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World Bank Economic Monitoring Report

to the

Ad Hoc Liaison Committee

April 2023

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*Note: the analysis contained in this report reflects data available as of March 31, 2023.

ACRONYMS

AHLC	**Ad Hoc Liaison Committee**
AML/CFT	**Anti-Money Laundering and Combating Financing of Terrorism**
CBRs	**Correspondent Banking Relationships**
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. The Palestinian economy's post-pandemic recovery continued in 2022. While the pace of recovery slowed from 2021, the GDP growth rate remained strong at 3.9 percent year-on-year (y-o-y) driven by a continued recovery of private consumption as COVID-19 mobility restrictions remained eased. The overall unemployment rate in the West Bank and Gaza fell from 26.4 percent in 2021 to 24.4 percent in 2022. Meanwhile, a rising number of Palestinians working in Israel and the settlements boosted remittances and supported household consumption. Nevertheless, unemployment remains pervasive, particularly in Gaza, where the unemployment rate reached 45.3 percent as economic and social conditions continued to be difficult. Stronger aggregate demand added to inflationary pressures in 2022[1] amid rising international prices. The GDP growth rate is expected to slow during 2023 as the post-pandemic rebound tapers off. Downside risks persist, with Russia's ongoing invasion of Ukraine threatening global supply chains and prices, while the ongoing escalation of clashes in the Palestinian territories remains a key source of risk, which is exacerbated by increased political and policy uncertainty following the latest Israeli elections.

ii. Increased revenue mobilization coupled with steady public spending improved the fiscal balances during 2022. Domestic tax collection rose by 19 percent y-o-y, reflecting increased economic activity and measures to strengthen revenue administration. Clearance revenues also increased by 20 percent, y-o-y, in 2022, driven by higher customs, value added tax (VAT), and petroleum excise collection. Recurrent public spending remained almost unchanged in nominal terms from 2021, with increases in the wage bill being offset by lower transfers, albeit at a high social cost. Amid rising revenue and stable expenditures, the total deficit (before grants) dropped by over 60 percent y-o-y during 2022. After accounting for donor financing and deductions made by the Government of Israel (GoI) from clearance revenues, the Palestinian Authority (PA) ended the period with a financing gap of US$351 million (1.8 percent of GDP). To cover the fiscal shortfall, the PA continued to accrue a large and growing stock of arrears to the private sector, the pension fund, and public employees, which poses risks to long-term macroeconomic stability.

iii. Establishing fiscal sustainability will require strong and sustained macroeconomic reforms as well as constructive and meaningful cooperation between the GoI the PA, combined with increased donor support to the PA. Unreliable funding of certain public services and mounting payment arrears to the private sector are tightening liquidity constraints and inhibiting economic development. Efforts to improve the equity, effectiveness, and efficiency of public spending must encompass the wage bill, the generous public pension system, and focusing the allocation of transfers to the more needy. Strengthening the management of referrals is a key priority in the health sector. Reforms to reduce net lending are also urgent, as the current system results in large unplanned subsidies to local governments.[2] At the same time, policy action by the PA alone will not suffice to achieve macro-fiscal sustainability: agreement on policy measures by Israeli authorities to advance cooperation is essential to achieve consequential improvements in the macro-fiscal environment. This report details concrete options for policy action to be considered by GoI and PA, and agreed upon to[3].

iv. Recent efforts to control the wage bill and strengthen public financial management, anchored by the adoption of a net attrition target for public employment and the clearance of the backlog of financial statements are encouraging. Net public employment has increased steadily for years, but in

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[1] With a CPI at 3.7 percent, in 2022.

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

[3] See, for instance, Box 1, Box 2, and Box 3.

November 2022 the PA announced that it would aim for new recruitments to not exceed 50 percent of retirements and other exits during 2023. This measure is in important in the signal it sends and on its own it could result in fiscal savings, albeit modest ones initially. However, those gains may be offset as ongoing negotiations with workers unions, especially in the education sector, could result into additional pressure on the fiscal envelope. The PA continues to make progress in improving the public financial management (PFM) system: the production and auditing of financial statements has accelerated, and the five-year backlog of audited financial statements has recently been fully cleared. The PA has also committed to implementing a commitment-control system for all expenditure categories by Q2 2023, which should strengthen arrears management. The passage of a new law has bolstered the anti-money laundering and combating the financing of terrorism (AML/CFT) framework. This effort will require continued commitment from the PA, in partnership with the donor community, to ensure smooth implementation.

v. **Sustained donor support will be critical as the PA continues its fiscal consolidation.** While the PA has made some progress on revenue and expenditure reform, these efforts must remain gradual to avoid creating adverse social or economic consequences. The ongoing consolidation is also highly vulnerable to exogenous shocks, as economic growth and the fiscal balances remain highly dependent on the political context and on Israel's cooperation. Adequate and predictable budget support will be necessary both to ease the fiscal consolidation and to hedge against political and economic uncertainty. In the medium term, donor support should be redirected toward development projects that will bolster economic growth. Further improvements in transparency through PFM reforms and cross-cutting governance measures could attract additional donor interest and resources.

vi. **While the PA's reform efforts are necessary to ensure fiscal sustainability, close and active cooperation by the Israeli Government remains critical for putting the Palestinian economy on a sustainable development path.** Previous World Bank analytical work has shown that movement restrictions in the West Bank and the near-blockade imposed on Gaza remain the most important obstacles to economic growth and private-sector development. Until existing constraints are eased or lifted, the economy of the Palestinian territories is expected to continue operating below its potential.

vii. **The financial sector has also continued to recover from the impact of COVID-19, but high levels of bank exposure to the public sector pose risks to financial stability.** Data from the Palestine Monetary Authority (PMA) through December 2022 indicates that the profitability of the banking sector has rebounded. Return on equity reached 11.02 percent and return on assets reached 1.55 percent by Q4 2022, both of which exceed pre-COVID levels. Customer deposits remained flat in 2022, compared to a moderate growth in credit, resulting in a gradual increase in the level of overall credit-to-deposit ratio to 67 percent by Q4 2022. Growth in credit during the reporting period was mainly driven by private sector loans (and some loans to PA employees). 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.

viii. **The PA has repeatedly resorted to borrowing from domestic banks during times of heightened fiscal stress, occasionally exceeding bank-exposure limits set by the Palestinian Monetary Authority and potentially threatening the stability of the banking system.** Before the COVID-19 pandemic, PA borrowing had remained broadly stable for several years at about US$1.3-1.4 billion. However, by Q4 2022 direct borrowing by the PA reached 2.2 billion, following a pandemic induced peak at 2.5 billion in December 2021. In addition to direct borrowing by the PA, bank loans to public employees, which are fully or partially backed by future PA salaries, and the use of promissory notes create indirect exposure to the public sector. The PA and public employees account for a combined US$4 billion in loans, representing almost 40 percent of banking-sector credit. Given the unstable economic context, financial regulators should continue to emphasize the importance of safeguarding the banking system against economic and fiscal shocks.

ix. The stability and predictability of cross-border payments remains a serious issue, while progress on establishing a more stable arrangement for correspondent banking relationships (CBRs) has been slow. Citing AML/CFT concerns, key Israeli banks have repeatedly signaled plans to limit or terminate correspondent banking services to Palestinian banks. The potential disruption of CBRs poses a major risk to the Palestinian economy, as Israel is its main trade partner, and the Israeli shekel is its primary currency. Over the years, the Government of Israeli has repeatedly extended the temporary indemnity and immunity package issued to key Israeli banks providing correspondent banking services to Palestinian banks, most recently in March 2023. A more stable arrangement for cross-border payments is being jointly developed by the Bank of Israel and the Palestine Monetary Authority, progress has been slow.

x. Rising food and fuel prices have underscored the critical importance of accelerating economic growth and development in the Palestinian territories. Between January and April 2022, the food component of the Consumer Price Index (CPI) rose to some of its highest point in at least six years. The effects of such price shocks disproportionately harm the poorest households, which spend the largest share of their income on food. Moreover, the official CPI likely understates the effective inflation experienced by many Palestinian households, as its weights are most representative of the wealthiest 40 percent of the population.

xi. This economic monitoring report focuses specifically on macro-financial aspects. World Bank staff opted to focus specifically on issues pertaining to macroeconomic, fiscal and financial sector developments, rather than expanding the diagnostic to additional focus areas – as in several of the past AHLC economic reports. This reflects the high level of uncertainty that characterized the months of conceptualization and preparation of this report (November 2022 – March 2023), when information about the timeline and even the materialization of the upcoming AHLC meeting has been fragmented and changeable.

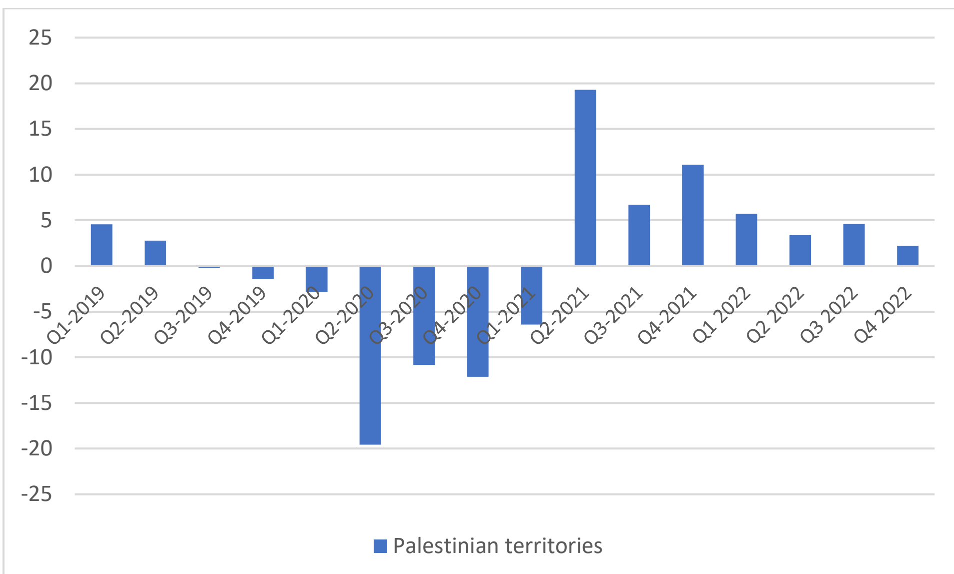
xii. Cooperation between the GoI and the PA remains vital to achieve long-lasting and mutually beneficial development outcomes. Poverty, inequality, and joblessness decrease societal resilience to social instability and violence. Young people who face bleak economic prospects and feel marginalized by society can also be prime targets for recruitment by criminal actors and extremist groups. Establishing a solid foundation for peace and security will not only benefit from, but largely depend on broad-based income gains supported by macro-fiscal stability and dynamic private-sector-led growth. For these reasons, the economic and security outlook for the Palestinian territories hinges on robust technical and political cooperation between the Palestinian and Israeli authorities.

RECENT ECONOMIC DEVELOPMENTS

1. Economic Activity

1. **The Palestinian economy continued to rebound from the shock of the COVID-19 pandemic during 2022, though the recovery slowed compared to 2021.** The real GDP growth rate in the Palestinian territories fell from 7.0 percent in 2021 to 3.9 percent, year-on-year (y-o-y), in 2022. As COVID-related measures remained eased, the economy continued to expand driven by consumption, which in turn prompted the growth of the wholesale and retail trade sector, as well as services. The increase in the number of Palestinians working in Israel and the settlements also aided the recovery, as they earn more than twice the average daily wage compared to workers in the Palestinian territories, implying a larger impact on aggregate demand. Nevertheless, economic output remained slightly below its pre-pandemic level at end-2022.

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



Source: Palestinian Central Bureau of Statistics.

2. **While employment increased in 2022, the unemployment rate remained high.** Employment rose by two percentage points in 2022, largely driven by increased labor force participation, as more workers returned to the labor market after the COVID-19-related lockdowns eased. The number of Palestinians working in Israel and the settlements continued to increase compared to 2021. As a percentage of those in employment, 22.5 percent of Palestinians in the West Bank worked in Israel and the settlements in 2022 compared to 0.8 percent of Gazans. Despite a decline from 26.4 percent in 2021, unemployment in the Palestinian territories remained high, at 24.4 percent in 2022. The overall rate masks a wide regional divergence whereby unemployment in the West Bank reached 13.1 percent in 2022 while in Gaza it was 45.3 percent, as movement restrictions imposed by Israel continue to create near-blockade in the local economy.

Table 1: Labor Market Statistics, 2022

Indicator (percent)	West Bank	Gaza	Palestinian territories
Unemployment rate	13.1	45.3	24.4
Full employment	85.7	52.6	74.1
Underemployment	1.2	2.0	1.5
Labor force participation rate	47.5	41.0	45.0
Youth unemployment (15-29 years)	20.0	61.1	35.0
Male	16.0	54.3	29.6
Female	36.6	83.7	55.8

Source: Palestinian Central Bureau of Statistics

3. **Rebounding demand and rising global prices put upward pressure on inflation in 2022 and the pressure seems to have continued so far in 2023.** The Consumer Price Index increased by 3.7 percent, y-o-y, up from 1.2 percent in 2021. Russia's invasion of Ukraine drove up food and fuel prices worldwide, compounding the surge in demand caused by accelerating local economic activity. A mild depreciation in the Israeli shekel, the primary currency in circulation in the Palestinian territories, helped keep inflation low by regional standards. Latest data for February 2023 indicate that y-o-y inflation continued to be high, exceeding 4.0 percent, mostly driven by food prices. Rising food prices disproportionately harm poorer households as food 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. [4]

4. **Increased domestic demand boosted imports, widening the current-account deficit.** While imports and exports both increased during the first three quarters of 2022, export growth remained severely constrained by trade restrictions. Consequently, rising imports widened the trade deficit from US$5.0 billion in the first three quarters of 2021 to US$6.9 billion during the same period in 2022. Meanwhile, net income from abroad improved, driven by increased private transfers, mainly due to the increased number of Palestinians working in Israel. This boosted the total compensation of employees working abroad by 30 percent, y-o-y, to US$3.4 billion in the first three quarters of 2022. The current-account deficit widened from US$1.1 billion in the first three quarters of 2021 to US$2.0 billion in the same period in 2022.

[4] World Bank report to the September 2022 Ad Hoc Liaison Committee.

Table 2: Key Macroeconomic Indicators, 2018-2022

	2019	2020	2021	Est. 2022
Real economy, annual percent change, unless indicated otherwise				
Nominal GDP	5.3	-9.3	16.6	5.5
Real GDP	1.4	-11.3	7.0	3.9
GDP per capita (nominal)	2.7	-11.6	13.8	3.0
Contributions to Real GDP Growth				
Private Consumption (growth)	4.1	-13.1	7.5	20.5
Gross Fixed Investment (growth)	-2.6	-20.9	13.7	11.8
Exports (growth)	2.0	-11.2	17.3	6.2
Imports (growth)	1.4	-14.2	14.8	25.7
Unemployment Rate (International Labor Organization (ILO) Definition)	25.3	25.9	26.4	24.4
GDP Deflator	3.8	2.2	9.0	1.5
Consumer Price Index (CPI) (year-average)	1.6	-0.7	1.2	3.7
Balance of Payments, percent of GDP unless indicated otherwise				
Current Account Balance	-10.4	-12.3	-8.2	-9.0
Imports, Goods and Services	53.5	51.9	56.6	68.4
Exports, Goods and Services	15.5	15.4	17.6	18.8
Net Foreign Direct Investment	-1.1	-0.9	-1.0	-1.0
Gross Reserves	3.8	4.5	4.8	3.6
External Government Debt	7.1	8.5	7.3	6.7
Memorandum items:				
GDP nominal (US$ million)	17,134	15,532	18,109	19,112

Source: PCBS, PMA, and MoF. **Note:** e = estimate

5. **The latest estimates indicate that the poverty rate peaked in 2020, then dropped slightly by 2022.** In the West Bank, poverty rates are lower, but households remain sensitive to economic shocks, while in Gaza any change in social-assistance flows will significantly affect the population's wellbeing. According to the most recent official statistics, 20.5 percent of Palestinians lived below the poverty line[5] in 2016/17. World Bank estimates using the $6.85 international poverty line and based on trends in real per capita GDP suggest that the poverty rate spiked at 26.4 percent in 2020. As the impact of pandemic-induced economic restrictions waned, the overall poverty rate dropped slightly to an estimated 24.5 percent in 2022, indicating that about 1.25 million people live below the poverty line.

6. **Growth is projected to soften in the coming years, causing real income levels to stagnate.** Under a baseline scenario that assumes continued restrictions on movement and access, a persistent political divide between the West Bank and Gaza, and unchanged aid levels, the Palestinian economy is expected to grow at a rate of about 3 percent in the coming years. Given projected trends in population growth, real per capita income is expected to stagnate. A continued gradual recovery in private consumption and in-person services are expected to drive growth as economic activity continues its return toward pre-pandemic levels. A steady increase in the number of Palestinians working in Israel, both from the West Bank and Gaza, is expected to further increase demand. At the same time, declining public expenditures, including the payment of partial salaries to civil servants, will put downward pressure on growth. Although inflation is likely to moderate gradually, additional shocks could reverse this trend, and higher prices would weigh on demand.

[5] The poverty line referred to here is the World Bank's international poverty line of $6.85 per day per capita in 2017 purchasing-power-parity terms. Note that this is different to the official national poverty line of the West Bank and Gaza.

7. Downside risks remain elevated and if they materialize, the impact on the Palestinian economy and people may be severe. An escalation of Russia's war in Ukraine that further strains global supply chains and increases pressure on food and energy prices, could slow the growth of the Palestinian economy and will have a direct impact on standards of living, especially for the poorest. Meanwhile, further clashes between Palestinians and Israeli forces in the West Bank and Gaza could derail the recovery and drive potential further restrictions on movement which would constrain Palestinian workers' access to the Israeli labor market. This may have a direct impact on consumption -- the main driver of growth in recent years. Recent events in Israel have increased political and policy uncertainty, which could exacerbate the macroeconomic and fiscal risks facing the Palestinian territories. The Palestinian Authority has little fiscal space to absorb such shocks. While momentarily suspended on March 27th, 2023, the domestic policy measures and reforms under discussion by the new Israeli Government may still negatively impact the Israeli currency and economy which, in turn, could weigh heavily on economic outcomes on the Palestinian side given the strong links between the economies. If this downside scenario materializes, the performance of the Palestinian private sector and the fiscal stance of the PA may suffer, and the impact will mostly be felt by the poorest.

2. The Public Finances

Fiscal Performance, January – December 2022

8. Public revenue rose substantially in 2022. Domestic tax collection grew by 19 percent y-o-y, reflecting accelerating economic activity and the expansion of the public revenue task force. Meanwhile, increased domestic fees and charges and the equalization levy collected by Israel from Palestinian workers and transferred to the PA boosted nontax revenue by 18 percent y-o-y.[6] Clearance revenues also increased by 20 percent y-o-y in 2022, driven by increased economic activity and higher import values which resulted in higher collections of customs fees, value-added tax (VAT), and the petroleum-excise. Also, the introduction of an electronic VAT (e-VAT) system piloted by the PA and the GoI since March 2022 has begun increasing VAT revenue. That said, the system remains voluntary for Israeli traders, and renewed efforts will be needed to bring all traders and transactions into the system with the aim of eventually fully exchange real-time information on all purchases being made, as that can significantly help reduce VAT leakage. Revenue growth offset a sharp increase in the fuel subsidy, categorized as a negative tax item, which rose by 191 percent in 2022 as global oil prices spiked.

9. Recurrent public spending remained consistent with 2021 levels in nominal NIS terms, as a sharp decline in transfers offset increases in certain spending items. Accounting revisions related to security sector pensions was the main contributor to the drop in transfers in 2022. Also, the PA provided fewer payments to poor households through the National Cash Transfer Program (NCTP) in 2022, causing government transfers to fall and incurring high social costs. At the same time, the wage bill rose by about 4 percent y-o-y, on a commitment basis, due to the implementation of the yearly step increase and the cost-of-living allowance. On a cash basis, the PA has been paying about 80 percent of the salaries of public employees, while protecting the lowest earners, since November 2021. Net lending, reflecting unplanned subsidies to local government units to cover unpaid utility bills to Israeli suppliers, remained roughly flat compared to 2021.

10. Strong revenues and stable spending significantly narrowed the fiscal deficit in 2022 y-o-y.

[6] Palestinians employed in Israel are entitled only to basic insurance benefits, and their contributions to the Israeli national insurance system are lower than those of Israeli workers, who are fully insured. To keep the wage costs of Palestinian labor equal to those of Israeli workers, the GoI introduced the "equalization levy," which adjusts the income of Palestinian workers to offset the difference between their reduced contribution to the national insurance system and the full amount paid by Israeli workers.

The total deficit (before grants) reached US$526 million, down almost 60 percent from 2021. Donor financing totaled US$350 million (with US$244 million in budget support and US$106 million in development financing) in 2022, with European Union funding reinstated in August. This remains a fraction of funding received in earlier years, which peaked at US$2 billion in 2008. After accounting for the GoI's deductions from clearance revenues, the PA's fiscal deficit was US$351 million.

11. **To cover its financing needs, the PA resorted to accumulating arrears to the private sector, the pension fund, and public employees.** By Q4 2022, PA borrowing from domestic banks had gradually fallen to US$2.2 billion, which is slightly below the PMA set limit as the PA mostly depended on arrears to make ends meet in 2022. While comprehensive arrears data are not available, the stock of arrears to the private sector is estimated to have increased from US$975 million at end-2021 to about US$1 billion. The bulk of these arrears are owed to hospitals, pharmaceutical firms, and contractors. Arrears to the civil-service pension fund are about US$3 billion, while data on the security sector pension scheme are unavailable. Arrears to public employees as a result of partial salary payments reached an estimated US$400 million in 2022. The large stock of arrears poses a risk to macroeconomic stability, as it drains liquidity from the private sector and could negatively affect bank balance sheets, and in turn – eventually – the real sector.

12. **Even though the PA's debt to the domestic banking sector declined in 2022, overall debt is expected to remain higher that the limit permitted by the law on public debt in the coming years**. The PA's public debt stood at about 50 percent of GDP at the end of 2022. It consisted of foreign debt- about 7 percent of GDP, borrowing from the domestic banking sector- around 12 percent of GDP, and domestic arrears- around 30 percent of GDP. It is important to note, though, that arrears to the Palestinian Pension Fund represent about one third of the PA's public debt. This has not been codified as a debt instrument, but it is counted as public debt. The pressure that this liability poses is not an immediate threat to loss of access to financing. Under a baseline scenario, public debt is expected to remain much higher than the 40 percent of GDP limit set by the law on public debt, by 2027. Actions by the PA alone are not sufficient to stabilize debt. Stabilizing and subsequently bringing down debt is contingent on actions and contributions by the GoI and donors. For example, monthly deductions from clearance revenues and the lack of stability in these transfers weighs heavily on the PA's finances. Also, the decline in donor aid has played a key role in larger than expected financing requirements. Therefore, PA reforms are a necessary but not sufficient condition for debt stabilization.

Table 3: Key Fiscal Indicators, 2019-2022

	2019	2020	2021	2022
Percent of GDP, unless indicated otherwise				
Overall Balance	-7.5	-7.5	-5.7	-1.8
Primary Balance	-7.2	-7.1	-5.1	-1.1
Total Revenues and Grants	21.8	25.1	24.6	26.2
Domestic Tax Revenues	4.4	4.7	5.5	6.0
Income tax	1.2	1.2	1.2	1.5
Value added tax	1.8	2.0	2.1	2.2
Customs	1.1	1.0	1.6	1.7
Excises on beverages	0.0	0.0	0.0	0.0
Excises on tobacco	0.3	0.5	0.6	0.6

Property tax	0.0	0.0	0.0	0.0
Non-Tax Revenues	2.1	2.4	2.2	2.4
Earmarked collections 1/	0.5	0.6	0.8	0.9
Clearance Revenues 2/	12.9	15.0	15.4	16.4
Grants	2.9	3.1	1.7	1.8
Tax Refunds	-1.0	-0.7	-1.0	-1.3
Total Expenditures	29.3	32.6	30.3	28.0
Current Expenditures	24.8	27.8	25.9	23.6
Wages and Compensation	13.0	14.1	14.6	13.9
Goods and Services	3.8	4.2	4.4	4.2
Interest Payments	0.3	0.4	0.6	0.7
Current Transfers	7.7	9.1	6.3	4.8
Capital Expenditures	2.1	2.0	1.5	1.6
Net lending	1.9	2.2	2.1	1.9
Earmarked Payments	0.5	0.6	0.8	0.9
Government Financing	7.5	7.5	5.77	1.8
External Borrowing (net)	1.1	0.7	0.0	-0.2
Domestic Borrowing (net)	3.6	2.9	0.5	-0.6
Domestic Arrears (net)	2.8	3.9	5.3	2.6
Memorandum items:				
Stock of Arrears	24.7	32.1	34.7	34.8

1/ Earmarked collections and payments are collections from taxes and revenues due to local government units.
2/ Revenue collected by Israel on behalf of and transferred to the Palestinian Authority.

3. Long-Term Fiscal Sustainability

13. **Fiscal sustainability requires a strong macroeconomic foundation, and this cannot be achieved without actions by the PA and the GoI as well as support from donors.** The unreliable funding of key public services and the high level of payment arrears to the private sector are inhibiting economic development and tightening liquidity constraints. Efforts by the PA to improve the equity, effectiveness, and efficiency of public spending must encompass the wage bill, the generous public pension system, and untargeted transfers. Strengthening the management of referrals is a key priority in the health sector. Reforms to reduce net lending are also urgent, as the current system results in large unplanned subsidies to local governments.[7] These reforms are necessary but not sufficient to place the PA's fiscal position on a sustainable path. For this to happen, cooperation by the GoI to is key. Adequate and predictable budget

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

support by donors will also be necessary both to ease the fiscal consolidation and to hedge against political and economic uncertainty.

14. **The PA has initiated steps to address its largest expenditure item, the wage bill, which accounted for half of total government spending in 2022.** Measures include the establishment of a committee, comprising representatives from the Ministry of Finance (MoF), the General Personnel Council (GPC), the Pension Authority, the Ministry of Justice, and the Security Forces Financial Administration to reform public sector compensation. The committee will study salaries and employment in the public sector and submit reform options to the Cabinet. Previous World Bank analysis has shown that remuneration drives the growth of the PA's wage bill. Between 2011 and 2021, allowances were responsible for 41 percent of personnel spending, indicating that they are being used to supplement basic salaries. Moreover, the distribution of allowances appears to be more closely linked to negotiating efforts by employee unions than to job skills or work performance. Reforming allowances will help generate fiscal space that can – in turn – support more extensive salary restructuring over the medium term.

15. **In November 2022, the Cabinet adopted an attrition target for net public employment in 2023, under which recruitments should not exceed 50 percent of retirements and other departures.** Net public employment has increased steadily in recent years, due to a rise in the West Bank where the number of employees increased from 83 thousand in 2010 to 116 thousand in 2021. The attrition target is an important first step that will help stop the drain. In addition, the PA is striving to review its human-resource needs on a yearly basis. To that end, the Cabinet has instructed each government agency to submit a list of surplus staff and a summary of skills shortages by October of each year. The GPC will then cross-check these submissions and reallocate staff within PA institutions. To facilitate staff reallocation and ensure that skills gaps are closed, the GPC has been requested to provide concerned public employees with three to six months of training. These measures should be complemented with additional reforms including on the wage structure and carrying out functional reviews of key line ministries as such actions will help improve efficiency and effectiveness in public spending in a sustainable manner.

Box 1: Short and medium-term priorities to reform the Palestinian Authority's wage bill

International experience shows that successful wage-bill reform requires a mix of short- and medium-term measures. In the Palestinian territories, a phased approach to managing the growth of public employment and the wage bill could include:

Short-term priorities (1-2 years)

- ❖ Set attrition targets for net public employment and explicitly link all hiring, wage and promotion decisions to workforce needs, budget availability, and merit.
- ❖ Scale back spending on allowances and tighten eligibility criteria to control the wage bill and ensure equitable pay across employee groups.
- ❖ Conduct targeted functional reviews to identify areas of over- and under-staffing and inappropriate compensation and create a staffing-reform plan based on the results.

Short- and medium-term priorities (1-5 years)

- ❖ Develop formal procedures for salary planning and workforce management in the public sector, supported by strong coordination between central agencies and spending units.
- ❖ Revise the public-sector salary structure to align it with local labor-market benchmarks and best-practice principles for salary decompression, competitiveness, and equity.
- ❖ Review the public-sector pension scheme to ensure that compensation and employment reforms yield the desired expenditure impact.

Source: Wage Bill and Employment Diagnostic: Key Drivers and Policy Recommendations. The World Bank, December 2022[8]

16. Central government revenues (before grants) are estimated at 24 percent of GDP in 2022 which is relatively high by the standards of fragile countries but below the PA's potential. The PA collects insignificant revenue from Gaza due to the political divide. In the West Bank, reforms are needed to widen the tax base to cover high-earning professionals such as doctors, lawyers, and engineers. Administrative enforcement powers should be strengthened, including penalties for tax evasion. The PA has prepared a new revenue strategy for 2022-2025, which focuses on identifying unregistered taxpayers, establishing a risk-management department, strengthening interagency coordination, expanding the use of digital platforms and processes, and formulating new or amended VAT, customs, and income-tax laws. Implementation has already started since 2022 and progress has been encouraging. As part of the strategy, the MoF plans to reduce the number of unregistered taxpayers by more than fifty percent, and fully digitize the tax payment procedures by end-2025.

17. Donor support will be vital to the success of the PA's reform agenda. The PA's efforts to reform revenue and expenditure management must remain gradual to avoid creating adverse social or economic consequences. Notably, and as mentioned above, there is limited scope for further significant improvements in revenues, hence the main focus going forward should be on public spending. The ongoing consolidation is also highly vulnerable to exogenous shocks, as economic growth and the fiscal balances remain highly dependent on the political context and on cooperation with Israel. Adequate and predictable budget support will be necessary both to ease the fiscal consolidation and to hedge against political and economic uncertainty. In the medium term, donor support could be redirected toward development projects that will bolster economic growth. Further PFM reforms and cross-cutting governance measures could attract additional donor resources as those could contribute to improved transparency and citizen engagement, among other things.

18. Cooperation by the GoI could substantially increase the PA's revenues. 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.[9] 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[10] exit fees that should also be transferred to the PA, according to the Paris Protocol (See box 2).[11] The parties reached an understanding to implement an e-VAT system and launched a pilot program in 2022, whereby traders on both sides were granted the option to voluntarily issue transaction receipts digitally, which was encouraging.[12] On the other hand, 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

[8] The report can be accessed here:
https://documents1.worldbank.org/curated/en/099320012152224196/pdf/P17870707ee3d60d0b5460a16a39379461.pdf
[9] 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) accessed here: https://www.gov.il/en/Departments/General/the-israeli-palestinian-interim-agreement-annex-iii
[10] Allenby Bridge is a crossing that crosses the Jordan River near the city of Jericho and connects the West Bank with Jordan.
[11] See Section G of Appendix 5 to Annex I of the Interim Agreement.
[12] According to the GoI 400 Israeli businesses had joined the e-VAT pilot at the time of writing.

compared to the share of Palestinian imports out of total imports handled by this department.[13] Finally, decisions by the newly elected Israeli government to double the monthly deductions from clearance revenues for a period of five months[14] and to capture NIS138.8 million from PA tax revenue previously collected and withheld in Israel have raised concerns, especially given the difficult fiscal situation, and could signal a discouraging trend going forward.

Box 2 : Allenby Bridge exit fees

The 1995 Interim Agreement established an arrangement for sharing the fees collected by the Israeli authorities from passengers leaving the country via the Allenby Bridge with Jordan,[15] but these arrangements have not been properly implemented. The agreement set the exit fee at US$26 per passenger, with income from the first 750,000 passengers per year divided on a 54/46 basis between the GoI and PA. In other words, the GoI collects US$14 of each fee, and the PA collects US$12. If the number of passengers exceeds 750,000 in a single year, the PA's share of each fee increases to US$16. The GoI unilaterally raised the fee to US$36 in 2008, US$44 in 2013, and about 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 even though the total number of passengers has increased. Based on data on annual fees from the Israeli MoF and figures from the Israeli Airport Authority (IAA) on the number of passengers that crossed the Allenby Bridge between 2008 and 2021, the GoI collected an estimated NIS1.82 billion (US$499 million)[16] over this period.[17] Had Israel maintained the passenger exit fee at US$26, the collections would have been lower, at NIS1.13 billion. However, none of the NIS697 million in additional revenue has been shared with the PA, resulting in an ongoing dispute over monthly transfers. Under the Paris Protocol's formula, the PA's share of the disputed amount would equal NIS391.6 million while the Israeli share would be NIS305.5 million.[18]

In addition, the GoI has not been fully remitting to the PA its share of the US$26 fee specified in the agreement. Transfers by the GoI to the PA MoF between 2008 and 2021 reached NIS491 million, yet calculations based on the number of yearly passengers multiplied by the US$26 fee show that about NIS561 million should have been transferred during this period—a shortfall of NIS70 million.

Going forward, changes to the exit fee should be agreed upon bilaterally before they are applied, and revenues should be shared according to the Paris Protocol formula. Any changes to the sharing formula should also be agreed upon by both parties. Transfers should be executed monthly to avoid the accumulation of disputed funds. Finally, detailed reports on the amounts deducted by the GoI should be published regularly on a relevant GoI website.

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[13] 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.

[14] A portion of the sum corresponds to the repayment of loans seized by the PA. The GoI implements the collection of the amount that is declared 'frozen' by law, according to Israeli laws. The collection for years 2021 and 2022 overlapped, due to a postponement on these repayments during the height of the COVID19 crisis.

[15] See Section G of Appendix 5 to Annex I of the Interim Agreement.

[16] The average USD/NIS exchange rate between 2008-2021 was used to convert the NIS amounts to US$ terms.

[17] 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.

[18] These calculations were made in cooperation with the Office of the Quartet.

19. While the PA's reform efforts are necessary to ensure fiscal sustainability, active cooperation by the GoI will be a critical factor for the Palestinian economy to reach its economic potential. The reforms outlined above could significantly reduce the size of the fiscal deficit. The PA could also implement additional measures to improve the business environment, which would accelerate private-sector growth. However, previous World Bank analytical work has shown that GoI restrictions on movement and access in the West Bank and the restrictions resulting in near-blokade in Gaza remain among the most important obstacles to growth and private sector development in the Palestinian territories. Until these challenges can be addressed, the Palestinian economy is expected to continue operating below potential. (See Box 3 for more information)

Box 3: The economic impact of external restrictions imposed by the GoI on the Palestinian economy

Restrictions on access to resources, particularly in Area C, [19] have severely constrained private investment and economic activity in the West Bank. Area C covers 61 percent of the West Bank and is under Israeli civil and security control. Palestinians have very limited access to economic opportunities in Area C, and the continued expansion of Israeli settlements has significantly reduced land available for use by the Palestinian private sector and leaves highly limited prospects for a contiguous Palestinian state, even if some land does eventually pass to the PA's control. Area C is the only contiguous territory in the West Bank, while Areas A and B compose 227 isolated areas. Consequently, Area C plays an essential role for the efficient movement of goods and people within the West Bank, and it is vital to the development of infrastructure networks. World Bank analysis suggests that removing GoI-imposed constraints on Area C would boost the size of the West Bank economy by one-third.

GoI restrictions also severely hinder Palestinian trade. A set of administrative, logistical, and security measures functions as nontariff barriers for Palestinian traders, weakening the competitiveness of Palestinian products. The average trade cost per transaction for a Palestinian firm is nearly three times as high as for an Israeli firm, while the average duration of the import process for a Palestinian firm is nearly four times as long as for an Israeli firm.[20]

Restrictions on revising the A1, A2, and B lists created by the Paris Protocol of 1994 have limited the PA's ability to benefit from them. The A1, A2, and B lists were designed as an exception to the custom union's common import policy, and they granted the PA autonomy to determine its own regime governing imports of specific products from Jordan, Egypt, and other Arab and Islamic states. These lists were seen as a first step toward the eventual establishment of an independent Palestinian tariff book. In practice, however, this opportunity for the PA is being undermined by a failure to update the lists. The current lists are based on Palestinian market needs as determined more than 20 years ago, when the Paris Protocol was signed.[21] The number of goods specified in Lists A1 and A2 has barely grown since 1994, even though total Palestinian imports have increased more than threefold since then. Consequently, Palestinian consumers

[19] The Interim Agreement between the PLO and the GoI divided the West Bank into three areas under different jurisdictions: Areas A, B, and C. Area A represents 18 percent of the West Bank, covers urban centers, and is under full Palestinian security and civil control. Area B represents 21 percent of the West Bank, covers peri-urban areas and small towns, and is under Palestinian civil control and Israeli security control. Area C represents 61 percent of the West Bank and is defined by the Interim Agreement as "areas of the West Bank, outside Areas A and B, which, except for the issues that will be negotiated in the permanent status negotiations, will be gradually transferred to Palestinian jurisdiction." According to the Interim Agreement, the gradual transfer should have been completed by 1997, but it has not yet been implemented.

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

[21] A significant adjustment to list A1 was agreed in July 2000 by the Ad Hoc Economic Committee that was established as part of the 1997 Wye River Agreement. However, the changes were not implemented.

cannot benefit from lower prices due to open competition between Israel and third-party producers, which restricts Palestinian consumption, especially for goods with a high price elasticity of demand.

The GoI applies a long list of dual-use items for which exports or re-exports from Israel to the Palestinian territories are highly controlled, which prevents the development of key economic sectors. The Defense Export Control Law of 2007 and a Military Order passed in 2008 stipulate that all dual-use items destined for the Palestinian territories require a special permit and entail reporting obligations. These requirements make it extremely difficult, or in some cases impossible, to import dual-use goods into the Palestinian territories. Currently, the dual-use list for the West Bank includes six fertilizers, two pesticides, and 23 pure chemicals, as well as 26 types of materials, machinery, and equipment. Gaza has a more extensive dual-use list that includes cement, rebar, insulating panels, and timber for furniture manufacturing, among many other items. Dual-use restrictions have an especially negative impact on the agriculture, manufacturing, and ICT sectors, as they severely inhibit the development of food processing, metal fabrication, and the production of pharmaceuticals, textiles, leather, paints, detergents, and cosmetics. In Gaza, the dual-use list adversely affects almost all economic activities.

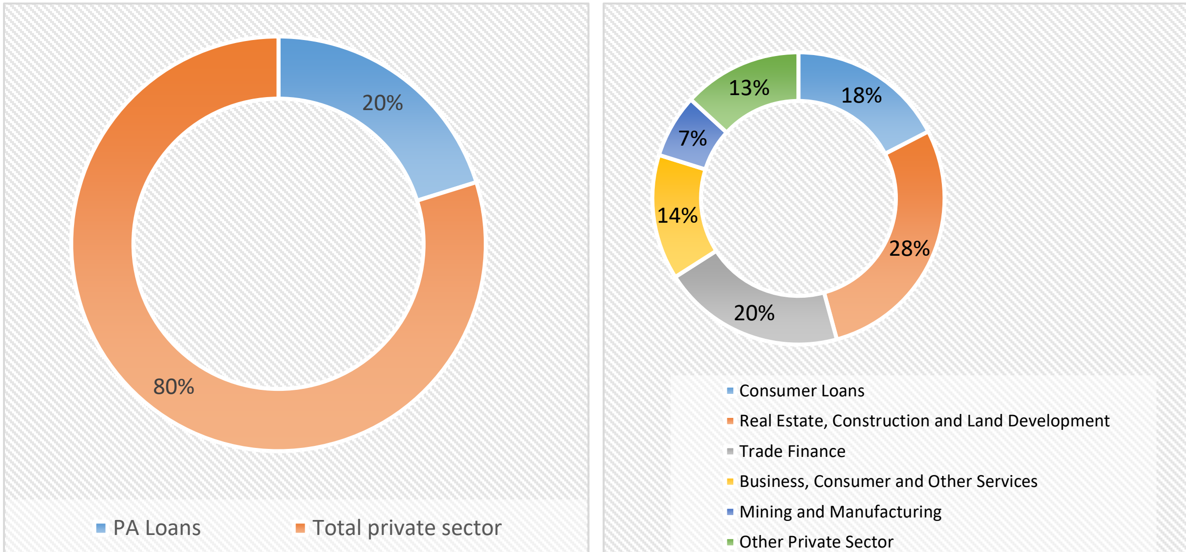
Since Hamas came to power in 2007, the GoI has sharply restricted the movement of goods and people into and out of Gaza. This has turned Gaza into an almost fully closed economy, isolated from the outside world. While the GoI has gradually eased certain restrictions, exports from Gaza correspond to a fraction of what they represented before the introduction of the restrictions, and sales to the formerly lucrative markets of East Jerusalem and the West Bank are largely forbidden. The GoI allows imports of consumer products and most construction material for donor-supervised projects, but the inflow of materials remains far short of demand. Gaza's nearly 2 million inhabitants are allowed to leave only with special exit permits, which – in previous years – were mostly provided for humanitarian cases, while recently (particularly since 2022) there has been an increase in work-related exits. Years of isolation have undermined the living conditions in Gaza and fragmented the economic and social fabric of the Palestinian territories.

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

4. Money and Banking

20. The financial sector remains largely stable and has generally recovered from the COVID-19 effects. Palestine Monetary Authority (PMA) data through December 2022 indicates that banking sector profitability has rebounded, as COVID related pressures remained absent. Return on equity reached 11.02 percent and return on assets reached 1.55 percent by Q4 2022, both of which exceed pre-COVID levels. Customer deposits remained flat in 2022, compared to a moderate growth in credit, resulting in a gradual increase in the level of overall credit-to-deposit ratio to 67 percent by Q4 2022. Growth in credit during the reporting period was mainly driven by private sector loans (and some loans to PA employees). 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.

Figure 2: Distribution of credit by sector (left) and by economic activity in the private sector (right)



Source: Palestine Monetary Authority.

21. Strong and sound prudential regulations and supervision framework are critical to ensure and safeguard the stability of the financial system. Particular attention should be given to the mutual interdependence between the fiscal imbalances and the stability of the financial sector in a context where several policy tools that are normally available to modern economies, are not available to the PA. Respect for the independence of the PMA, as supervisor and prudential regulator of the banking system in the West Bank and Gaza, is a critical pillar of a stable financial framework.

22. The banking sector's exposure to the public sector must be carefully managed to limit risks to financial stability. The PA has repeatedly resorted to borrowing from domestic banks during times of heightened fiscal distress, occasionally exceeding bank-exposure limits set by the PMA, which could generate new stability risks for the banking system. Following several years of relative stability, the banking system's exposure to the public sector increased considerably during the COVID-19 pandemic, rising from a pre-pandemic average of about US$1.3-1.4 billion to US$2.5 billion in December 2021. By Q4 2022, PA borrowing had gradually fallen to US$2.2 billion, which is slightly below the PMA set limit. In addition to direct borrowing by the PA, bank loans to public employees, which are fully or partially backed by future PA salaries, and the use of promissory notes have created indirect exposure to the public sector. Together, borrowing by the PA and public employees amounts to about US$4 billion, representing close to 40 percent of total banking-sector credits. Given the unstable economic context and other sources of risk, financial regulators should redouble their efforts to limit the banking system's direct and indirect exposure to the public sector.

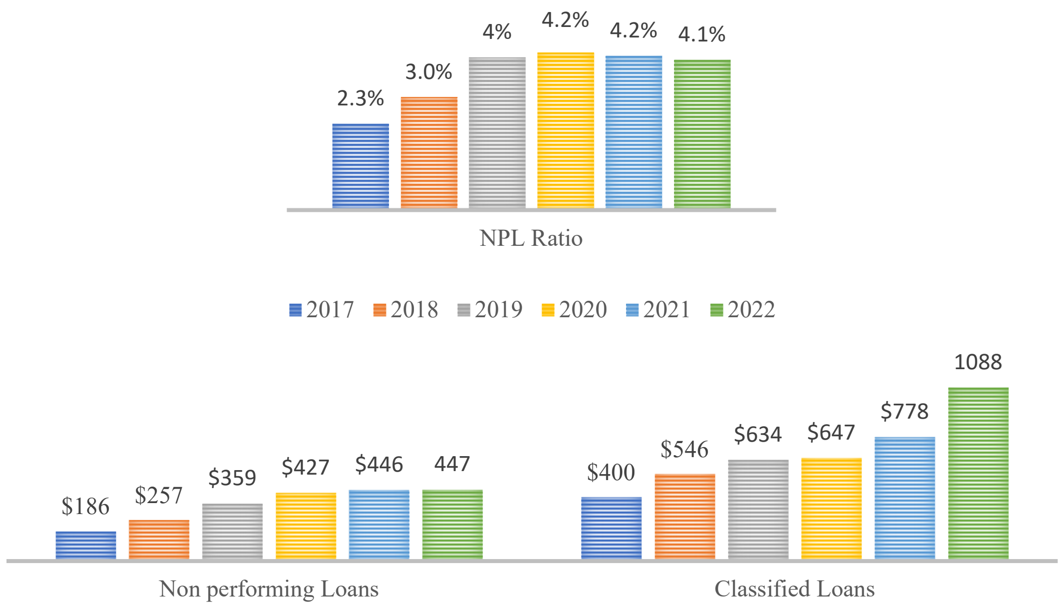
23. Sustained fiscal challenges, growing PA arrears, and economic uncertainty compound credit risks within the financial sector. The share of nonperforming loans (NPLs) in total loans remained stable at about 4.1 percent, while the share of classified loans increased by 40 percent y-o-y between 2021 and 2022.[22] The NPL ratio for loans to the private sector loans likely exceeds the aggregate ratio of 4.1 percent. NPLs tend to be concentrated in critical segments such as small and medium enterprises and civil-servant

[22] The adoption of International Financial Reporting Standard (IFRS) 9 has affected certain banking-sector indicators.

portfolios, but the PA's mounting arrears may also be contributing to NPLs by disrupting the flow of liquidity among government contractors.

Figure 3: Trends in NPLs and Classified Loans

(US$ millions and % of gross loans)



Source: Palestine Monetary Authority

24. **The stability of cross-border payments remains in doubt, as progress on developing a more stable arrangement for correspondent banking relationships (CBRs) has been slow.** Citing anti-money laundering/countering the financing of terrorism (AML/CFT) concerns, key Israeli banks have repeatedly signaled plans to limit or terminate correspondent banking services to Palestinian banks. 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. The cumbersome process for repatriating shekels from Palestinian banks to Israel has contributed to the accumulation of an estimated NIS 4.5 billion in excess shekel-denominated liquidity in Palestinian banks (equivalent to 6.4 percent of assets) as of end-September 2022. In 2017, the GoI approved a temporary indemnity and immunity package for Israeli banks working with Palestinian banks to mitigate the risk of immediate disruptions to CBRs between the two banking systems, and for years the GoI has repeatedly extended this arrangement, most recently in March 2023. A more stable arrangement for cross-border payments is being jointly developed by the Bank of Israel and the PMA but progress has been limited due to several unresolved points of disagreement including the equal treatment of all licensed Palestinian banks (subject to due diligence by the Israeli counterpart), and the approval of pending legislation by GoI. Efforts to implement a system of cashless payments for Palestinian workers in Israel, which would offer direct deposits into Palestinian banks, have begun to gain traction, but the process of verifying the legal status of workers and onboarding them into the cashless payment system has been slow.

25. **The PMA and the Palestinian Financial Intelligence Unit are coordinating a national effort to bring the Palestinian AML/CFT system in line with international standards.** This effort, which requires a "whole-of-government" approach, is coordinated by the Financial Follow-up Unit[23] and the PMA, with participation from the Ministries of Finance, National Economy, Justice, Interior, and Foreign

[23] Official name of the Financial Intelligence Unit in the West Bank and Gaza.

Affairs, the Public Prosecutor's Office, Customs Services, and other relevant stakeholders. During 2022, several new AML/CFT laws and regulations were issued, including a new AML/CFT law (39/2022), a Presidential Decree (14/2022) on the implementation of UN Security Council sanctions, and instructions on AML/CFT controls for financial institutions and designated non-financial business and professions. Prior to the pandemic, the Middle East and North Africa Financial Action Task Force (MENAFATF) agreed to conduct an external evaluation of the PA's AML/CFT regime. This evaluation will follow an earlier self-assessment, underscoring the PA's commitment to meeting the AML/CFT standards required for membership in the MENAFATF. The evaluation was originally scheduled to start in 2020, but the onsite visit by MENAFATF assessors was repeatedly postponed, first due to the pandemic and then the security developments in the West Bank and Gaza. Technical reports required for the assessment have been prepared by the PA and shared with the assessors, while the PA and MENAFATF identify a new date for the onsite visit.

ANNEX I: STOCKTAKING OF WORLD BANK RECOMMENDATIONS TO THE AHLC MEETINGS OVER THE YEARS

Structural constraints continue to slow the growth of the Palestinian economy, while downside risks threaten the outlook. Previous reports have identified several priority actions to strengthen the macroeconomic fundamentals of the Palestinian territories, but implementation has been slow. The World Bank's September 2016 report to the Ad Hoc Liaison Committee presented an assessment of the status of all previous World Bank recommendations to AHLC meetings. The report was designed to establish a baseline for evaluating progress on development priorities while building momentum for further reforms. A subsequent update included more recent progress, organized under two pillars: (i) fiscal sustainability, and (ii) economic development.

a) Fiscal Sustainability

While the PA has implemented important reforms to increase revenues and rationalize spending, structural rigidities continue to undermine long-term fiscal sustainability. Multiple AHLC reports have underscored three priority areas for fiscal reform: (i) civil administration; (ii) electricity and other utility subsidies; and (iii) the health sector. The PA is aware of the challenge posed by the wage bill and has adopted a 50 percent attrition target for net employment and a staff reskilling and redeployment program. These are important first steps, but more needs to be done to address the underlying causes of wage-bill growth, including excessive spending on allowances. Additional reforms will be needed to reinforce the sustainability of the public pension system. Efforts to contain the impact of the electricity sector on net lending have yielded limited progress, and the cost of water and sanitation utilities is rising. The contribution to net lending from water and sanitation averages NIS 30 million per month, and the GoI charges the PA NIS 110 million per year to treat transboundary wastewater. No common accounting principles have been agreed upon to calculate these costs. The debts of service providers increased substantially during the COVID-19 pandemic. To mitigate this issue, all stakeholders should agree on a new mechanism to ringfence water revenues and increase payments of bulk water purchases from the Israel water utility. Finally, outside medical referrals impose a large fiscal burden on the PA, and the authorities must tightly monitor these costs. The integration of the new digital referral system into the PA MoF's Integrated Financial Management Information System (IFMIS) should enhance referral transparency and increase expenditure efficiency.

Revenues rebounded in 2021 and continued to grow during 2022, but risks remain elevated, and further reforms will be necessary to bring revenues in line with their potential. Domestic tax revenue rose by 19 percent 2022, but tax avoidance remains widespread, especially among high-earning professionals. The MoF's new revenue strategy focuses on improving tax administration and strengthening compliance via a new VAT law, a new customs law, and amendments to the 2011 income tax law. The PA is updating public fees and charges, including an increase in the license fee for petrol stations. The PA and the Government of Jordan have electronically linked their customs systems, which has significantly reduced smuggling.

The GoI's cooperation is crucial to curb fiscal leakages, as deductions from clearance revenues significantly weaken the PA's fiscal situation. The new Israeli administration has doubled monthly deductions from clearance revenues and plans to continue this for a period of five months during 2023. Prior to this, it appropriated NIS 138.8 million (~US$40 million) from tax revenues already collected on behalf of the PA. These deductions have intensified stress on the PA's financial position and underscore the urgent need to reform and strengthen revenue-sharing arrangements. Existing agreements that promote transparency around trade between Israel and the Palestinian territories, including Israeli sales to Gaza, should be fully enforced. Implementing the agreement regarding the sharing of Allenby Bridge exit fees is also critical. The GoI and PA are engaged in ongoing talks to introduce customs-bonded warehouses for Palestinian imports and to gradually transfer customs authority to the PA. However, recent talks on separating fuel taxes from the clearance process were not successful, and the GoI continues to collect these taxes and transfer them to the PA after deducting a 3 percent handling fee. The pilot e-VAT system has yielded encouraging results, but a comprehensive system that links all traders and transactions and enables full information-sharing between parties will be essential to tighten VAT enforcement.

Donor assistance is falling, and direct budget support is insufficient to cover the PA's large financing gap. Aid through the budget fell from 27 percent of GDP in 2008 to 1.8 percent in 2022. In recent years, donor support has played a key role in strengthening the PA's public financial management system.

b) Economic Development

The restrictions on movement, access, and trade imposed by the GoI remain the most important constraint on economic growth in the Palestinian territories. Palestinian access to the economically critical Area C remains very limited. Pilot programs for door-to-door transportation through the West Bank crossings continue to make progress, and the initial Hebron program has been extended to Nablus and Qalquilia. However, these are still small pilot programs, and their scope remains modest. In August 2022, a new three-month pilot was launched enabling Palestinian firms to ship imports and exports through Jordan in 40-foot containers rather than the standard 20-foot containers. In energy, the expansion of power networks in the West Bank, particularly sections necessary to increase electricity imports from Jordan, unavoidably involves some segments traversing Area C and continues to suffer from approvals being opaquely delayed for years. The GoI has updated the extensive list of restricted dual-use items, but the severe developmental constraints this list imposes have not been significantly eased. Given adequate compliance incentives, a risk-based approach could be used to grant access to dual-use items, with streamlined procedures offered to Palestinian firms that have established their ability to safely and securely manage dual-use items. The GoI has recently announced that it will ease some restrictions on the movement of goods and people in and out of Gaza. The GoI has facilitated imports of textiles, agricultural produce, and rebar into Gaza, and it has raised the quota for Gazan workers in Israel to 20,050[24]. According to a recent labor-force survey by the Palestinian Central Bureau of Statistics (PCBS)[25], just 3,200 Gazans worked in Israel in Q4 2022; while more recent numbers by the GoI indicate that around 17,000 workers from Gaza are active in Israel, some with work permits and other with permits for business activity[26].

With technical assistance from the World Bank, the PA has approved a new Companies Law designed to improve the business climate. The new law was adopted and published in December 2021 and became effective in April 2022.The World Bank continues to support the development of related forms and bylaws by the Ministry of National Economy, as well as capacity building for staff involved in implementing the new regulatory framework and designing the electronic registration platform. 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. The new law and related regulations will significantly improve the business environment by providing firms, entrepreneurs, and foreign investors with a legal framework that conforms to international standards. The new Companies Law fosters a more hospitable and transparent business environment by: (i) enabling firms to register online; (ii) eliminates unnecessary barriers to incorporation, including minimum capital requirements; (iii) easing the regulatory burden on SMEs and reducing compliance costs; iv) allowing home-based businesses to be registered, to support youth and women entrepreneurs; v)

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[24] Employing Palestinian Workers from the Gaza Strip in Israel | Decision No. 1328 | Israel Prime Minister's Office; https://www.gov.il/he/departments/policies/dec1328_2022
[25] Labor Force Survey of the PA's Central Bureau for Statistics (PCBS) for Q4/2022
[26] Data sourced from WB staff's exchanges with GoI (MoFA) officials, April 2023.

introducing improved company forms; (vi) alleviating restrictions on foreign investment; (vii) expanding access to businesses registration data; (viii) strengthening rules for larger businesses with multiple shareholders; (ix) introducing new tools to enable company mergers, divisions, and transformations; (x) requesting that at least one-third of the board members of public companies be women; (xi) enabling publicly traded companies to issue an expanded range of share types, employee stock-option plans, and convertible bonds; (xii) strengthening protections for minority investors; and (xiii) providing entrepreneurs with access to more affordable and predictable liquidation procedures.

With support from the World Bank, the PA is making further improvements to the business climate. The Cabinet has approved a draft Competition Law, which is now awaiting the president's signature. In 2019, the PA updated the 1953 Law of Crafts and Industries to simplify the approval process for municipal business licenses and reduce the costs involved. The PA has complemented these reforms by automating parts of the approval process and removing administrative obstacles. To strengthen land administration, the Cabinet adopted a draft Amendment to the Palestinian Land Authority (PLA) Laws, which calls for the establishment of a Board of Directors to oversee the operations of the PLA and increase transparency as part of the ongoing reform process. In 2020, the President's Office sent the PLA Law back to the Council of Ministers with comments on its financial implications. These comments were addressed, and the text of the law was reformulated accordingly, but the draft law still awaits the president's signature. Land registration in the West Bank is proceeding under the mandate and direction of the Land and Water Settlement Commission in cooperation with local governments. The president approved a new telecommunications law in December 2021, but while the law requested the establishment of a Telecommunications Regulatory Authority (TRA), it did not grant it the independence necessary to fulfill its role. Following comments from the World Bank and other stakeholders, the Cabinet revised the law to strengthen the technical and administrative authority of the regulator. The president signed the amendment to the law in May 2022. Following the amendment of the telecommunications law in May 2022, to implement a recommendation from the WB to strengthen the technical and administrative independence of the regulator, the TRA Board Of Directors (BoD) was appointed in January 2023. The BoD is currently finalizing a one-year operationalization plan, funded under the Digital West Bank and Gaza project. The plan includes hiring the CEO in accordance with the law, develop the TRA institutional framework (internal regulations and by-laws), and timelines to handover the relevant activities and resources from the Ministry of Telecommunications and Information Technology, while maintaining technical independence.

Despite the shock of the pandemic, the PA continues to make progress on reforming the energy sector. The PA continues to implement the interim power-purchase arrangements with the GoI, under which the Palestinian Electricity Transmission Company (PETL) manages the electricity supply provided to the West Bank by the Israeli Electricity Company (IEC). The IEC's provides 87 percent of electricity supply in the West Bank and Gaza, which has negative implications for net lending, though PETL also provides solar energy supplied by independent producers in the northern West Bank. While PETL has maintained a good payment record, recent Amendments to the Electricity Law may diminish its role as a single buyer of electricity and create uncertainty around the direction of future sectoral development. Increasing the electricity supplied through the high-voltage substations could help reduce technical losses, easing supply constraints and improving the quality of electricity services in the West Bank. Establishing a transparent auction-based procurement framework for independent solar producers could further increase the supply of affordable energy in the West Bank, creating a more diverse and sustainable electricity sector that is less dependent on the IEC, while also contributing to the achievement of the PA's commitments under the Paris Climate Agreement. The Palestinian Energy and Natural Resources Authority (PENRA) continues to strengthen collection efficiency, though the pandemic-induced economic slowdown badly disrupted financial flows across the energy supply chain, affecting all sectoral institutions. A revenue-protection program, an updated management information system, and smart-metering technology are being deployed among electricity distribution companies in the West Bank and Gaza, but the lack of electricity infrastructure in Area C remains a major challenge. Ensuring a stable and reliable electricity supply will require diversifying electricity imports and reinforcing the distribution grid, but land-access issues and limited network infrastructure hinder these efforts. The restrictions on the construction of utility-scale solar power plants and transmission and distribution infrastructure in Area C constitute a particularly important obstacle to energy sector development. Gaza requires a comprehensive action plan to provide an adequate electricity supply to critical services and households, and large gaps between demand and supply underscore the importance of institutional reforms. The PA should focus on implementing the recommendations of a recent institutional review and audit of energy-sector finances in Gaza. The Office of Quartet and development partners continue to explore the feasibility and design of the "Gas for Gaza" initiative to decrease reliance on diesel power, increase generation capacity, and rehabilitate and upgrade transmission and distribution infrastructure.

Table Summary of World Bank Recommendations to AHLC Meetings

Actions	Responsible Party	Progress as of Sep 2016	Progress as of May 2023
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		
<u>GAZA RECONSTRUCTION AND RECOVERY</u>			
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		
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		

<u>Legend</u>

	On track
	Some progress achieved
	No progress