestinian Central Bureau of Statistics**
PEFA	**Public Expenditure and Financial Accountability**
PENRA	**Palestinian Energy and Natural Resources Authority**
PETL	**Palestinian Electricity Transmission Company**
PFM	**Public Financial Management**
PLA	**Palestinian Land Authority**
PMA	**Palestine Monetary Authority**
PMABCI	**Palestine Monetary Authority's Business Cycle Index**
PPA	**Power Purchase Arrangements**
PPP	**Purchasing Power Parity**
SBD	**Standard Bidding Document**
SME	**Small and Medium Enterprise**
T&D	**Transmission and distribution**
TRA	**Telecommunications Regulatory Authority**
UNFCCC	**United Nations Framework Convention on Climate Change**
UNRWA	**United Nations Relief and Works Agency for Palestine Refugees in the Near East**
VAT	**Value Added Tax**
WFP	**World Food Program**

Executive Summary

i. **In the first quarter (Q1) of 2022, the Palestinian economy continued its rebound from the COVID-19 shock, although at a slower rate than 2021.** Real Gross Domestic Product (GDP) growth reached 5.7 percent, year-on-year (y-o-y), in Q1 2022, driven mainly by increased private consumption in both the West Bank and Gaza as COVID-19 restrictions remained eased. Growth was also supported by an increase in the number of Palestinians working in Israel and the settlements. The unemployment rate decreased from 26 percent in 2021 to 24 percent in Q2 2022 while remaining high especially in Gaza, where it reached 44 percent, reflecting the dire economic and social conditions faced by the population. Inflation continued to increase in the first seven months of 2022, on account of a rebound in demand as well as rising global food and fuel prices. Growth is projected to soften over the course of 2022 and full year GDP growth is expected to reach 3.5 percent. Downside risks persist, related to further potential negative impacts from the war in Ukraine and an escalation of clashes in the Palestinian territories.

ii. **Addressing fiscal policy challenges remains a critical priority for the Palestinian Authority (PA) in 2022.** Public revenue mobilization experienced a boost in the first half (H1) of 2022, as domestic tax collections increased by 26 percent y-o-y reflecting the improvement in economic activity and efforts to expand the revenue tax force. Clearance revenues also increased by 13 percent, y-o-y, in H1 2022, driven by higher customs and value added tax (VAT) collections as well as increases in petroleum excise. The fuel subsidy, classified as a negative tax item, grew by 250 percent in H1 2022 following global fuel inflation, although this was offset by the growth in revenue collections. Recurrent public spending was maintained at the same level as in 2021, in absolute terms, as the suspension of payments of the National Cash Transfer Program (NCTP) offset some increases in the wage bill, medical spending, and unplanned subsidies to Local Government Units (LGUs). Given strong revenues and stable spending, the total deficit (before grants) in H1 2022 was 70 percent lower than in the same period last year. After accounting for donor financing and deductions made by the Government of Israel (GoI) from clearance revenues, the PA ended H1 2022 with a financing gap of US$164 million. The PA relied on arrears to the private sector, the pension fund, and to public employees to make ends meet. This large and growing stock of arrears can pose risks to long-term macroeconomic stability.

iii. **Tight financing conditions are expected to persist in 2022, which – coupled with the partial salary payments – lend renewed urgency to the need for fiscal reforms to support long-term sustainability.** The PA's deficit is expected to reach US$770 million in 2022 (4 percent of GDP), on a commitment basis. Donor financing is projected at US$315 million: US$195 million in budget support and US$120 million in project financing. After accounting for donor financing and for deductions by the GoI from clearance revenues, the PA is expected to face a financing gap of US$637 million (3.3 percent of GDP). Filling this gap requires effort by all parties to meet pressing needs and reorient toward long-term sustainability. To support a more sustainable fiscal position, the fairness, effectiveness, and efficiency of public spending need to be improved, while prioritizing support to the most vulnerable. The focus should be on priority recommended areas for reform, including the public pension system, untargeted transfers, management of health referrals, organization of civil service arrangements, and unplanned subsidies to LGUs (net lending). More can also be done on the revenue side as the PA collects insufficient revenue from Gaza, the tax base does not adequately cover high earning professionals, and penalties for non-payers are weak.

iv. **The financial sector is also continuing to recover from the negative impacts of the COVID-19 pandemic, but sustained fiscal challenges heighten stability risks.** Banking sector profitability has rebounded, with improvements in returns on equity and assets. However, the lingering effects of compounded crises and the continuation of partial salary payments by the PA contribute to risks across loan portfolios in the banking and microfinance sectors. Non-performing loans (NPLs) and classified loans have risen since 2018, and while the official NPL ratio seems manageable, local banks and microfinance institutions have expressed concerns about NPL composition and underestimation. The banking system's exposure to the public sector increased substantially during the COVID-19 crisis, and bank loans to PA employees and promissory notes create additional indirect pressure. Preliminary data for 2022 indicate that direct borrowing by the PA is gradually declining, but PA and public sector employees combined still account for close to 40 percent of total banking sector credits. This poses destabilization risks, and Palestinian policymakers will need to balance fiscal, monetary, and financial considerations in responding to economic shocks. The stability of cross-border payments also remains a concern for the sector, as joint progress on a more stable arrangement for correspondent banking relationships (CBRs) continues to be slow.

v. **Donor commitment in support of the PA's reform agenda remains critical for its success.** Reforms are needed on both the revenue and expenditure sides for sustainability, but they must be implemented with care to avoid negative impacts given the importance of fiscal multipliers in the Palestinian context. Consequently, a stable and predictable continuation of donor assistance to the PA through budget support operations will be pivotal during this time. The PA continues to make progress in improving the public financial management (PFM) system mainly through addressing some of the major delays in the production and audit of financial statements. The backlog of audited financial statements will be cleared by the end of 2022. The PA has also committed to implementing a commitment control system (CCS) for all categories of expenditure by the end of 2022, which will help with the management of arrears. The PA has also recently strengthened the Palestinian Anti-Money Laundering and Combating Financing of Terrorism (AML/CTF) framework by enacting a new AML/CFT law and issuing specific relevant instructions for financial institutions. Building on these efforts will be an important aspect of the partnership with the donor community. In the medium to long-erm, donor support could be reoriented toward development projects that will foster economic growth.

vi. **It is also important to note that efforts by the PA, while necessary to improve the fiscal position, are not by themselves sufficient for sustainable development, and cooperation by the GoI remains essential for this goal.** The PA's fiscal and business environment reforms will be critical; at the same time, previous work by the World Bank has shown that restrictions on movement and access in the West Bank and the nearly closed Gazan economy continue to be the main impediments to growth and private sector development. In addition, cooperation by the GoI could greatly improve the PA's fiscal situation. The World Bank estimates that granting Palestinian businesses access to Area C would boost the Palestinian economy by about a third and increase the PA's revenues by 6 percentage points of GDP. The GoI could also transfer the revenues it collects from businesses operating in Area C and Allenby Bridge exit fees, which it is mandated to remit to the PA under the 1995 interim agreement. Since the May 2022 Ad Hoc Liaison Committee (AHLC) meeting, there has been some limited progress on the payment of electronic salaries to Palestinian workers,[1] and also on the pilot e-VAT system. The latter is an important step, but more is needed to bring all traders and transactions into the system with the aim of eventually moving toward the exchange of real-time information that could greatly reduce VAT leakages. Renegotiating the 3 percent administrative fee that finances a considerable share of the Israeli customs and VAT department's budget would also have a significant impact on the PA's revenue situation.

[1] According to the GoI, once the mechanism for the payment of electronic salaries to Palestinian workers is established, the Israeli Population and Immigration Authority intends to obligate Israeli employers to pay the wages of their Palestinian employees solely through a bank transfer, and employers violating this obligation will be subject to enforcement proceedings.

vii. **Cooperation toward the goal of sustainable fiscal policy and economic development is all the more important to mitigate the impacts of rising food and fuel prices accelerated by the war in Ukraine.** From January to April 2022, the food component of the Palestinian Consumer Price Index (CPI) rose steeply to its highest point in at least the past six years. The prices of bulk wheat flour have also spiked in both the West Bank and Gaza, along with the costs of bread, corn oil, and sunflower oil. The rapid inflation represents a substantive break with trends in these item prices over the six years preceding the war in Ukraine. If prices continue to rise at the rates tracked so far in 2022, households could face average total increases of up to 80 percent in the cost of bread, flour, and vegetable oil between January 2022 and January 2023. Consumption patterns indicate that these price shocks will harm poorer households relatively more than wealthier deciles of the population. The analysis also highlights that the inflation rate based on the official CPI likely understates the effective inflation experienced by many Palestinian households because the CPI weights are most representative of the wealthiest 40 percent of households.

viii. **Even modest inflation could reduce households' ability to meet basic needs because Palestinian purchasing power is already low, an outcome of the Paris Protocol on Economic Relations.** The Paris Protocol has led to price levels that are out of proportion with Palestinian incomes, and its restrictions limit the PA's ability to use trade policy to respond to rising global prices. Revisions that could help meet the immediate challenge of food price shocks include allowing a lower Palestinian VAT rate on basic food items, and adding food commodities directly affected by the war in Ukraine to List A2.[2] To address the longer-term challenge of high baseline prices, a comprehensive review should be undertaken to update the lists of items for which the PA is able to set its own import rates and policies. Close cooperation between GoI, PA, and the international community will be vital to support Palestinian households to cope with already-rising prices. GoI efforts to reduce economic restrictions and sources of fiscal leakage can help create greater fiscal space for social assistance. The PA and international community together should review spending allocations to direct funding toward the most effective forms of assistance, including reviving the NCTP. International donors can also help ensure that humanitarian assistance providers like the World Food Program (WFP) and United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA) receive sufficient levels of support and speak against export restrictions that have the potential to further escalate prices.

ix. **The main body of the report is organized in two chapters and one supporting annex.** Chapter I focuses on recent economic developments in the real, fiscal, and banking sectors while providing a near-term outlook that highlights critical challenges facing the Palestinian economy, in particular, the required fiscal reform. Chapter II examines the exposure of Palestinian households to food price shocks triggered or accelerated by the war in Ukraine. It reviews household vulnerability based on consumption patterns, assesses the magnitude of price increases in the first half of 2022, and simulates variation in the effective inflation experienced by households with different baseline levels of welfare. It clearly finds that the effects of price increases on households are regressive, as poor households are impacted more than wealthier households, and offers recommendations to mitigate the damage of this and future episodes of rapid food inflation.

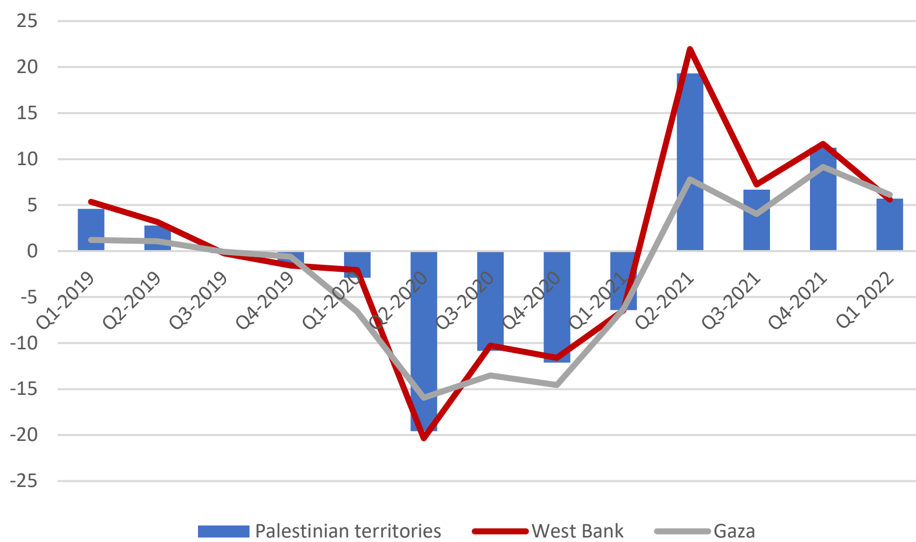
[2] See Box 6 for further detail on Lists A1, A2, and B under the Paris Protocol.

Chapter I: Recent Economic Developments

1. Economic Activity

1. **The Palestinian economy started its rebound from the COVID-19 shock in 2021 and continued to recover in the Q1 2022, albeit at a slower rate**. The ease in lockdowns and the pickup in the vaccination campaign in 2021 had a positive impact on consumer confidence and business activity as the economy is estimated to have grown by 7.1 percent, in real terms. According to latest available data from the Palestinian Central Bureau of Statistics (PCBS), the Palestinian economy continued its recovery in Q1 2022, but at a slower rate, with the real GDP growth reaching 5.7 percent, y-o-y. Despite this positive trajectory, the economy is yet to rebound to its pre-pandemic level.

Figure 1: Real GDP growth in the Palestinian territories (percent change, y-o-y)



Source: Palestinian Central Bureau of Statistics.

2. **The Q1 2022 recovery was led by both the West Bank and Gaza**. In the West Bank, the economy grew by 5.6 percent in Q1 2022, y-o-y, driven by an increase in consumption as the COVID-related measures remained fully eased during this period. The increase in the number of West Bank Palestinians working in Israel and the settlements from 153,000 in Q4 2021 to 203,000 in Q1 2022 also aided the recovery, as the average daily wage of these workers is more than twice the average daily wage in the West Bank, implying a larger impact on demand.[3] In Gaza, real GDP growth in Q1 2022 reached 6.1 percent, y-o-y. Similar to the West Bank, growth was mainly driven by private consumption due to the removal of the COVID-related measures and as the impact of the May 2021 war on Gaza started to ease. For the first time since the second intifada in 2000, around 1,000 Gazans worked in Israel in Q1 2022. The figures are yet too small to impact overall demand but announcements by Israel confirm that additional permits are in the pipeline. The boost in private consumption, in both the West Bank and Gaza, was reflected in the growth of the wholesale and retail trade sector and services, which were the main drivers of growth of the Palestinian economy on the production side.

[3] The quota for Palestinian workers in Israel was recently increased by 16,000 – including the allocation, for the first time, of 500 permits for Palestinian hi-tech workers.

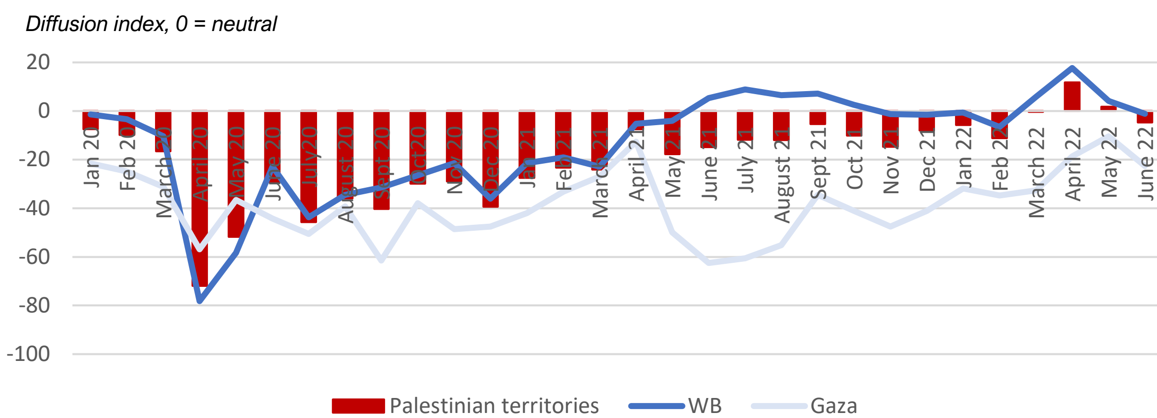
Table 1: Contribution to real GDP growth by sector, Palestinian territories

Sector	Percent
Agriculture, Forestry and Fishing	-0.2
Mining, Manufacturing, Electricity and Water	0.5
Construction	0.1
Wholesale and Retail Trade, Repair of Motor Vehicles and Motorcycles	1.7
Transportation and Storage	0.3
Financial and Insurance Activities	0.1
Information and Communication	-0.1
Services	0.8
Public Administration and Defense	0.1
Households with Employed Persons	0
FISIM	0
Customs Duties	1.8
VAT on Imports, net	0.6
GDP Growth	**5.7**

Source: Palestinian Central Bureau of Statistics and WB staff calculations.

3. **Monthly indicators of economic activity indicate that the recovery continued in Q2 2022, specifically in April.** The Palestine Monetary Authority's Business Cycle Index (PMABCI),[1] which is obtained by surveying a representative sample of businesses on the current conditions in their respective markets, points to a significant improvement in economic activity in the month of April, when the indicator recorded its highest value since the COVID-19 outbreak. Firms attributed this improvement to increased demand during the month of Ramadan. In the following two months, the value of the PMABCI declined from its peak in April but continued to be higher than in Q1 2022, indicating a continued improvement in economic activity. Latest available data for the Industrial Production Index (IPI) is for June 2022 and it shows a significant increase in the value of the indicator during this month, mainly driven by manufacturing activity.

Figure 2: Business Cycle Index



Source: Palestine Monetary Authority

4. **Despite some improvement, the unemployment rate remained high in Q2 2022, especially in Gaza.** It reached 24.2 percent in Q2 2022 in the Palestinian territories – down from 26.4 percent in 2021. The overall rate masks a wide regional divergence whereby unemployment in the West Bank reached 13.8 percent in Q2 2022 while in Gaza it was 44.1 percent, reflecting the difficult social and economic conditions in the Strip caused by the ongoing Israeli movement and access restrictions. The number of

Palestinians working in Israel and the settlements has continued to increase. As a percentage of those in employment, 25 percent of Palestinians in the West Bank worked in Israel and the settlements in Q2 2022 compared to 0.7 percent of Gazans.

Table 2: Labor Market Statistics, Palestinian territories, Q2 2022

Indicator (percent)	West Bank	Gaza	Palestinian territories
Unemployment rate	13.8	44.1	24.2
Labor force participation rate	47.2	39.6	44.3
Youth unemployment (15-29 years)	21.3	59.1	34.8
Male	17.6	52.1	29.4
Female	37.3	82.2	55.4

Source: Palestinian Central Bureau of Statistics.

5. **Inflation in the Palestinian territories continued to increase so far in 2022, mainly reflecting higher food and fuel prices.** Growth in consumer prices had been modest before the outbreak of COVID-19, where prices generally moved in the 1-2 percent range. However, in April 2020, growth in prices turned negative and continued this way throughout the year. In total, prices in 2020 were 0.7 percent lower than in 2019, reflecting weak demand by consumers. Consumer prices gradually increased in 2021 and have continued so far in 2022. Price growth was particularly rapid in the first four months of 2022, with some moderation in the months following. The latest data for January-July 2022 shows that the CPI rose by 3.6 percent, y-o-y, reflecting a pickup in demand as well as rising global food and fuel prices mainly driven by the war in Ukraine (see Chapter II for more information). The appreciation of the Israeli Shekel, the main currency in circulation in the Palestinian territories, kept inflation lower compared to other Middle East and North Africa (MENA) countries.

6. **Latest estimates suggest that poverty slightly dropped in 2021, after peaking in 2020.** Based on the latest available official data, 22 percent of Palestinians lived below the US$5.5 2011 purchasing power parity (PPP) a day poverty line in 2016/17. In the West Bank, poverty rates are lower but sensitive to shocks in household expenditures, while in Gaza any change in social assistance flows can significantly affect the population's wellbeing. Estimates based on GDP per capita growth suggest that in 2020 the poverty rate spiked to 29.7 percent - an increase of nearly 8 percentage points from 2016. As the impact of the pandemic receded, the poverty rate is estimated to have declined to 27.3 percent in 2021. This represents a poor population of about 1.5 million people.

7. **In 2022, growth in the Palestinian territories is projected to slow down, as the low base effect weakens, public consumption declines, and inflationary pressure persists**. Growth will mainly be driven by a continued recovery in private consumption as COVID-related restrictions are expected to remain fully eased in 2022. The number of Palestinians working in Israel is also expected to continue to increase, both from the West Bank and from Gaza, resulting in a further push to demand. Simultaneously, downward pressure on growth may come from a decline in public consumption as the PA is expected to continue paying partial salaries to its employees for the rest of the year. Further, the increase in prices is not expected to significantly ease in the remainder of 2022 and inflation is expected to hover around 3.6 percent for the full year, also weighing negatively on demand. The recent armed conflict in Gaza that took place in August 2022 is not expected to have a significant impact on growth given that it lasted for 3 days without severe destruction to the Strip's assets or a long disruption in economic activity. Put together, these factors are expected to result in a total growth rate of 3.5 percent in the Palestinian economy in 2022.

8. **Downside risks remain elevated**. If the war in Ukraine further strains supply chains and has a larger than expected impact on the prices of food and energy, this will negatively impact the outlook. Also, if

further clashes between Palestinians and Israeli forces in the West Bank and Gaza escalate, and restrictions are imposed on the entrance of Palestinian workers to Israel, there is little room left to absorb such shocks.

2. Public Finance

a) *Fiscal Performance, Q1 2022*

9. H1 2022 witnessed a significant boost to public revenues. Domestic tax collections increased by almost 26 percent y-o-y driven by a growth in all tax categories, except tobacco excise. Income tax collections grew by 40 percent while VAT and domestic customs grew by 27 and 22 percent, respectively. This growth was driven by an improvement in economic activity, as discussed in section 1. Collections from excise on tobacco dropped by 3 percent as the re-opening of the bridge with Jordan, after the removal of the COVID-related travel restrictions, may have allowed for some tobacco smuggling, but it seems this practice remains limited given that monthly collections continue to be higher than the pre-COVID era. Non-tax revenues increased by 27 percent in H1 2022 driven by an increase in domestic fees and charges, and also by the equalization levy collected by Israel from Palestinian workers and transferred to the PA.[4] Investment profits received by the PA from the Palestine Investment Fund also increased and reached NIS15 million. Tax refunds, a negative tax item under which the fuel subsidy is classified, increased given a 250 percent growth in spending on the subsidy following the PA's decision to continue subsidizing fuel despite the increase in global prices. The increase in tax refunds was offset by a growth in revenue collections, as mentioned above, resulting in an overall increase in revenue.

Box 1: Fuel subsidies in the Palestinian territories

According to the Paris Protocol, fuel imported by the PA should be of specific standards that are not met by fuel produced and exported by other countries in the MENA region. As a result, the PA purchases all of its fuel from Israeli companies. The Petroleum Authority oversees this operation, and it buys the fuel from Israeli companies on a monthly basis, according to the price set by the Israeli refinery. In addition, fuel transportation expenses are added to the price, along with the refinery's profit margin and customs and VAT. Afterwards, fuel is sold to Palestinian gas stations at a reduced retail price that depends on the size of the fuel subsidy which is determined by the Ministry of Finance (MoF) every month. Gas stations then add their profit margin, which is fixed and agreed upon with the Petroleum Authority, to get the final consumer price.

In 2021, the fuel subsidy provided by the PA MoF was US$77 million, or 0.5 percent of GDP. In 2022, amid the global increase in fuel prices, the PA has continued to subsidize fuel to alleviate the impact of the inflationary pressure on Palestinian consumers. As a result, the fuel subsidy reached US$104 million in the first six months of 2022, already exceeding its annual level in the previous year. The subsidy is expected to continue increasing throughout the year, resulting in a growing fiscal burden on the PA.

Global experience has shown that higher energy subsidies have resulted in inefficient and wasteful consumption patterns tied to the perceived low value of energy and impacts on associated products such as water and food. This has further led to the increase of global CO_2 emissions driven by higher consumption of fossil fuels. Subsidized energy prices have led to the accumulation of a significant fiscal

[4] Palestinians employed in Israel are only entitled to basic insurance benefits, and hence their contribution to the Israeli national insurance system is lower than Israeli workers who are fully insured. To keep the wage costs of Palestinian labor equal to those of Israeli workers and avoid any preference toward cheaper labor from the Palestinian territories, the GoI introduced the so-called "equalization levy" on the income of Palestinian workers.

burden, with a detrimental effect on government spending on other pro-poor sectors. If not targeted and delivered well, energy subsidies could be regressive because richer households consume more energy than those in the lower quintiles. Energy subsidies also weaken the performance of the energy sector in the long term as they could lock an economy into a more fossil fuel intensive trajectory, while leading to under-investment in renewable energy generation, in demand-side energy efficiency (such as in buildings, transport, and industry) and in access to electricity.

Source: PA MoF data and World Bank's Energy Subsidy Reform Assessment Framework (ESRAF)

10. **Clearance revenues also performed well in H1 2022, increasing by 13 percent, y-o-y.** This performance is mainly attributed to higher customs and VAT collections which increased due to a rise in imports.[5] Petroleum excise also increased due to higher imported quantities compared to the same period in the previous year and the rise in global fuel prices. Also, the appreciation of the NIS encouraged higher imports from abroad, in line with the rebound in economic activity. Notably, income tax collected by Israel from Palestinian workers reached NIS71 million in H1 2022, up from NIS30 million in the same period last year.[6] Deductions by Israel from clearance revenues to account for some of the payments made by the PA to Palestinian prisoners in Israeli prisons, ex-prisoners, and families of those deceased as a result of violence, were reduced to NIS50 million per month in 2022, down from NIS100 million since August 2021.

11. **Recurrent public spending was maintained at last year's level, in nominal NIS terms, as increases in certain spending items were offset by a strong drop in transfers.** Government transfers declined by 19 percent as the PA did not provide any payments to poor beneficiaries through the NCTP in H1 2022. The strong decline in transfers offset the increase in other spending items. Mainly, the wage bill rose by about 5 percent, on a commitment basis, in H1 2022 y-o-y due to the implementation of the yearly step increase and the cost-of-living allowance. On a cash basis, the PA has been paying around 80 percent of the salaries of public employees, while protecting the lowest earners, since November 2021. Spending on goods and services increased by 2 percent, reflecting higher expenses mainly related to outside medical referrals and also vaccines and medical supplies. The increase in net lending, reflecting unplanned subsidies to LGUs covering utility bills to Israeli suppliers, was limited to 1.2 percent in H1 2022.

12. **Given strong revenues and maintained spending, the PA's deficit significantly dropped in H1 2022, y-o-y.** The total deficit (before grants) reached US$153 million, almost 70 percent less than in the same period last year. Donor financing was US$80 million (US$44 million in budget support and US$36 million in development financing). After accounting for deductions made by the GoI from clearance revenues, the PA ended with a financing gap of US$164 million (1.7 percent of GDP). The PA relied on arrears to the private sector, the pension fund, and to public employees to make ends meet. Even though comprehensive data on arrears is not available, the current stock of arrears to the private sector is estimated at about US$950 million, while arrears to the pension fund are around US$2 billion only for civil schemes, while data is unavailable on the security schemes. The large stock of arrears causes a risk to macroeconomic stability as it pulls out liquidity from the market and can eventually also negatively impact the banking sector. The PA has paid down its debt from the domestic banking sector to US$2.2 billion as of June 2022, down from US$2.5 billion as of December 2021. Notably, the reported debt stock does not include Promissory Notes. A significant amount of these notes remains outstanding to the private sector and is not reflected in the MoF debt statistics.

[5] PCBS trade data show that imports between January and June 2022 (latest available data) increased by 33 percent compared to the same period in 2021.
[6] According to the PCBS, the number of Palestinians working in Israel and the settlements increased from 146,000 in Q2 2021 to 210,500 in Q2 2022 (latest available data).

b) Fiscal Forecast 2022

13. **The financing situation is expected to be persistently tight, and the PA is expected to continue paying partial salaries in 2022.** Assuming that the lockdown measures remain fully lifted, public revenue is expected to grow by 11 percent in 2022. Revenue growth will be driven by both domestic and clearance revenues as the economy continues to grow and due to the PA's efforts to expand the revenue taskforce and place more focus on large taxpayers. Fuel subsidies, classified as a negative tax item, are expected to increase by more than 180 percent as the PA continues to subsidize fuel amid rising global prices. The increase in this item, however, will be offset by the growth of domestic and clearance revenues. Expenditures are expected to be maintained at their 2021 level, on a commitment basis, as increases in certain items will be offset by a decline in transfers. The PA is expected to disburse only one NCTP payment in the last quarter of this year as the European Union's contribution to budget support, which finances a portion of the NCTP payment, is expected to be disbursed in late Q3 2022. Reduced NCTP payments will result in fiscal savings, but at a large social cost given that the majority of the program's beneficiaries have been left without any social assistance for months. Put together, the PA's deficit is expected to reach US$770 million in 2022, on a commitment basis. Donor financing is projected at US$315 million: US$195 million in budget support and US$120 million in project financing. After accounting for donor financing and for deductions by the GoI from clearance revenues, the PA is expected to face a financing gap of US$637 million. The projected gap remains large and additional efforts by all parties are key to avoid a worsening crisis whereby the PA encounters difficulties in meeting other recurrent commitments in 2022, on top of continuing partial salary payments.

Box 2: Welfare effects of the suspension of NCTP payments

As a flagship social assistance program, the NCTP has played an important role in poverty alleviation. An impact evaluation of the first five years of the consolidated program found that, in the West Bank, participating households were 23 percentage points less likely than non-participating households to be living in extreme poverty at the time of the evaluation. In Gaza, the importance of the transfers grew as socioeconomic conditions deteriorated, with the volume of assistance as a share of household consumption rising from roughly 23 percent to almost 34 percent. In 2020 the NCTP provided assistance to more than 114,000 families, of which 86 percent lived below the national extreme poverty line. The program disbursed almost NIS 408.5 million in three rounds of transfers. Since the start of 2021 the program has disbursed only one set of payments estimated at NIS 86 million. The impact of the suspension of the program on beneficiary households is likely to have been significant, with one recent study finding that the lack of regular transfers has exhausted families' ability to cover health and educational expenses not covered by other sources of food aid, and to smooth consumption by buying on credit.

Sources: The World Bank. (2018). *Implementation Completion and Results Report: West Bank and Gaza Cash Transfer Project.;* Palestinian Center for Human Rights. (2022). *Poverty in Palestine*.; Ministry of Social Development. (2021). *2020 Annual Statistical Report* [Ar].
https://www.mosd.gov.ps/uploads/1653306170635320869.pdf

Table 3: Palestinian Territories' fiscal operations

US$ million	2022 WB Proj.	2021 Actual	Change percent
Total net revenues	**4671**	**4234**	**10.3**
Tax revenues	1099	995	10.5
Non-tax revenues	440	401	9.5
Clearance revenues	3193	2880	10.9
Tax refunds	277	183	51.2
Fuel	214	77	179.6
Other	64	107	-40.4
Earmarked collection	217	141	53.3
Recurrent expenditure	**5184**	**5250**	**-1.3**
Wage bill	2449	2407	1.8
Social contributions	237	229	3.4
Goods and services	837	805	4.0
Transfers	939	1138	-17.5
Minor capital	8	33	-75.8
Interest	110	124	-11.7
Net lending	387	373	3.9
Earmarked expenditure	217	141	53.3
Recurrent deficit	-513	-1016	-49.5
Development expenditure	257	241	6.5
Total deficit	**-770**	**-1257**	**-38.8**
Financing	**770**	**1257**	**-38.8**
Budget support	195	186	5.0
Development financing	120	131	-8.5
Clearance revenue deduction	182	104	74.6
Other	--	1045	--
Gap	**637**	**0**	--

Source: PA MoF for actuals and WB staff estimates for projections.
Note: "Other" financing refers to net domestic bank financing and the net accumulation of arrears.

c) *Beyond the urgent priorities, a longer-term fiscal agenda for sustainability*

14. **The fiscal position needs to become more sustainable based on strong and stable macroeconomic foundations.** The unreliable funding of some services, and the high level of payment arrears to private sector suppliers is inhibiting the development of the economy and adding to firms' liquidity constraints. To support a more sustainable fiscal position, the fairness, effectiveness, and efficiency of public spending need to be improved and prioritized toward supporting the most vulnerable. The focus should be on tackling recommended reforms targeting the wage bill (See box 3), the generous public pension system, and untargeted transfers that result in significant support to those connected to the PA at the expense of other, often more needy, parts of society. Better managing health referrals is a priority. Reforms to reduce net lending are also a priority as these unplanned subsidies to LGUs have become one of the thorniest fiscal issues facing the PA.[7] On the revenue side, central government revenues (before grants) as a share of GDP in the Palestinian territories stood at around 23 percent of GDP in 2021, which compares well to other fragile countries at the same level of development. However, more can be done. The PA collects insignificant revenue from Gaza due to the internal divide. Also, reforms are needed to widen the tax base in the West Bank to cover high earning professionals such as doctors,

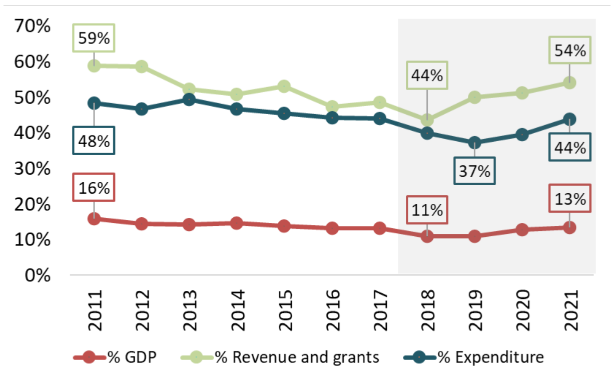
[7] For more details, see the World Bank's Public Expenditure Review of The Palestinian Authority: Towards Enhanced Public Finance Management and Improved Fiscal Sustainability. September 2016. http://documents1.worldbank.org/curated/en/320891473688227759/pdf/ACS18454-REVISED-FINAL-PER-SEPTEMBER-2016-FOR-PUBLIC-DISCLOSURE-PDF.pdf

lawyers, engineers, etc. Furthermore, legislation must be strengthened to penalize non-payers. Encouragingly, the PA has prepared a new revenue strategy to boost domestic revenue that focuses on a new VAT law, as well as a new customs law and amendments to the 2011 income tax law.

Box 3: Public sector wage bill spending and employment under the PA

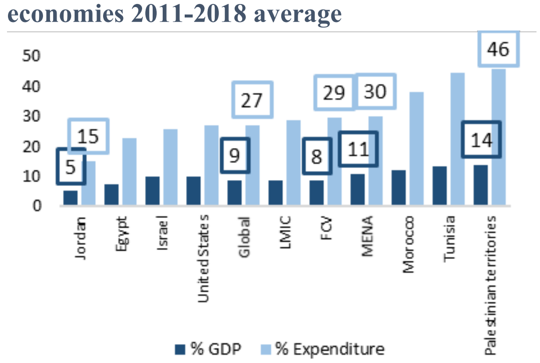
The PA's spending on its wage bill is out of step with indicators of fiscal affordability and is higher than regional comparators. Between 2011 and 2018, the PA's wage bill averaged 14 percent of GDP and 46 percent of central government expenditure. The equivalent figures for the Middle East and North Africa region were 11 and 30 percent respectively. Similarly, for countries affected by fragility, conflict and violence (FCV), the averages were 8 and 29 percent. On average, the PA spends more on its wage bill as a share of GDP and central government expenditure than countries such as Jordan, Egypt, Morocco and Tunisia.

Figure 3: Share of wage bill spending in budget indicators



Source: PA MoF

Figure 4: Wage bill spending in comparator economies 2011-2018 average



Source: PA MoF; Worldwide Bureaucracy Indicators

The main driver of wage bill growth in the Palestinian context has been the increase in the salaries of public employees, largely due to increases in allowances, while growth in employment has been relatively low. Between 2011 and 2021, spending on the wage bill grew at an average annual rate of 2.3 percent, in nominal terms. The majority of this surge came from spending on employee salaries, which increased at an average rate of 2 percent per annum, while the residual 0.3 percent annual increase is attributable to net additional employment/jobs created in the public sector. Notably, the ministries of health and education represent the largest share of wage bill spending and they have also seen the largest increases over time, mostly in the forms of allowances. The PA has gradually channeled an increasing portion of its salary increases over the years into allowances, using them as a supplement to base pay instead of as a reward for specific jobs or work performance. Specifically, two types of allowances, 'job' and 'other', have been used to channel most of the compensation increases that have taken place over the years often as a result of salary bargaining.

In terms of territorial distribution, the West Bank has been responsible for a larger share of wage bill growth compared to Gaza. Between 2011 and 2021, wage bill spending in the West Bank increased by 87 percent, whereas it declined in Gaza by 27 percent, in nominal terms. Trends in public employment are similar. Between 2011 and 2021, public employment in the West Bank increased by 32 percent, reaching 116,458 employees. During the same period, PA employment in Gaza declined by 40 percent and reached 39,156 employees.

Further, public sector salaries in the West Bank are misaligned with private sector benchmarks, potentially creating negative externalities in the local labor market and in the PA's wage bill.

Wage premium analysis conducted using data from the 2021 Labor Force Survey shows that public sector employees in the West Bank receiving an income at the 10th income percentile level earn 99 percent more than their private sector peers and that this gap cannot be explained by differences in characteristics such as education and experience. Further, above the 20th income percentile, the effect is opposite whereby the public sector is likely under-paying its employees, creating incentives for job seekers to prefer private sector jobs, thereby potentially depriving the public sector of much needed skills. The story in Gaza is different as, on average, the public sector pays more than the private sector across almost all levels of income, except the senior most levels where the private sector pays more.

Authorities are aware of the importance of setting the right weights in the structure and composition of public employment and that is why they have re-dedicated recent efforts to wage bill reform. One option that has been under consideration is a Voluntary Retirement Scheme. However, a VRS should be considered with caution as it may not deliver the level of savings needed to stabilize wage bill spending. Simulations by the World Bank show that the VRS will only result in modest savings initially as the PA will be able to realize the reduction in its wage bill due to the exit of the voluntary retirement employees. However, thereafter, the wage bill will continue to grow as it has in the past. Further, the VRS may also be mis-targeted and negatively impact performance given that public employment under the PA has a relatively smaller share of employees with significant years of service. A voluntary retirement scheme that further reduces employee numbers in this cadre may therefore result in the loss of skilled employees and negatively affect government performance. The PA is aware of these risks and is, therefore, looking into other wage bill and employment reforms including a functional review to assess whether current staffing levels are appropriate based on the functional needs of the public sector.

World Bank simulations show that reforms that address *both* employment and wage growth can result in better outcomes as they can deliver significant fiscal savings for the PA. For example, if the PA were to (i) freeze wages for two years in 2022-2023 and then index them to a standard rate of increase such as 1.5 percent in 2024-2026, (ii) gradually reduce spending on 'job' and 'other' allowances by a 20 percent spread over 2022-2026, and (iii) put in place an attrition target, such as two employees out for every one that enters (based on an assumption that 3,000 employees exit annually for every 1,500 that enter), it would be able to reduce the wage bill from NIS 7.7 billion in 2021 to NIS 7 billion by 2026. This will represent a 9 percent nominal reduction in the wage bill compared to the 2021 baseline.

Global experience shows that governments that have succeeded in wage bill reform typically combine short-term controls to rein in spending with medium-to-long term structural reforms to improve wage bill management. In the short-term, governments can make use of a variety of strategies to monitor wage and employment trends. They may opt to freeze wages or link wage growth to a standard percentage decided annually by a pay commission as a way to rein in spending on the wage bill. Governments can also use hiring freezes or attrition targets. Medium-to-long term structural reforms are country-specific and allow governments to improve overall wage bill management and government performance. For example, modern civil services around the world typically fold the majority of allowances into base pay in order to improve horizontal equity (equal pay for equal work), while keeping certain special allowance categories in place to reward high performance. Another best practice includes aligning public sector pay with private sector wages to promote salary competitiveness in the labor market. Governments have also undertaken reforms in their pay and grading structure to limit pay fragmentation and improve salary and career management. Last but not least, governments may also choose to link human resource and compensation planning to the medium-term budget to improve overall fiscal sustainability of the wage bill.

Source: World Bank and PA MoF

15. **Donor commitment to continue supporting the PA's reform agenda remains paramount.** Pressing on with reforms both on the revenue and expenditure sides is crucial for the sustainability of the fiscal position but needs to be carried out gradually to avoid social implications, given the importance of fiscal multipliers in the Palestinian context. Hence, it is crucial that donors continue supporting the PA with generous and predictable budget support as this will reduce some of the short-term negative impacts that sharp fiscal consolidation may have on the economy. In the medium term, donor support could be redirected toward development projects that can help support economic growth. PFM reforms, in addition to efforts by the PA to strengthen governance, may revive donors' appetite to increase financial support.

Box 4: Recent progress in Public Financial Management

The PA continues to make progress on improving the public financial management system. The PA has a comprehensive PFM Strategy (2021-2023), which incorporates the findings of the latest Public Expenditure and Financial Accountability (PEFA) assessment. A World Bank-funded project has been providing support with a focus on budget execution, financial accountability, and procurement. A second World Bank project became effective on June 29, 2022, with a continued focus on budget execution, financial accountability, and procurement as well as new focus areas of revenue mobilization, anti-corruption, and statistics production. Good progress has been achieved through the project on addressing some of the major delays in the production and audit of financial statements. The 2018 and 2019 audited reports were issued in December 2021 by the State Audit and Administrative Control Bureau and the 2020 and 2021 joint audits are expected to be published in 2022. In line with the PFM strategy, support continues on the CCS, which is partially implemented for operating expenditures (including salaries) and will be fully implemented by the end of 2022. The project is also supporting the modernization of financial control, intergovernmental fiscal transfers, and improvement of payroll management. Good progress was achieved during 2019-2022 on the implementation of the procurement law with the single procurement portal operational, new standard bidding documents approved by the Council of Ministers, a capacity-building program of the procurement workforce launched, and the operationalization of the complaint mechanism officially launched in March 2022. Priority actions going forward include enforcing the use of the single portal and Standard Bidding Documents (SBDs) by all procuring entities and equipping High Council for Public Procurement Policies (HCPPP) with the qualified human resources necessary to effectively assume its role in the development of the procurement system, policymaking, and oversight of all public procurement activity. The PA has also prioritized the development and implementation of an e-Government Procurement system and the professionalization of the procurement function. A PFM project funded by the Foreign, Commonwealth and Development Office (FCDO) continues to focus on budget management, revenue administration, and improving the policy development/planning processes led from the Prime Minister's Office.

16. **It is important to note that efforts by the PA are necessary to improve the fiscal position, but they are not sufficient to put the Palestinian territories on a sustainable development path**. The reforms explained above will help reduce the size of the fiscal deficit. But even with PA measures to improve the business environment and transparency, this will not allow the economy to reach its potential. Previous work by the World Bank[8] has shown that restrictions on movement and access in the West Bank and the Israeli movement and access restrictions on Gaza continue to be the main impediments

[8] Prospects for Growth and Jobs in the Palestinian Economy: A General Equilibrium Analysis. The World Bank, 2017.

to growth and private sector development. Hence, without progress on alleviating these challenges, the economy of the Palestinian territories will continue to operate below potential.

17. **Further, cooperation by the GoI on access to Area C could provide a significant boost to the PA's revenues.** Lack of access to Area C contributes to the PA's lower-than-potential revenue. The World Bank estimates that granting Palestinian businesses access to Area C would boost the Palestinian economy by about a third and increase the PA's revenues by 6 percentage points of GDP.[9] Even without access to Area C, the 1995 interim agreement states that the Israeli civil administration is expected to collect revenues from businesses operating in Area C and remit them to the PA.[10] Even though the Israeli civil administration does collect these funds, they have not been transferred to the PA. Further, the GoI currently retains Allenby Bridge[11] exit fees that should also be transferred to the PA, according to the Paris Protocol (See box 2).[12] The parties reaching an understanding to implement an e-VAT system and moving ahead with a pilot earlier in 2022, whereby traders on both sides are granted the option to voluntarily issue transaction receipts digitally, is encouraging.[13] However, more is needed to bring all traders and transactions into the system with the aim of eventually fully linking the interfaces of both authorities to exchange real-time information on all purchases being made, as it will significantly reduce VAT leakage. Furthermore, renegotiating down the 3 percent handling fee charged by the GoI to handle Palestinian imports, and removing this fee on fuel imports, could further mitigate the PA's trade-related fiscal losses. This fee is considered extremely high especially as it finances a much larger part of the Israeli customs and VAT department's total budget compared to the share of Palestinian imports out of total imports handled by this department.[14]

Box 5: Allenby Bridge exit fees

The 1995 Interim Agreement sets up arrangements for sharing the passenger exit fee collected by the Israeli authorities at the Allenby Bridge with Jordan,[15] but the PA argues that these arrangements have not been properly implemented. The agreement sets the passenger exit fee at the Allenby Bridge at US$26 per voucher, to be collected by Israeli officials. Income from the first 750 thousand passengers per year should be divided on a 54/46 basis, whereby US$14 of each voucher accrue to the Israeli authorities while US$12 are transferred to the PA. If in any given year the number of passengers exceeds 750 thousand, the PA's share of each voucher increases to US$16. The GoI has unilaterally raised the fee to US$36 in 2008, then to US$44 in 2013, and to approximately US$50 in 2021.

The increase in the fee applied by the GoI has not resulted in a commensurate increase in revenues transferred to the PA, despite an overall increase in the number of passengers. Based on data from the Israeli MoF on the yearly fee and figures from the Israeli Airport Authority (IAA) on the number of passengers that crossed the Allenby bridge between 2008 and 2021, it is estimated that the GoI collected

[9] Area C and the Future of The Palestinian Economy. The World Bank, 2014.
[10] See Annex III, Appendix I, Article 8, Paragraph 2 (a), 2(b) and Article 18, Paragraph (4) of the Interim Agreement on the West Bank and the Gaza Strip, Washington, D.C., September 28, 1995 (the Interim Agreement).
[11] Allenby Bridge is a crossing that crosses the Jordan River near the city of Jericho and connects the West Bank with Jordan.
[12] See Section G of Appendix 5 to Annex I of the Interim Agreement.
[13] According to the GoI 400 Israeli businesses had joined the e-VAT pilot at the time of writing.
[14] In certain years, the handling fee collected by the GoI financed close to a third of the Israeli customs and VAT department's total budget, even though the share of Palestinian imports out of total imports handled by this department was a mere 6 percent. Previous analysis by the Bank concluded that the 3 percent fee should be reduced to 0.6 percent to become commensurate with the share of Palestinian imports in total imports handled by the Israeli customs and VAT department.
[15] See Section G of Appendix 5 to Annex I of the Interim Agreement.

around NIS1.82 billion in fees over this period.[16] Had Israel maintained the passenger exit fee at US$26, the collections would have been lower, at NIS1.13 billion. This has resulted in additional collections by the GoI, amounting to NIS697 million. None of this amount, however, has been shared with the PA resulting in an ongoing dispute over monthly transfers. A possible way to divide the disputed sum could be through applying the Paris Protocol's sharing formula, explained above. By applying this formula, the PA's share of the disputed amount would equal NIS391.6 million while the Israeli share would be NIS305.5 million. [17]

Further, the GoI has not been fully remitting to the PA its share from the originally agreed US$26, as agreed upon in the agreement. In fact, transfers by the GoI to the MoF between 2008 and 2021 have reached NIS491 million, while calculations based on the number of yearly passengers from the IAA multiplied by the USD26 fee show that the amount transferred over these years should have been NIS561 million, resulting in NIS70 million owed to the PA and not transferred.

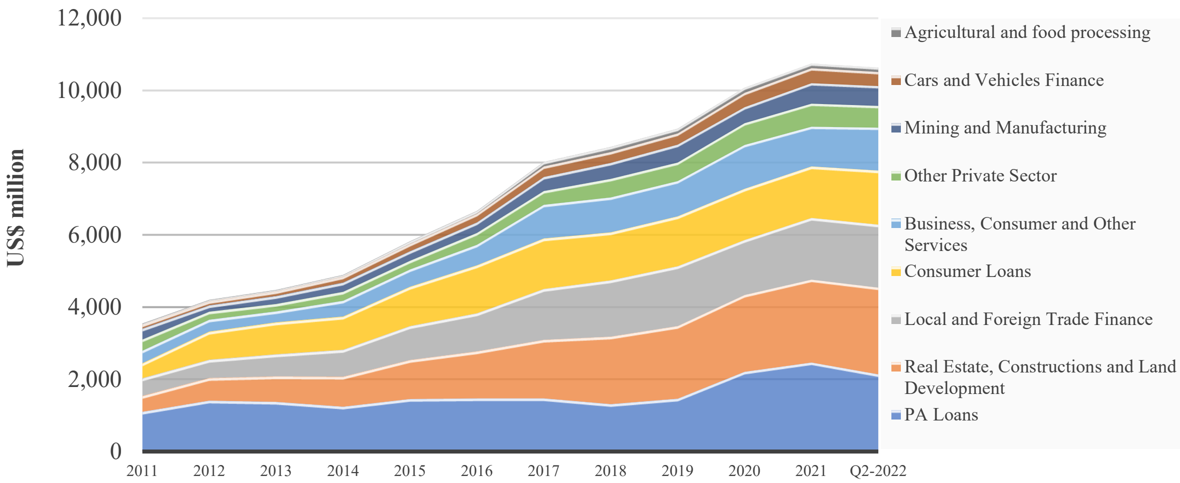
Going forward, it is encouraged that increases in the fee are agreed upon bilaterally before they are applied. If there is a deviation from the sharing formula set in the agreement, the new formula should be agreed upon by both parties and monthly transfers should be done accordingly to avoid the accumulation of disputed funds in the future.

3. Money and Banking

18. **The financial sector continues to recover from the negative impacts of the COVID-19 pandemic, but stability risks remain due to lingering fiscal risks**. According to preliminary reporting by the Palestine Monetary Authority (PMA) through June 2022, total banking system assets exceeded US$20 billion, and banking sector profitability rebounded, following the dip in 2020. Return on equity rebounded to 10.4 percent by Q2 2022, a substantial improvement compared to 2020 levels (5.4 percent) and even pre-COVID levels of 8.7 percent (2019). Return on assets registered a similar trend, reaching 1.5 percent in Q2 2022, compared to 0.9 percent (2020), also exceeding pre-COVID levels of 1.25 percent (2019). The growth in deposits during 2022 only marginally exceeded growth in credit when compared to the same reporting period in 2021, therefore maintaining the level of overall credit-to-deposit ratio at 66 percent in Q2 2022 (in line with 2021 levels), on a slight downward trend vis-a-vis 70 percent registered in Q2 2020. Growth in credit during the reporting period was mainly driven by private sector loans, as opposed to public sector loans which was the case in the year prior. Both credits and deposits registered a small decline in Q2 2022. A review of credit exposure to the private sector indicates unchanged sectoral concentration, with two-thirds of all private lending going to construction and real estate development, trade finance, or consumer loans.

[16] Fee increases were obtained from Israeli MoF. The fee is published in NIS but was converted to US$ based on the yearly average exchange rate as published by the Organization for Economic Co-operation and Development (OECD). The US$ value was then used to apply the fee sharing formula as provided in the agreement. A weighted average of the fee was used to make the calculations based on the number of passengers and to reflect the different fees assigned to each passenger category.
[17] These calculations were made in cooperation with the Office of the Quartet and the findings can also be found in their AHLC report to the September 2022 meeting.

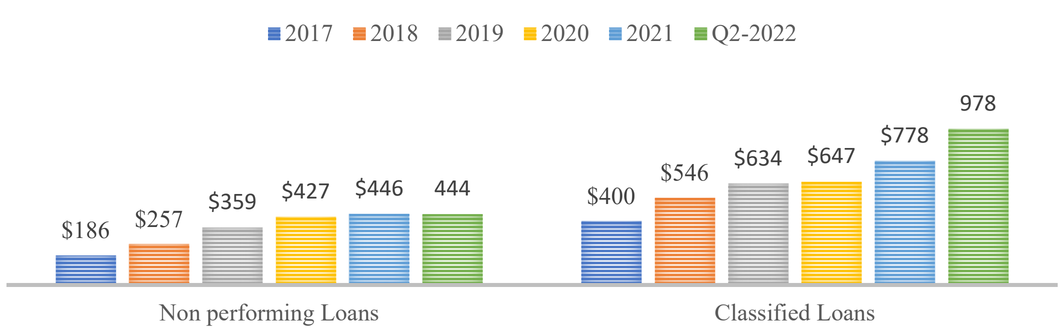
Figure 5: Distribution of credit facilities by economic sector



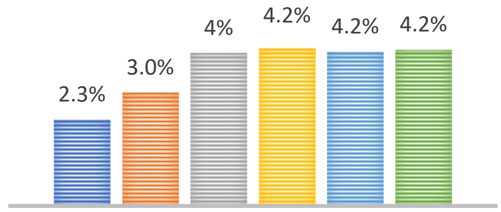
Source: Palestine Monetary Authority.

19. **The combination of compounded crises with the partial payments of salaries by the PA is contributing to risks across loan portfolios in the banking and microfinance sectors.** Both NPLs and classified loans have maintained an upward trajectory since 2018.[18] The NPL ratio (which represents the percentage of NPLs out of all direct loans and is a lagging indicator) stands at about 4.2 percent as of Q2 2022, in line with 2021. While this appears manageable given the context and regional comparators, discussions with several local banks and microfinance institutions indicated growing concerns. The NPL ratio for private sector loans (i.e., when excluding loans to the PA) is likely to exceed the aggregate ratio of 4.2 percent. NPLs tend to be concentrated in critical segments such as Small and Medium Enterprise (SME) and civil-servant portfolios, and NPL indicators are likely underestimated as a result of repeated regulatory forbearance measures. With classified loans in 2022 exceeding 2021 by 25 percent for the same reporting period, further deterioration represents a realistic scenario.

Figure 6: Growth in non-performing and classified loans (US$ million & % of gross loans)



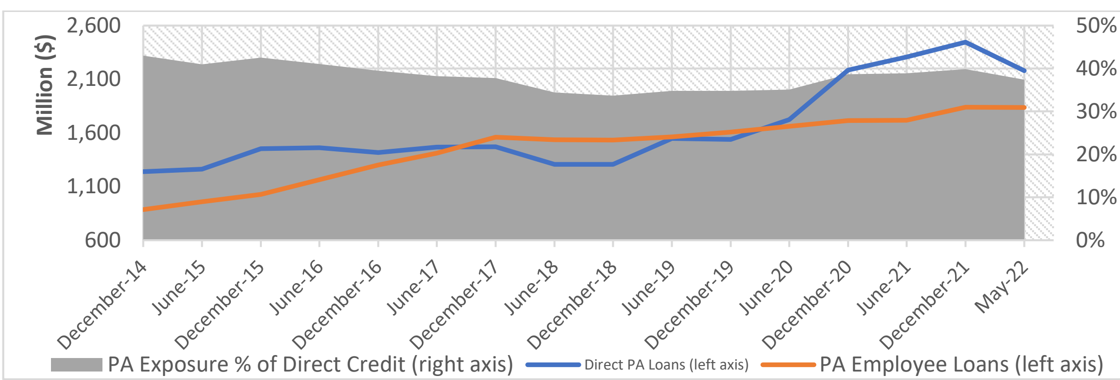
[18] It is worth noting that some of the banking sector indicators have been impacted by the adoption of International Financial Reporting Standard (IFRS) 9.



Source: Palestine Monetary Authority.

20. **With declining financing and sustained fiscal imbalances, Palestinian policymakers should carefully balance fiscal, monetary, and financial considerations.** At times of heightened fiscal distress, the PA has regularly resorted to increased borrowing from domestic banks, at times exceeding bank exposure limits set by the PMA, and potentially generating new stability risks for the banking system. Following several years of relative stability in PA borrowing (about US$1.3-1.4 billion), the banking system's exposure to the public sector increased considerably, reaching US$2.5 billion in December 2021. Preliminary 2022 data indicates a gradual decline in PA borrowing, down to US$2.2 billion (20 percent of total direct credit). In addition to direct borrowing by the PA, bank loans to PA employees (backed by future salaries) also represent an indirect channel of exposure to the public sector, along with the usage of promissory notes. When combined, PA and public employees account for about US$4 billion, close to 40 percent of total banking sector credits. In light of the unstable economic context and lingering sources of risk, financial sector regulators should continue to emphasize the importance of safeguarding the banking system against emerging and protracted economic shocks.

Figure 7: Direct and indirect exposure to the PA (US$ million)



Source: Palestine Monetary Authority.

21. **The PMA and Financial Follow-up[19] Unit are taking steps toward upgrading the Palestinian AML/CFT system to be more in line with international practices**. In 2018, the local authorities conducted their first AML/CFT self-assessment with World Bank support, enhancing their ability to identify and assess money laundering and terrorism financing (ML/TF) risks. In parallel to the self-assessment, the PA requested, and was granted approval for, an external evaluation of its AML/CFT regime by the regional Financial Action Task Force (FATF). The evaluation was originally scheduled to start in 2020, but the on-site visit by MENAFATF assessors was repeatedly postponed (initially due to COVID-19 and more recently due to the conflict in Gaza). This external evaluation, in combination with the above-mentioned self-assessment, represents steps toward the commitment to, and

[19] This corresponds to the Palestinian Financial Intelligence Unit.

implementation of, the FATF AML/CFT standard conditions of membership to the MENAFATF. Several new AML/CFT laws and regulations have been issued in recent months, including a new AML/CFT law (39/2022), Presidential Decree (14/2022) on the implementation of UN Security Council sanctions, and Instructions (2/2022) on AML/CFT controls for financial institutions. Other elements of AML/CFT reforms are currently under preparation, expected to be adopted in the coming months.

22. **Recognizing that the two economies are highly interlinked, the stability of cross-border payments remains a cause for concern due to the potential negative impact of de-risking by Israeli banks.** In recent years, Israeli banks have signaled plans to limit or terminate correspondent banking services to Palestinian banks, citing money-laundering and financing of terrorism concerns. Disruptions to CBRs are likely to significantly impact the Palestinian economy, due to Israel being its primary trade partner, and the reliance on the Israeli Shekel as the primary currency in the cash-based Palestinian economy.[20] An example of this is the current complexity associated with the repatriation of NIS cash from Palestinian banks to Israel, contributing to the accumulation of excess NIS liquidity in Palestinian banks.[21] In 2017, the GoI approved a temporary indemnity and immunity package for Israeli banks working with Palestinian banks, thereby taking on part of the risks, to alleviate the potential for immediate disruptions to CBRs between the two banking systems. The GoI repeatedly extended this temporary package while a more stable arrangement for cross-border payments is being developed by the PA and GoI. However, joint progress remains slow (e.g., implementation of cashless payment of Palestinian workers in Israel).

[20] Payment activity between Israel and the West Bank and Gaza has an estimated yearly value of more than NIS44 billion.

[21] Banks in the West Bank and Gaza are having to manage large amounts of excess cash due to limits on the amount of cash which can be shipped to Israel.

Chapter II: Household Exposure to Rising Food Prices

1. Introduction and Context

23. **The first chapter provided an update on current fiscal and economic constraints and offered recommendations to increase the sustainability of fiscal policy and improve allocation of resources.** In this context, the second chapter assesses the magnitude of price increases since the start of the war in Ukraine and finds that these price increases disproportionately affect poorer households in the West Bank and Gaza.

24. **The war in Ukraine has exacerbated global inflationary trends.** COVID-related supply chain disruptions, early post-pandemic economic recovery, and expansionary monetary policy drove global prices higher even before January 2022. The war in Ukraine has caused direct shocks to the supply of certain basic food commodities—most notably wheat, maize, and sunflower oil—and indirect effects touch a broad swath of the global agri-food system. Shipping disruptions around the Black Sea have compounded pandemic-related supply chain problems. Price increases in directly-shocked food commodities spill over to prices of related foods, such as other vegetable oils or animal products, and rising fertilizer and fuel prices increase the costs of agricultural production and transportation. National policy responses can also contribute to further rising prices, as countries compete to find alternative supplies and institute export restrictions on basic food items.[22]

25. **Food prices, in particular, rose dramatically in early 2022.** The global Food and Agriculture Organization of the United Nations (FAO) Food Price Index (FFPI) averaged a new all-time high of 159.7 points in March—an increase of 23.7 points or 17.4 percent from the average in January 2022. This reflected record highs in vegetable oils, cereals, and meats, as well as increases in sugar and dairy products. The global Cereal Price Index increased from 140.6 points in January 2022 to 170.1 points in March 2022 (a 20.9 percent increase), while the global Vegetable Oils Index increased from 185.9 points in January 2022 to 248.6 points in March 2022 (a 33.7 percent increase). Since March, the FFPI has declined but remains (as of June) 23.1 percent higher than its value in June 2021.[23]

26. **The West Bank and Gaza is exposed to rising prices through high import dependency ratios in general, and through substantial direct and indirect food import shares from Ukraine and Russia.** The West Bank and Gaza has the second highest food import share in the region (behind only Yemen), with food imports comprising about 34 percent of total imports.[24] It also has among the highest import dependency ratios of wheat (91 percent) and vegetable oil (95 percent).[25] The territories source a substantial share of their wheat flour and sunflower oil imports from Ukraine and Russia, both directly and indirectly through key trade partners like Israel and Turkey.[26]

[22] Laborde, D., Mamun, A., & Parent, M.. (2020.) *COVID-19 Food Trade Policy Tracker* [dataset]. Washington, DC: International Food Policy Research Institute (IFPRI). https://www.foodsecurityportal.org/tools/COVID-19-food-trade-policy-tracker

[23] Food and Agriculture Organization of the United Nations (FAO). (8 Apr 2022). The FAO Food Price Index makes a giant leap to another all-time high in March. *FAO Food Price Index*. https://www.fao.org/worldfoodsituation/foodpricesindex/en/

[24] World Development Indicators, cited in WFP (Mar 2022). *Ukraine conflict: Impact on RBC operations and MENA economies*.

[25] World Food Programme (WFP). (2022). *Regional Market Analysis: Economic Trends Across RBC Region, H2 2021 Update.*

[26] United Nations (UN). (n.d.). *COMTRADE* [Dataset]. https://comtrade.un.org/

27. **Baseline prices in the West Bank and Gaza were already high relative to incomes, prior to the recent exacerbation caused by the war in Ukraine**. The Paris Protocol on Economic Relations tightly links the Palestinian economy with that of Israel and requires, among other stipulations, that the PA keep its standard VAT rate within two percentage points of the Israeli rate and follow Israeli import policies for all but selected lists of items. Israel is the West Bank and Gaza's largest trading partner,[27] and the two economies share a common currency. As the Israeli economy is many times larger than the Palestinian economy—Israeli GDP per capita is more than 13 times Palestinian GDP per capita in constant 2015 U.S. dollars[28]—this integration has inflated baseline price levels in the West Bank and Gaza relative to its neighbors. Palestinian Gross National Income (GNI) per capita is close to that of Jordan and Egypt when measured in current U.S. dollars (about 94 percent of Jordanian GNI per capita and about 1.2 times Egyptian GNI per capita). When measured in PPP terms (current international dollars), however, Palestinian GNI per capita is only about 68 percent of Jordanian GNI per capita and about 57 percent of Egyptian GNI per capita.

Box 6: PA import policy under the Paris Protocol

The Paris Protocol divided Palestinian imports into two categories, including:

a. Goods subject to an independent Palestinian policy

The agreement enables the PA to set an independent import and customs policy for goods that are listed on the A1 and A2 lists. The A1 list includes goods locally produced mainly in Jordan and other Arab countries, according to the Rules of Origin specified in Article III(8). The A2 list includes products from Arab, Islamic, and other countries. For goods on these lists, the PA can set the rates for customs and other import charges, in addition to the licensing regulation and standards. The Protocol enables the PA to import these goods in limited quantities based on the Palestinian market needs as determined by a sub-committee of experts and as agreed upon by both parties. In reality, however, this sub-committee was never formed. The agreement also enables the PA to determine the rates of customs and other import charges on goods on List B—primarily equipment and machinery—in addition to motor vehicles. However, licensing regulations, customs procedures, and standards for these goods have to follow those applied in Israel.

b. Goods subject to the Israeli policy

According to the Protocol, the PA must apply the Israeli rates for customs and other charges to all goods not specified in the A1, A2, and B lists, and to quantities exceeding the quotas set for goods on those lists. Notably, the Protocol allowed the PA to implement upward changes to the Israeli rates while requiring the two parties to apply the same import policy, customs procedures, and standards for these goods. Giving the PA the option to increase import taxes may, in principle, enable the PA to protect promising local Palestinian industries from foreign competition. However, in reality, this tool cannot be used effectively because the PA does not have any control over the crossings. Palestinian merchants may opt to import goods that are taxed more in the Palestinian territories through Israeli importers rather than directly importing them. As a result, the PA would lose purchase and customs taxes that it could have made on direct imports since, according to the Protocol, the PA only collects VAT on goods exported/re-exported from Israel.

[27] United Nations (UN). (n.d.). *COMTRADE* [Dataset]. https://comtrade.un.org/

[28] All GDP/GNI figures in this paragraph sourced from: The World Bank Group. (n.d.). *World Development Indicators* [Dataset]. https://databank.worldbank.org/source/world-development-indicators

28. **The PA has put in place policy responses to the rising food prices, while structural fiscal rigidities limit the ability to mitigate negative effects on vulnerable households.** The PA instituted a Value Added Tax exemption of 16 percent on bulk wheat flour and on bakeries for the months of March-August 2022 and reached an agreement with the bakeries union to freeze bread prices.[29] However, the government is hampered by a continued fiscal crisis. Broadly, the economy is highly constrained by restrictions on trade and access and has seen falling levels of international assistance, which are likely to be further diverted to the needs in Ukraine. The PA has been forced by fiscal constraints to pay only partial civil servant salaries since November 2021 and to suspend cash transfers to families registered with its flagship social protection program since May 2021.[30] The difficult circumstances have sparked protests over rising prices and limited government action.[31]

Box 7: The 2008 global food price crisis and the PA response

During the last global food price crisis that began in 2008, the West Bank and Gaza experienced an unprecedented rate of inflation of 9.9 percent. Globally, there was a surge in inflation, particularly in food, energy, fertilizer, and transportation costs. These effects were compounded in the West Bank and Gaza by several other factors, leading to an acute food security crisis. The conflict in Gaza and its associated restrictions on trade resulted in farmers having to either destroy their harvest usually destined for exports, or to sell at very low prices. Overall, food prices saw an exceptional increase due to the short available supply to meet the high demand. To mitigate the immediate effect of the crisis, the PA mobilized US$315 million to invest in social protection programs, food vouchers, and improving health and education facilities. Similarly, the FAO and the WFP joined efforts to provide an emergency response to around 31,000 Palestinians in the form of cash-based vouchers, with a total value of US$4.17 million.

Sources: World Development Indicators, Inflation- Consumer Price (annual %) – West Bank and Gaza, World Bank Group. https://data.worldbank.org/indicator/FP.CPI.TOTL.ZG?end=2021&locations=PS&start=2000; Inflation Takes Its Toll on Palestinians, UNOCHA, ReliefWeb, May 5, 2008. https://reliefweb.int/report/occupied-palestinian-territory/inflation-takes-its-toll-palestinians; Israel-OPT: Food Insecurity Increasing After War, UNOCHA, ReliefWeb, February 19, 2009. https://reliefweb.int/report/occupied-palestinian-territory/israel-opt-food-insecurity-increasing-after-war

29. **The WFP and UNRWA, which provide food assistance to around 1.5 million people in Gaza, are also facing heightened constraints, putting pressure on their ability to continue to provide a high level of much-needed support.**[32] They face rising supply costs (the WFP sourced over half of its global wheat grain procurement from the Black Sea region in 2021),[33] and the WFP reported that the average value of food rations per capita in the West Bank and Gaza increased by 5.4 percent from January to April 2022 and by 16.3 percent in April 2022 relative to April 2021.[34] Households in Gaza are still recovering from the May 2021 conflict, and an estimated 80 percent of the population depends on humanitarian assistance.[35] These households' experience of inflation is mediated by how much the

[29] World Food Programme (WFP) Palestine. (2022). *Monthly Market Dashboard: May 2022*; World Food Programme (WFP) Palestine. (2022). *Monthly Market Dashboard: April 2022*; World Food Programme (WFP) Palestine. (2022). *Monthly Market Dashboard: March 2022*.
[30] WFP Palestine. (2022). *Monthly Market Dashboard: March 2022*.
[31] Reuters. (6 Jun 2022). Palestinians protest against soaring prices ahead of strike. https://www.reuters.com/world/middle-east/palestinians-protest-against-soaring-prices-ahead-strike-2022-06-06/
[32] WFP Palestine. (2022). *Monthly Market Dashboard: March 2022.*
[33] WFP. (2022). *Food security implications of the Ukraine conflict*.
[34] WFP Palestine. (2022). *Monthly Market Dashboard: April 2022.*
[35] Oxfam International. (n.d.). *Crisis in Gaza*. https://www.oxfam.org/en/what-we-do/emergencies/crisis-gaza, cited in Gramer, R. & Lu, C. (28 Apr 2022). Palestinians feel economic pain from the war in Ukraine. *Foreign Policy*.

WFP and UNRWA are able to absorb the effects of rising prices and supply costs through additional donor assistance.[36]

30. **Welfare shocks induced by the COVID-19 pandemic worsened poverty and food insecurity in both the West Bank and Gaza and highlighted household vulnerability to future shocks.** This is of particular concern, as food price increases will exacerbate these vulnerabilities. At the peak of economic restrictions, the pandemic pushed more than 110,000 Palestinians into poverty, bringing the poverty rates to 19.1 percent in the West Bank and 61.1 percent in Gaza (35.6 percent nationally). At the same time, 23 percent of households in the West Bank and more than half of households in Gaza were food insecure. Even better-off households were vulnerable to food insecurity after a negative shock to incomes, and food insecurity rose by a larger share in the West Bank than in Gaza despite higher initial levels of welfare.[37]

31. **In this context, assessing the likely exposure of Palestinian households to price shocks related to the war in Ukraine is a policy question of interest.** The analysis that follows examines household consumption of commodities that are particularly affected by the recent price shocks, assesses the magnitude of price changes between January and June 2022, and simulates variation in the effective inflation experienced by households across the welfare distribution. It projects that, if prices continue to rise at the same rates seen between January and June, the poorest 40 percent of households will experience an average effective inflation rate of 7.34 percent between January 2022 and January 2023. In the same period the projection is that the wealthiest 60 percent of households will experience on average 7.1 percent inflation. It also highlights that inflation rates based on the official CPI likely understate the inflation experienced by many Palestinian households.

Box 8: West Bank and Gaza in regional context since the start of the war in Ukraine

For most countries in the MENA region, Russia and Ukraine constitute the main suppliers of wheat, seed oils, corn, fertilizers, and other energy products. As a result of the ongoing war, inflationary pressure has been heightened with price spikes particularly severe in Lebanon (43 percent) and Yemen (30 percent). The rise in food prices has resulted in an increase in poverty, given the relatively high share that food holds in the budgets of vulnerable households. A recent World Bank study shows that for every 1 percent increase in MENA food prices, as many as half a million more people could be pushed into poverty. Below is a summary of price increases observed in a selection of MENA countries during the first six months of 2022:

West Bank and Gaza	Lebanon	Yemen	Tunisia	Morocco	Egypt
Wheat Flour (23.6%) **Corn oil (26.3%)**	Wheat flour (47%)[1]	Wheat (35%)[1]	Food staples (13%)[1]	Food staples (4.3%)[1]	Bread (25%)[1]

Source: How Rising Inflation in MENA Impacts Poverty, Lopez Acevedo et al, World Bank Blogs, June 30, 2022. https://blogs.worldbank.org/arabvoices/how-rising-inflation-mena-impacts-poverty

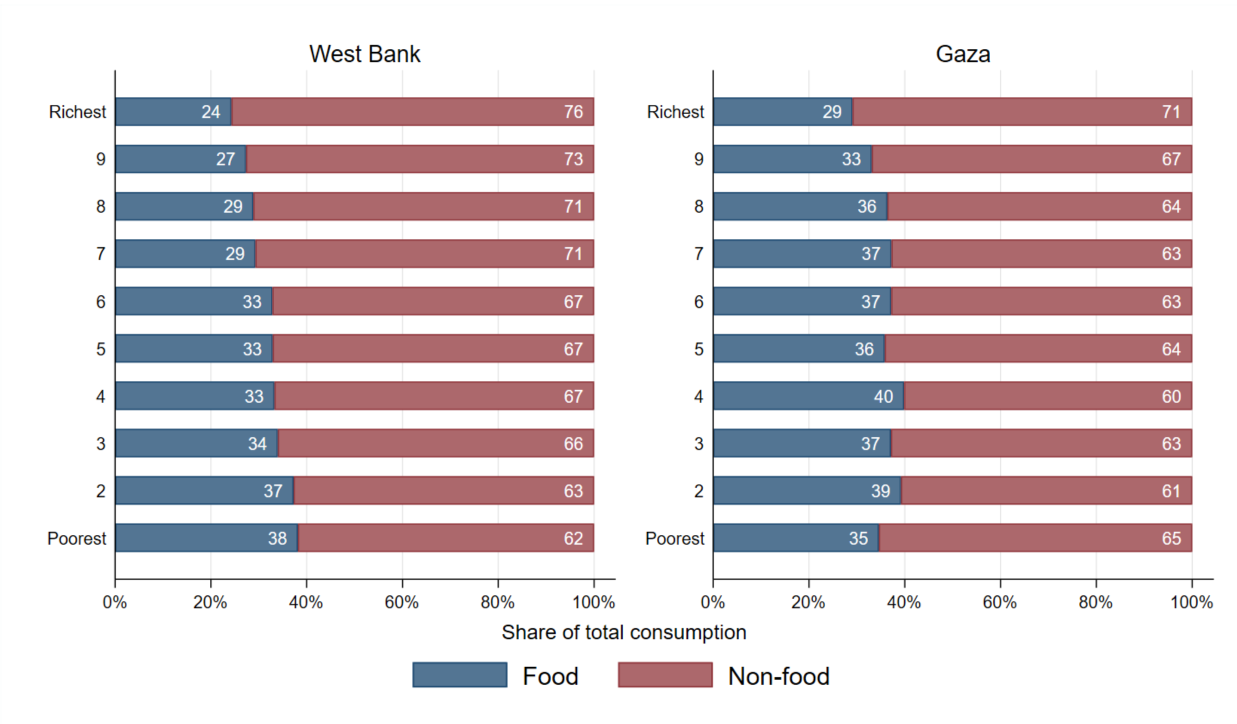
[36] Gramer & Lu (28 Apr 2022).
[37] The World Bank Group. (10 May 2022). *Economic monitoring report to the Ad Hoc Liaison Committee*.

2. Household Consumption Patterns

32. Rising food prices will disproportionately harm poorer households. Households in the wealthiest decile (the richest 10 percent of households) spend on average more than four (in the West Bank) to six (in Gaza) times as much on food per person per year as households in the poorest decile. However, food consumption forms a larger share of total consumption for poorer households than it does for wealthier households—ranging in the West Bank from 38 percent in the poorest decile to 24 percent in the wealthiest decile, and in Gaza from 35 percent in the poorest decile to 29 percent in the wealthiest decile (see Figure 8).

Figure 8: Poor households spend a higher share of their income on food

Food and non-food shares of total consumption by welfare decile

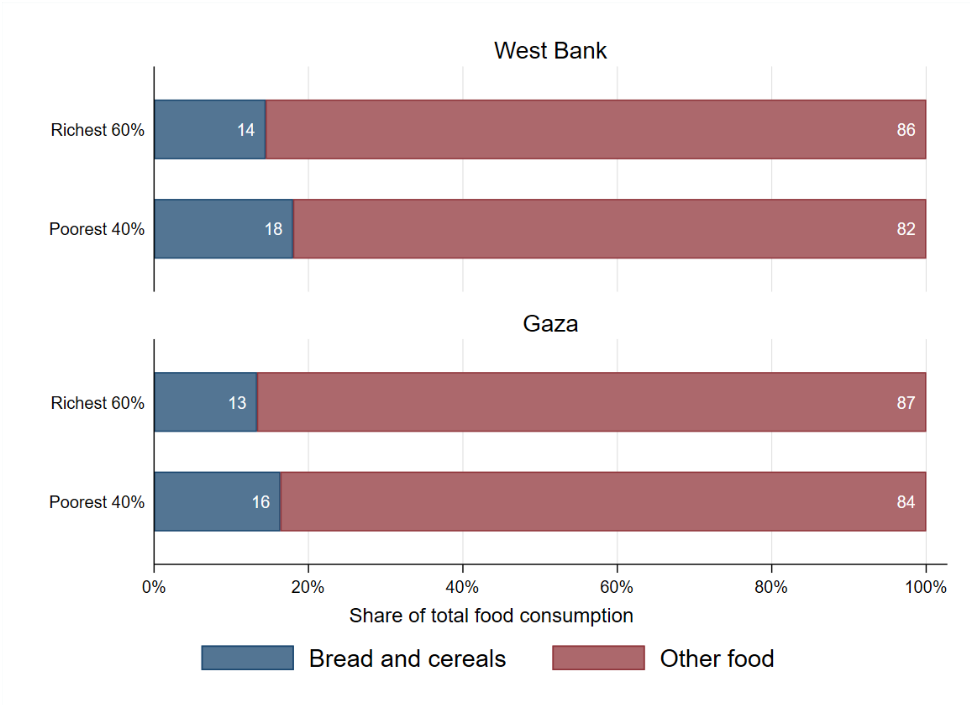


Source: WB staff calculations from PECS 2017.

33. Poor households will be particularly impacted by increases in the prices of wheat flour, corn oil, and sunflower oil. Households in poorer deciles consume larger shares of bread and grains relative to total food consumption than households in wealthier deciles (see Figure 9), and within bread and grains poorer households consume relatively more wheat flour and bread. Oils and fats constitute a small share of food consumption across the welfare distribution, but within that category poorer households tend to consume larger shares of corn oil and sunflower oil than wealthier households.

Figure 9: Within food categories, poorer households consume relatively more bread and grains

Bread and cereals share of total food consumption



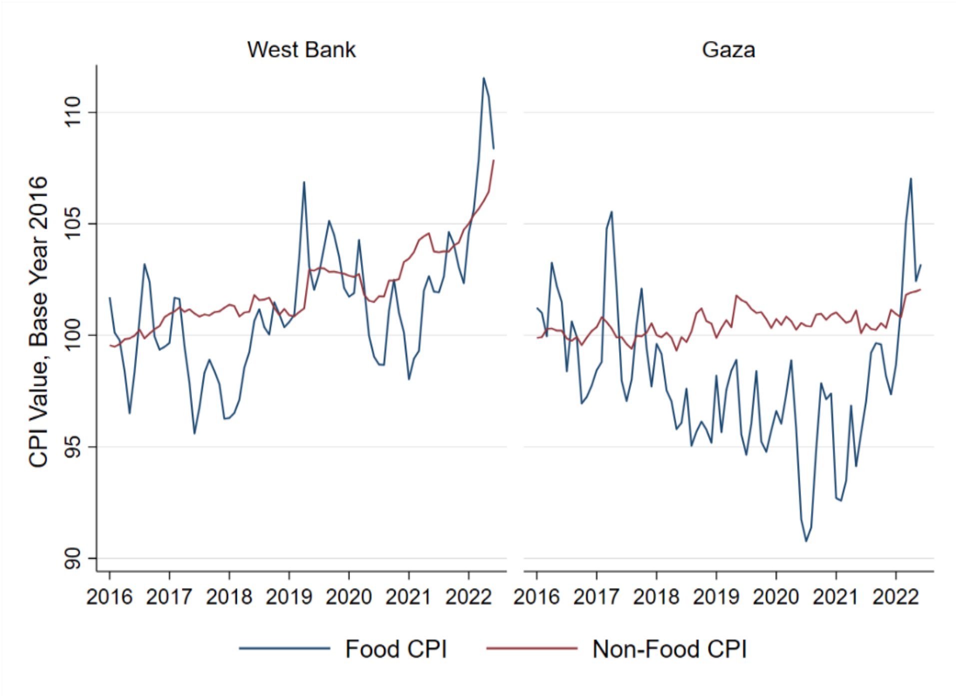
Source: WB staff calculations from PECS 2017.

3. Price Increases

34. **From January to April 2022, the food component of the Palestinian CPI rose steeply to its highest point in at least the past six years** (see ***Figure 10***). Both the food and non-food components of the CPI had been trending upward since 2021, but the rise of the food CPI in early 2022 dwarfed recent peaks. Some of this rise can be attributed to typical patterns of seasonality that peak in the spring and fall, but even as the food CPI has begun to come down from its spring peak it remains high relative to recent trends. The non-food CPI has also risen steadily since January, most rapidly in the West Bank.

Figure 10: Food CPI rose steeply from in the first half of 2022

Monthly food and non-food CPI from January 2016 to June 2022



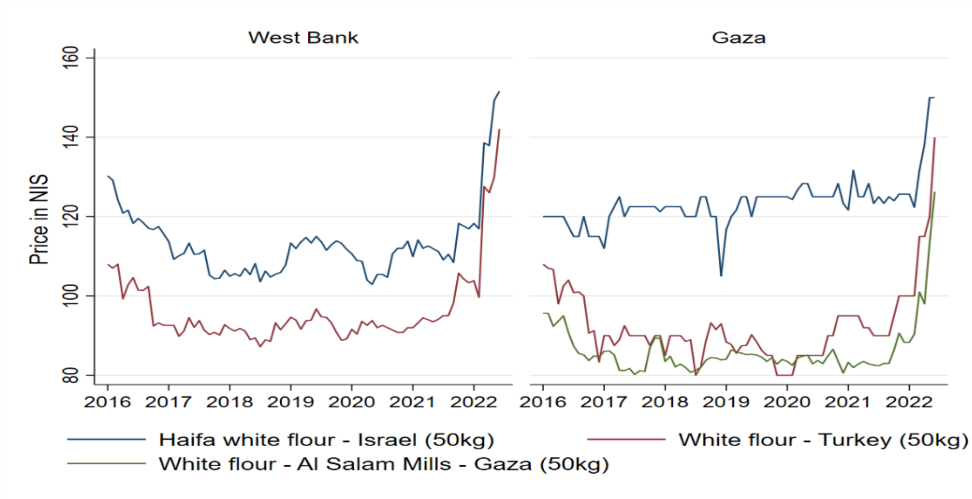
Source: PCBS price data, 2016-2022.

35. **The price of bulk flour has skyrocketed since February** (see ***Figure 11***). This rise continues inflationary trends that began in 2021 but breaks from those trends in speed and consistency across flour varieties from different geographic origins. In addition to these spikes in prices of 50kg bags, consumer packages of flour from Haifa (around 1kg in weight) are also becoming more expensive. Bread prices were temporarily stabilized in early 2022 by an agreement between the government and the bakeries union to freeze the price of bread, but have increased noticeably in early summer.[38] Corn and sunflower oil prices are also rising, and at a faster pace in the West Bank.

[38] WFP Palestine. (2022). *Monthly Market Dashboard: March 2022.*

Figure 11: Bulk flour prices are skyrocketing

Monthly prices of 50kg bags of flour from January 2016 to June 2022

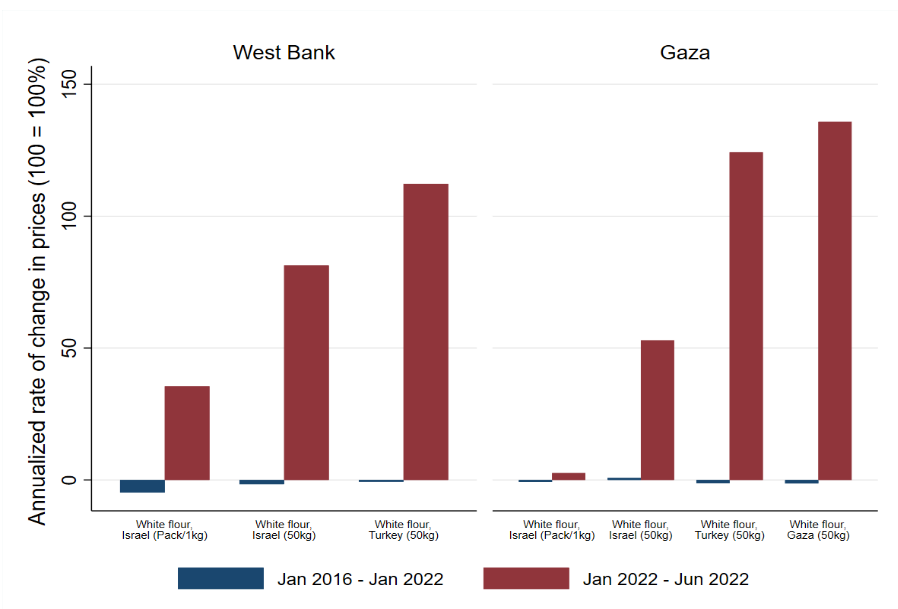


Source: PCBS price data, 2016-2022.

36. **The pace of these flour price increases differs substantially from the trend over the preceding six years** (see Figure 12). Between January 2016 and January 2022, flour prices tracked by the PA on average dropped by around 8.7 percent—the equivalent of decreasing about 1.5 percent per year over the six-year period. From January 2022 to June 2022, over a period of five months, tracked flour prices on average increased by 27.9 percent. If this trend continues for a full year, it will result in an annualized average increase of 80.6 percent.

Figure 12: If prices continue to increase at this pace, then the price of bulk flour will be up over 50 percent by the start of 2023

Annualized rates of change in flour prices from January 2016 to January 2022 and from January to June 2022



Source: PCBS price data, 2016-2022.

4. Household Exposure to Inflation

37. Most Palestinian households are likely feeling the effects of inflation in the prices of basic food items. If these prices continue to rise at the rates tracked so far in 2022, households could face very large increases in the prices of basic goods by January 2023. As shown in the table below, flour would be 80.6 percent more expensive at the start of 2023. For bread and vegetable oils the increases would be 27.9 percent and 23.5 percent respectively.

Table 4: Expected Price Increases for Certain Key Food Items

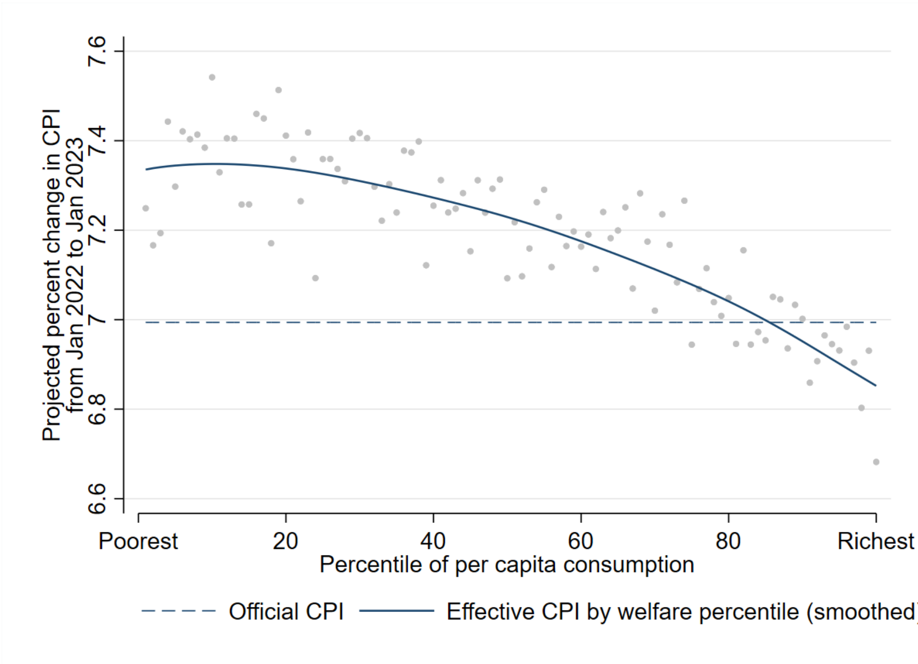
Food items	Average expected price increase from Jan 2022 to Jan 2023
Bread	27.9 %
Flour	80.6 %
Vegetable oils/fats	23.5 %

38. Poorer households have experienced higher effective inflation rates than wealthier households because the rapid rise in food prices affects a relatively larger share of consumption in poorer households (see ***Figure 13***). Effective inflation rates were simulated by weighting the food and non-food components of the CPI by average food and non-food shares of household consumption in each percentile of the welfare distribution. This analysis suggests that, if prices continue to rise at the same rates seen between January and June 2022, the poorest 40 percent of households will experience on average 7.34 percent effective inflation between January 2022 and January 2023, while during the same period the wealthiest 60 percent of households will experience on average 7.1 percent inflation. This gap is expected to grow if the rate of food inflation further exceeds the rate of non-food inflation.

39. The inflation rate based on the official CPI likely understates the effective inflation experienced by many Palestinian households because the weight of the food component of the CPI is low relative to average food shares of consumption across the welfare distribution. At the national level, official CPI inflation is most representative of the experience of the wealthiest 40 percent of households, and is lower than the effective inflation experienced by the poorest 40 percent of households (in the context of higher food than non-food inflation). As can be seen in the figure below, the official CPI number best reflects the inflation rate experienced by households in the 82nd percentile of the distribution. The exercise highlights that the CPI may not provide a useful measure of the central tendency in household exposure to inflation, as well as masking by construction variation in this exposure across the welfare distribution.

Figure 13: Poorer households are experiencing higher inflation

Percent change in effective CPI by welfare percentile, constructed by weighting food and non-food components by average household consumption shares per percentile



Source: WB staff calculations from PECS 2017 and PCBS price data, 2016-2022.

5. Conclusions and Policy Recommendations

40. This analysis has examined Palestinian households' exposure to inflation induced by the war in Ukraine and finds that poorer households are likely to be more affected than wealthier households by food inflation, and particularly rising prices of wheat products and vegetable oils, because these goods form a higher share of consumption in poorer households. It outlines the magnitude of increases in the CPI and selected basic food items since the start of the crisis and finds that, while most Palestinian households have felt the effects of inflation, poorer households are likely experiencing higher effective inflation rates on average than wealthier households because of their higher shares of food consumption.

41. Exploring household experiences of rising prices also highlights some difficulties related to building an accurate and meaningful picture of inflation. Reputable sources like PCBS and the WFP have at times reported different prices for the same or similar items, leading to different pictures of price changes. Summary measures like the CPI can seem out of sync with dramatic price changes in individual items, and the construction of the Palestinian CPI means that it is more representative of the experience of the wealthiest households than it is of the poorest households—a challenge for efforts to understand and respond to the effects of price shocks on poorer households. There may also be an important disconnect between official figures (whether specific item prices or indices) and the experiences of individuals trying to make daily purchases. A June Reuters article about Palestinian protests over rising prices contrasted merchant and protester reports of increases of as much as 30 percent in the cost of basic food items with official figures of 15-18 percent from PCBS.[39] Even if these individual experiences represent an extreme of the distribution of price increases, the disconnect between perceptions and official analysis matters.

42. **Regardless of the true distribution of price changes, even modest inflation could affect households' ability to meet basic needs because price levels in the Palestinian territories were already high relative to income levels prior to the war in Ukraine.** The Paris Protocol on Economic Relations integrates the Palestinian economy tightly with the much larger Israeli economy, leading to price levels that are out of proportion with incomes.[40] The West Bank and Gaza is highly dependent on trade with Israel, cannot set its VAT standard rate more than two percentage points away from the Israeli rate, and must for the bulk of its imports abide by customs policies that are defined by their benefit to the Israeli economy.[41] These restrictions also limit the ability of the PA to use trade policy levers to respond to the global inflation driving up domestic prices.

43. **Given the influence of the Protocol on Economic Relations on price levels in the West Bank and Gaza, the GoI, PA, and international community should renew and expedite efforts to ensure its implementation, along with necessary updates to certain provisions.** The Paris Protocol created some space for the PA to set its independent imports and customs policy on goods in the A1, A2, and B lists. The number of goods and quotas on these lists, however, have not been revised since the Paris Protocol was signed. In June 2000, following the recommendations of the Wye River Ad hoc Economic Committee, the parties agreed to add 1,300 tariff items to list A1. The additional items were limited to originating goods produced and imported directly from Jordan or Egypt only with a fiscal limit of US$20 million annually. According to the Paris Protocol, a subcommittee of experts should have been formed to review and update the Palestinian market needs in lists A1 and A2. However, such a committee was never formed, and the Wye River recommendations were never implemented. The lists have become outdated and no longer reflect the reality of Palestinian consumption and resource use. Given the current crisis, cooperation by the parties to update the lists to initially address quantities and quotas of the food items affected by the war in Ukraine is a priority as it may mitigate the immediate challenge of rising prices. To address the underlying challenge of high baseline prices, a broader review of the lists should be undertaken to update both items and quotas.

44. **Palestinian households will also need help to face already-rising prices, and the PA has limited fiscal space to provide support.** To this end, it is important that the GoI takes steps to reduce economic restrictions and sources of fiscal leakage that have been identified in previous reports. The international community should also ensure that support to the PA, as well as to other critical assistance providers like UNRWA and the WFP, is maintained at levels sufficient to fill immediate gaps in social assistance. The PA and international community together should review spending priorities to try to restore funding to the NCTP, which has been of limited assistance to its participants for several months now.

45. **On a wider front, the international community can also exert influence to limit export restrictions that have the potential to further escalate prices of basic food items.** As many as 33 countries

[39] Reuters. (6 Jun 2022). Palestinians protest against soaring prices ahead of strike. https://www.reuters.com/world/middle-east/palestinians-protest-against-soaring-prices-ahead-strike-2022-06-06/
[40] The World Bank Group. (2000). Poverty in the West Bank and Gaza. *Palestine-Israel Journal*, Vol. 7 No. 4. https://pij.org/articles/264/poverty-in-the-west-bank-and-gaza; Jamil, M. (n.d.). *National Trade Policy for Palestine – Analysis of Tariff and Industrial Policy Options*. Palestine Economic Policy Research Institute.
[41] Jamil, M. (n.d.). *National Trade Policy for Palestine – Analysis of Tariff and Industrial Policy Options*. Palestine Economic Policy Research Institute; United Nations Conference on Trade and Development. (2019). *The Economic Costs of the Israeli Occupation for the Palestinian People: Cumulative Fiscal Costs*.

imposed export restrictions during the global food crisis of 2008, and as of June 2022 the number of countries imposing export restrictions during the current crisis has already reached 34.[42]

[42] International Food Policy Research Institute. (9 June 2022). Analysis: Many countries have reacted to the food crisis in the worst possible way, making it increasingly difficult (YLE). https://www.ifpri.org/news-release/analysis-many-countries-have-reacted-food-crisis-worst-possible-way-making-it; Estevão, M. (18 July 2022). For poor countries already facing debt distress, a food crisis looms. World Bank Blogs: Voices. https://blogs.worldbank.org/voices/poor-countries-already-facing-debt-distress-food-crisis-looms

Annex I: Stocktaking of World Bank Recommendations to the AHLC Meetings Over the Years

46. **The Palestinian economic outlook is challenged by both structural constraints and downside risks.** Bold actions are needed from all parties to put the Palestinian economy on more sustainable, including and sounder footing. Several actions have been identified in previous reports by the World Bank to the AHLC meeting, while implementation has lagged behind. In the World Bank's September 2016 report to the AHLC, a stocktaking of all previous World Bank recommendations to the meeting was conducted. This exercise was intended to achieve two main goals: 1) provide a baseline for evaluating progress in achieving the Palestinian territories' development priorities; and 2) generate momentum for reform efforts by all parties, to address the immediate needs while maintaining focus on the reforms that would deliver results over time. The present report updates the 2016 stocktaking exercise to show recent progress, and uses the same three pillars: (1) fiscal sustainability, (2) economic development, and (3) Gaza reconstruction and recovery.

a) Fiscal Sustainability

47. **Over recent years, the PA has implemented important reforms to increase revenues and rationalize spending but more needs to be done to address structural rigidities that are key to achieving long-term fiscal sustainability.** Several AHLC reports have highlighted in particular three areas to tackle, which can ease up fiscal space for the PA: 1) civil sector reforms; 2) electricity (and utilities, at large) sector subsidies; and 3) health sector inefficiencies and loopholes. First, the PA should adopt a comprehensive plan for civil service reform that considers inefficiencies and overstaffing – especially in the West Bank. The MoF started to elaborate proposals to rationalize the wage bill, which are expected to be discussed at the Cabinet soon. Parametric reforms are also needed to support the public pension system's sustainability. Limited progress has been made on steps to control electricity sector impacts on "net lending" – although the problem remains in this sector and is also increasing with other utility payments, mainly water and sewerage. The net lending situation for the water sector continues to face challenges: i) net lending for water and sanitation is at NIS30 million per month; ii) Israel charges the Palestinian MoF NIS110 million per year to treat the transboundary wastewater. There is no agreement on accounting principles for these costs; and iii) service providers continue to accumulate debt, which has increased due to COVID-19. All stakeholders should agree on a new mechanism to ringfence water revenues and increase payments of bulk water purchases from the Israel water utility Mekorot. Finally, outside medical referrals (OMR) also represent a sizeable source of fiscal burden for the PA. While any steps on this front should not jeopardize access to healthcare – and particularly so for the most vulnerable – authorities should continue monitoring closely this category of spending, as demonstrated by the recent introduction of a digitalized system to monitor OMRs. The integration of this e-referral system to the MoF's Integrated Financial Management Information System (IFMIS) will further enhance transparency on OMRs and allow for higher spending efficiency and better financial planning.

48. **After declining in 2020 due to the COVID-19 crisis, revenues rebounded in 2021 and continued on that trend so far in 2022, but risks remain elevated and additional efforts will be required to bring revenue mobilization closer to its full potential.** As the COVID-19 containment measures remained eased in 2022, domestic taxes increased by 26 percent. Despite this impressive performance, efforts are still needed by the PA to improve tax administration. For instance, tax avoidance is still widespread, particularly among high earning professionals, and the PA needs to focus efforts on this group of taxpayers. Importantly, the MoF has recently prepared a new revenue strategy that focuses on

tax administration and improving compliance, which is an encouraging step forward in the right direction. The strategy also focuses on a new VAT law, as well as a new customs law and amendments to the 2011 income tax law. Progress has also been made on updating public fees and charges with a notable decision to increase the license fee for petrol stations. Further, the PA and the Government of Jordan have agreed to further cooperation on customs through electronically linking their customs systems, which has significantly reduced smuggling.

49. **Cooperation by the GoI to offset fiscal leakages remains key, as past records clearly indicated that deductions from clearance revenues produce highly negative impacts on the PA's fiscal situation.** The GoI increased monthly deductions from clearance revenues from NIS40 million (in previous years) to NIS50 million (in April 2021) and further up to NIS100 million (in August 2021). The monthly deduction has been reduced back to NIS50 million in 2022 and the Israeli Knesset has recently taken a decision to continue deducting this amount in the coming year. These deductions have placed large stress on the PA's financing situation. Hence, there is an urgent need to resolve outstanding issues related to the revenue sharing arrangements. Efforts should focus on implementing existing agreements that provide for full information sharing on trade that takes place between both parties, including Israeli sales to Gaza. The parties could also reach an agreement regarding the sharing of Allenby Bridge exit fees. Talks have been underway for some time between the GoI and the PA to introduce customs bonded warehouses for Palestinian imports and to regulate a gradual transfer of customs authority to the PA over time. In addition, despite encouraging talks about separating fuel taxes from the clearance process, this did not materialize as these taxes continue to be collected by the GoI and are then transferred to the PA upon deduction of a 3 percent handling fee. The pilot program for an e-VAT system on a voluntary basis is also encouraging, but more work is needed to bring all traders and transactions into the system and eventually electronically link the interfaces of both parties, as that will be essential to attaining any meaningful declines in VAT leakage.

50. **Budget support from donors has significantly declined in recent years and funds remain insufficient to close the large financing gap.** As a share of GDP, aid to the budget fell from 27 percent in 2008 to 1.8 percent in 2021 and is expected to remain around the same level in 2022. Donor support has helped to progress the PFM system over the last few years (see more details in Box 3).

b) Economic Development

51. **The constraints on movement, access, and trade continue to be the main impediment to economic growth in the Palestinian territories.** Area C remains key to Palestinian economic development but access to this area remains severely limited. Further progress has been made on the piloting of door-to-door transport through the West Bank crossings, with the initial Hebron pilot being extended to Nablus and Qalquilia regions, however the current scope of this activity remains limited. On August 1, a pilot was initiated to allow Palestinian businesses to ship imports and/or exports through Jordan in 40-foot containers, up from the standard 20-foot containers, to facilitate trade. The pilot is expected to last for three months and is an encouraging step in the right direction. Building power networks in the West Bank, particularly for increasing imports from Jordan, unavoidably involves some segments traversing Area C and continues to suffer from approvals being opaquely delayed for years. The long list of dual-use items key for the development of the economy and whose access is restricted has been updated but not significantly eased. With time, and as more incentives are put in place to promote compliance, access to dual-use items should be based on a risk-based criterion rather than a blanket approach. For instance, all Palestinian businesses that have established a strong track record of their ability to safely and securely handle hazardous materials and dual-use goods should be granted access to these goods without the need for cumbersome licensing procedures. Encouragingly, the GoI has recently announced

that some restrictions on the movement of goods and people in and out of the Strip will be eased. According to the GoI, it has facilitated the entrance of textiles, agricultural produce and rebar to Gaza. Also, the quota for Gazan workers in Israel was raised to 15,500.

52. **The adoption of the Companies Law is a major milestone in improving the business climate.** With technical assistance from the World Bank, a new draft of the Companies Law was adopted and published on December 30, 2021, and became effective on April 1, 2022. The World Bank is providing support to the Ministry of National Economy in implementation of the law, including development of registration forms and required by-laws. Capacity building of the Companies Register staff on the new regulatory framework as well as design of the e-platform for registration has started with the support of the World Bank. Continuation of capacity building of key stakeholders, public and private, and development and launching of the Companies Register e-platform for registration will be key for successful implementation of this major reform. This reform will significantly improve the Palestinian business environment by offering SMEs, entrepreneurs, as well as local and foreign investors a legal framework at international standards, corresponding to a digitalized and fast-paced business world. The new enacted Companies Law provides a more predictable and transparent business environment by introducing new concepts and approaches. Specifically, the new Companies Law: a) enables businesses to register online; b) facilitates the incorporation of businesses by removing unnecessary formalities, minimum capital requirements; c) regulates SMEs only to the extent necessary for the public interest and reduces the compliance cost by removing excessive requirements; d) allows home-based businesses to be registered, to support youth and women entrepreneurs; e) introduces new types of company forms; f) removes restrictions to foreign investment; g) enhances transparency of and accessibility to businesses registration data; h) provides better rules for larger businesses with multiple shareholders; i) introduces tools that the business community was missing, such as mergers, divisions, and transformation; j) promotes women in leadership roles by requesting public companies to have at least one-third of the Board of Directors women; k) equips shareholding companies with new tools to address the diversity of situations they face in their operation, such as different types of shares, employee stock option plans, and convertible bonds; l) introduces stronger protections for minority investors; and m) enables entrepreneurs to close their businesses faster and through more affordable and predictable procedures for mandatory and voluntary liquidation.

53. **Progress has also been seen in other areas of the business environment, but more efforts are needed.** A draft Competition Law was approved by the Cabinet and is now awaiting the President's signature. With support from the World Bank, the PA has also updated the Law of Crafts and Industries of 1953 to facilitate municipal business licensing through simplifying the approval process and reducing the cost. The amendments took effect from January 1, 2019, and the focus has more recently been on removing administrative obstacles to faster processing of municipal business licenses and automating the process. To establish strategic and policy oversight of institutions in land administration, in November 2018 the Cabinet of the previous administration adopted a draft Amendment to the Palestinian Land Authority (PLA) Laws. The amendment calls for the establishment of a Board of Directors that would oversee the operations of the PLA and facilitate increased transparency in the land sector in line with the ongoing reform process. In 2020, the President's Office sent the PLA Law back to the Council of Ministers with comments on the financial implications of the law. The PLA and Land Water Settlement Commission (LWSC) addressed all the comments, and the text of the law was reformulated accordingly and sent back to the Council of Ministers for approval. The draft law was sent to the Presidency again in April 2021 for enactment, but still awaits the President's signature. Land registration is proceeding in the West Bank under the mandate and direction of the LWSC in cooperation with LGUs. A new telecommunication law was enacted by the President and then published on December 23, 2021 in the 186th edition of the Gazette. Even though the gazetted law

requested the establishment of the Telecommunications Regulatory Authority (TRA), it did not grant it the level of independence expected to effectively perform its role. Following comments from civil society and international organizations, including the World Bank, the Palestinian cabinet revised the law to strengthen the technical and regulatory authority of the regulator, in line with advice provided by the World Bank. The amendment to the law was signed by the Palestinian President on May 18, 2022 and was published in the Official Gazette on May 25, 2022.

54. **Progress in the energy sector continues in the shadow of COVID-19.** The interim Power Purchase Arrangements (PPA) between the GoI and the PA continue to be implemented. Based on these arrangements, the Palestinian Electricity Transmission Company (PETL) has started managing electricity supply from the Israeli Electricity Company (IEC) through the four high-voltage substations in the West Bank. However, IEC's high share of 95 percent of electricity supply in the West Bank and Gaza continues to have implications on net lending (as indicated in para 2). PETL is providing solar energy, supplied by private-sector independent power producers (IPPs) in the northern West Bank and has maintained a good payment record under the interim arrangements and solar PPAs. However, due to the Amendments to the Electricity Law in early 2022, PETL's role as a single buyer of electricity has been diminished creating some uncertainties over the direction of development of the sector. Increasing electricity supply through the high-voltage substations will contribute to reducing technical losses, alleviating supply constraints, and improving quality of electricity supply across the West Bank. In addition, the establishment of a transparent, competitive auction-based procurement framework of private sector-led IPPs will contribute to the scale-up of more reliable and affordable solar power in the West Bank. These actions would not only lead to a diverse and sustainable electricity sector, with less dependence on IEC, but would also contribute to the PA's global climate change commitments endorsed under its Nationally Determined Contributions (NDCs) submitted to the United Nations Framework Convention on Climate Change (UNFCCC) in 2021. The Palestinian Energy and Natural Resources Authority (PENRA) continues to implement reform measures to improve collection, efficiency, and payment-related performance. The pandemic and economic slowdown continue to cast a shadow in terms of disruption in financial flows across the energy supply chain, which is affecting all energy sector institutions. A Revenue Protection Program, along with updated management information systems, continues to be rolled out to the electricity distribution companies in the West Bank and Gaza. However, improvements in the sector continue to be hampered by a lack of progress in other areas - particularly those related to electricity infrastructure in Area C. Diversification of electricity supply from neighboring countries and distribution grid reinforcements are needed to enable reliable supply and growing electricity needs in the future, but are hindered primarily by land access issues. Construction restrictions for electricity generation (such as from large, utility-scale solar power plants), and transmission and distribution (T&D) infrastructure in Area C, continue to pose major obstacles to strengthening the energy supply and sustainability through renewable IPPs and interconnections. In Gaza, the need for implementing a comprehensive large-scale energy action plan to enable increased and improved reliability of electricity supply to critical services and households, and institutional reforms remains urgent, due to current significantly high demand-supply gaps. The recently concluded institutional review and audit of energy sector finances in Gaza provides comprehensive recommendations and accelerating their implementation is a priority in addressing the energy crisis and managing the electricity sector's fiscal impact. These elements are also anchored around the "Gas for Gaza" initiative, facilitated by the Office of Quartet (OQ) along with other development partners, aimed at bringing more natural gas into Gaza, enhancing the gas-power plant's generation capacity and high voltage T&D infrastructure.

c) Gaza Reconstruction and Recovery

55. **The 11-day Gaza conflict in May 2021 resulted in severe damages across all sectors in Gaza.** The immediate humanitarian response started, and efforts are still needed by all parties to ensure this response lays the groundwork for medium and long-term reconstruction and recovery phases. There is a need for action by the PA, GoI, and international community to address the needs and ensure that this reconstruction process paves the way for an efficient recovery and a more sustainable trajectory for Gaza. The PA needs to take on an active approach in leading the reconstruction efforts, building on experience from previous conflicts, namely in 2014. The PA will also need to take prompt actions to ensure sustainability of governance arrangements in Gaza as the current situation of dual administrative systems results in complicated public service arrangements and is not sustainable. Access to materials for reconstruction should be eased to allow for an efficient and speedy reconstruction, while also addressing legitimate security concerns. Efforts also need to focus on easing constraints that currently stifle private activity and setting the enabling conditions for private investment, as achieving a sustainable growth path for Gaza cannot happen without allowing its economy to connect to the outside world. Finally, sizable and predictable donor support will not only be crucial to implement reconstruction activities, but Gaza's economy will continue to depend critically on donor support for several years to come, until gradually the tradable sectors replace the role of donor aid as the key source of foreign exchange to fuel the economy.

Table Summary of World Bank Recommendations to AHLC meetings

Actions	**Responsible Party**	**Progress as of Sep 2016**	**Progress as of Sep 2022**
FISCAL SUSTAINABILITY			
Expenditures			
Control the oversized wage bill	PA		
Control medical referrals to Israel	PA		
Control medical referrals to local facilities	PA		
Implement administrative reforms for the pension system	PA		
Implement parametric reforms to restore the pension system's sustainability	PA		
Reduce the size of net lending	PA		
Revenues			
Enhance the PA's tax effectiveness in Gaza	PA		
Increase the number of registered large taxpayers	PA		
Strengthen legislation to penalize non-compliant taxpayers	PA		
Revise government fees and charges upward	PA		
Transfer to the PA fiscal losses accumulated over the years	GoI		
Implement institutional measures to reduce fiscal losses on clearance revenues	PA and GoI		
Public Financial Management			
Improve budget preparation procedures	PA		
Align budget execution with available resources	PA		

Clear the backlog of outstanding financial statements • 2021-2022	PA		
Develop systems for monitoring and reporting expenditure arrears	PA		
Budget support			
Provide sizable, predictable, and timely support to the PA's budget	Donors		
ECONOMIC DEVELOPMENT			
Area C			
Expand spatial plans for Palestinian villages in Area C	GoI		
Increase number of building permits approved in Area C	GoI		
Grant approval to Palestinian business projects in Area C	GoI		
The Gaza economy			
Allow exports out of Gaza to reach pre-2007 level	GoI		
Significantly reduce items on restricted dual-use list for Gaza	GoI		
Create a unified legal system in the West Bank and Gaza	PA		
The business climate			
Adopt the Secured Transactions Law and establish a movable asset registry	PA		
Adoption of new Companies Law	PA		
Adoption of Competition Law	PA		
Accelerate land registration in Areas A and B	PA		
Improve access to finance for SMEs	PA		
Reform the education system to bridge gap between graduates' skills and labor market needs	PA		
Securing energy for development			
Sign interim PPAs to energize high-voltage substations	GoI and PA		
PETL operating on commercial basis	PA		
Diversify electricity supply	GoI and PA		
Access to dual-use items			
Make the process to import dual-use goods more transparent	GoI		
Allow access to potent fertilizers in the West Bank	GoI		
Facilitate access to machinery in the West Bank	GoI		
Adopt a risk-based approach in the West Bank and Gaza to control dual-use items	GoI		
Meet international standards for controlling and regulating dual-use goods	GoI and PA		
GAZA RECONSTRUCTION AND RECOVERY			
Complete a DNA to guide reconstruction and recovery following May 2021 conflict	PA, donors		
Establish and monitor timeline indicators for review and approval of dual-use items	GoI		

Include delivery monitoring in Gaza Reconstruction Mechanism (GRM) system	GoI and PA		
Establish Gaza import mechanism able to handle long-term recovery needs	GoI and PA		
Gaza Development[1]			
Streamline trade procedures at commercial crossing and expand capacity	GoI		
Expand Gaza's fishing zone	GoI		
Implement donor-financed labor-intensive projects	PA, GoI, donors		

Legend

	On track
	Some progress achieved
	No progress