Economic Monitoring Report to the Ad Hoc Liaison Committee

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Acronyms

AHLC	Ad Hoc Liaison Committee
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GoI	Government of Israel
IEC	Israel Electric Corporation
MoF	Ministry of Finance
MoSA	Ministry of Social Affairs
NCTP	National Cash Transfer Program
NIS	New Israeli Shekels
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PMA	Palestine Monetary Authority
USD	United States Dollar
VAT	Value Added Tax

Executive Summary

a. The conflict and humanitarian tragedy in Gaza has made an already struggling Palestinian economy worse and put further stress on the fiscal situation of the Palestinian Authority (PA). To return to a sustainable growth path, action is needed in three areas: (i) providing access to imports and exports into, out of and between the West Bank and Gaza; (ii) re-integrating the governance framework between the West Bank and Gaza under the Palestinian consensus government; and (iii) additional funding from the international community to facilitate continued reforms and the re-construction of Gaza's economy.

b. Political uncertainty and restrictions on movement and access are the main reasons why the Palestinian economy is unable to take off. Private investment in the Palestinian territories remains far from sufficient to fuel adequate rates of economic growth and to create enough jobs to allow unemployment to fall. The lack of a comprehensive peace agreement leads to a vicious cycle of economic decline and conflict. The impact of this political instability on the Palestinian investment climate has been severe, resulting in uncertainty, increased costs for businesses and investors, and the fragmentation of Palestinian economic space and markets. There are positive aspects in the investment climate, such as a stable financial sector and low incidence of bribery; and firm performance indicates potentially competitive productivity levels. These positive aspects imply that the Palestinian private sector could respond effectively once movement and access is allowed.

c. While impacting the West Bank adversely, the effect of political uncertainty and restrictions has been particularly severe in Gaza. In the past decade, employment in the manufacturing sector fell from an already low 9 percent to 5 percent as main markets (Israel and the West Bank) were lost. Firms are unable to invest in capital goods – making Gaza's labor force productivity lower than in the West Bank. Gaza's energy crisis is also a binding constraint, second only to political instability. In the recent conflict, the only power plant in Gaza was targeted and it is now out of commission, making an already serious situation even worse.

d. Growth in the Palestinian territories, already decelerating since 2012 slowed down further to less than 2 percent in 2013; and the economy entered into recession in 2014. The closures of the illicit tunnels with Egypt hit Gaza hard, as they were its main trade channel. The economic decline has resulted in growing unemployment – as a share of the labor force, one in six in the West Bank is unemployed, and nearly every second person in Gaza. As international experience and recent history in Gaza shows, such a dire situation may fuel further violence.

e. Even without the additional expenditures resulting from the Gaza conflict, the PA would face a financing gap in the range of USD350 million by the end of 2014. The PA managed to keep its current fiscal deficit below its target for the first half of 2014. The PA increased revenues while expenditures have also risen on non-wage items mainly to repay past arrears. Donors' assistance in the first six months of 2014 has fallen by more than USD200 million compared to the same period in 2013.

f. To build a viable economy in Gaza after the conflict would also require access to goods and markets, improved governance and funding. While urgently addressing the humanitarian crisis and the early recovery needs, the PA is leading a full needs assessment to facilitate a "build back better" scenario. Given the scale of the destruction and the already serious situation before the conflict, building a sustainable economy in Gaza will require substantial funding from the international community to be channeled through the PA, preferably as budget support. For such support to be effective it has to be accompanied by (i) allowing access in and out of Gaza, while protecting legitimate security concerns of neighboring governments; and (ii) the PA establishing a strong governance framework under the consensus government.

g. In summary, the following elements are critical for a sustainable Palestinian economic future:

- For the international community, continued budget support to strengthen the PA's fiscal position will be essential to sustain reforms and enable provision of services to the Palestinian population, including those in Gaza.

- For the PA, strong efforts are needed to address governance challenges in Gaza both to support recovery and reconstruction efforts and to provide a unified business climate.

- For the Government of Israel (GoI), sincere efforts are needed to allow better and faster movement of people and goods in, out and among the Palestinian territories, while taking into account legitimate security concerns of the GoI.

I. Constraints to Economic Growth

1. **There is growing consensus that private sector led growth is the only sustainable future for the Palestinian territories.** Growth would also enhance the PA's revenue base and its ability to invest in physical and human capital within a sustainable fiscal framework. For now the private sector is stifled by political uncertainty, the divide between Gaza and the West Bank; and most importantly restrictions on movement and access.

2. **Political uncertainty restricts the Palestinian private sector to low capital intensity, small-size and low productivity.** During the last seven years, there has been no significant growth in capital investment or in employment. Palestinian firms' capital intensity is among the lowest in the region. For instance, more than three out of four firms choose not to apply for a loan, even though they would be eligible. The costs and uncertainty associated with following special procedures for obtaining movement permits, entry for goods on the dual use goods lists, and visas for investors, technical experts, or workers add another layer of complexities. This has led private enterprises towards informality with an estimated 100,000 extremely small businesses (with 1 to 2 workers) that are unregulated, but has also restricted access to finance. The proportion of formal firms with more than 20 workers is just 11 percent, compared to 35 percent in comparable lower-middle income countries.

3. **Fragmented legal and regulatory business environments impede private sector development.** The de jure legal and regulatory environment and de facto administrative practices for Palestinian firms differ among the Gaza Strip, Areas A and B of the West Bank (under the PA's security and administrative control), and Area C of the West Bank and East Jerusalem (under Israeli control). Business registration, licensing and permits, banking, taxation, investment incentives, courts, and enforcement of contracts are all affected by the divide between Gaza and the West Bank; and only a very few Palestinian firms attempt to do business in both territories.

4. **Restrictions on movement and access adversely impact all firms.** In 2012, Palestinian exports amounted to only 7.6 percent of GDP while trade between the West Bank and Gaza has dropped drastically since 2007. Firms in the West Bank and those in East Jerusalem that do business with the West Bank, experience difficulties in navigating through restrictions on movement and access within and around the West Bank (checkpoints, the Separation Barrier, the crossing points into Israel and non-physical, procedural restrictions such as the permit system)[1]. Mobility restrictions *within* the West Bank have improved since 2006. But, exports are still virtually blocked from Gaza and must be destined to a third country (neither Israel nor the West Bank, which traditionally absorbed 85 percent of Gaza's exports.).

5. **Even before the recent conflict[2] these constraints were more binding in Gaza.** There, the economy has been struggling for years due to recurring conflicts and the ongoing blockade on exports and imports. It has suffered from a series of armed conflicts, including the most recent one. The multiple episodes of conflict have had a severe impact on the economy as they paralyzed economic activity while they lasted and left severe infrastructure damages

1 The GoI claims that these restrictions are necessary to protect its citizens.

2 The latest conflict ended with a cease-fire in late August and since then there have been no missiles fired or incursions made into Israel or Gaza.

that crippled potential output after they abated. Furthermore, Gaza was placed in 2006-7 under a blockade that prohibited the movement of goods and people to and from the strip. Even though the blockade was slightly eased in 2010 to allow in some construction materials, private sector activity continues to be severely constrained. As a result, the situation in Gaza was dire, even before the recent conflict with two thirds of the population of Gaza receiving some form of social assistance. Similarly, Gaza's labor force productivity is lower than that in the West Bank or in East Jerusalem, mainly because firms in Gaza are able to invest less in capital goods or have had their capital destroyed in the repeated conflicts.

Figure 1. Labor Productivity in Gaza is lower than in the West Bank or in East Jerusalem

Source: The World Bank, 2014. West Bank and Gaza Investment Climate Assessment: Fragmentation and Uncertainty

6. **Gaza's energy crisis is a binding constraint for firms there, second only to political instability**, resulting from long-term generation capacity deficits and poor distribution infrastructure. The situation has worsened over the last year due to chronic fuel shortage and disruption of fuel supply from both Israel and Egypt. Because they cannot afford their own generators, Gaza's small and medium enterprises have been more adversely impacted by power outages (averaging around eight hours per day in 2013) than larger enterprises and those located in West Bank and East Jerusalem. The severe damage to Gaza's only power generating plant by Israeli forces during the recent conflict has exacerbated the crisis.

7. **If these constraints were relieved, the Palestinian economy could bank on a number of assets:**

   - Labor productivity of Palestinian firms is on par with comparator countries, while unit labor costs remain competitive within the region. There is a potential opportunity to bring labor productivity up if Palestinian firms would invest more, and if resources shifted towards higher productivity sub-sectors in manufacturing and services.

   - The financial sector continues to be stable and liquid.

   - The emergence of a venture capital fund and a few private equity funds aimed at growing startups and small and medium enterprises are all important steps toward the development of equity financing in the Palestinian territories. A number of equity investors, including private equity funds and conglomerates, have attracted foreign direct investment and launched new investments.

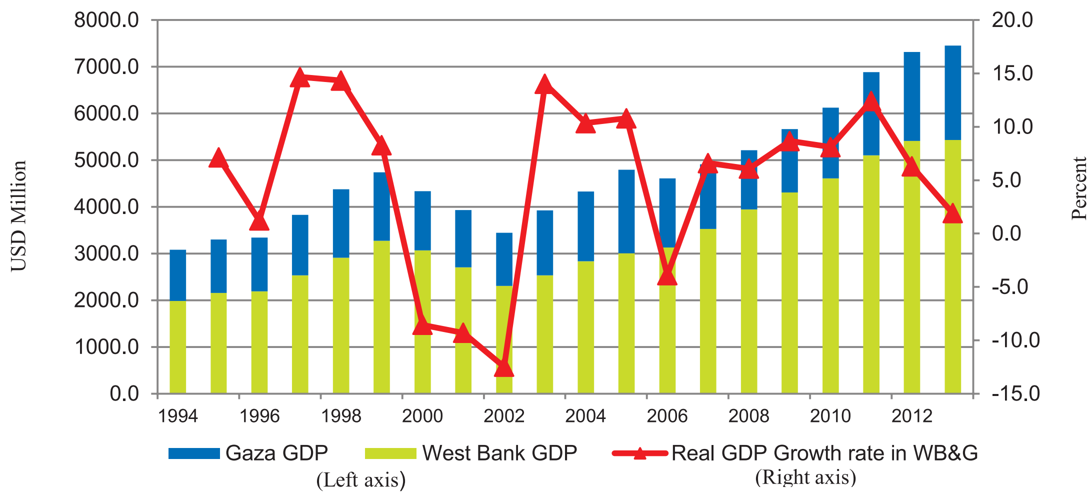
- The emergence of a technology-based entrepreneurship network, although nascent, shows a potential for growth, especially as it links up and gains support from broader regional initiatives.
- Few Palestinian firms report petty corruption in the form of informal payments to officials in their business operations.

II. Recent Economic Developments

a. Output, Employment and Welfare

8. **The Palestinian economy buckled under the burden of the constraints discussed above and entered into recession in 2014.** Following a period of sustained economic recovery between 2007 and 2011 (when growth exceeded 8 percent on average), the economy has increasingly struggled. The downturn started in 2012 when growth decelerated to about 6 percent as a result of a steep drop in foreign aid. With domestic revenue generation constrained by the restrictions on movement and access, this forced a sharp fiscal tightening and led to a significant fall in public and private consumption. Growth further declined to 1.9 percent in 2013 and preliminary estimates by the Palestine Central Bureau of Statistics (PCBS) indicate that the economy experienced a contraction in the first quarter of 2014 (at a rate of -1 percent overall, of which 0.5 percent in the West Bank and -4 percent in Gaza).

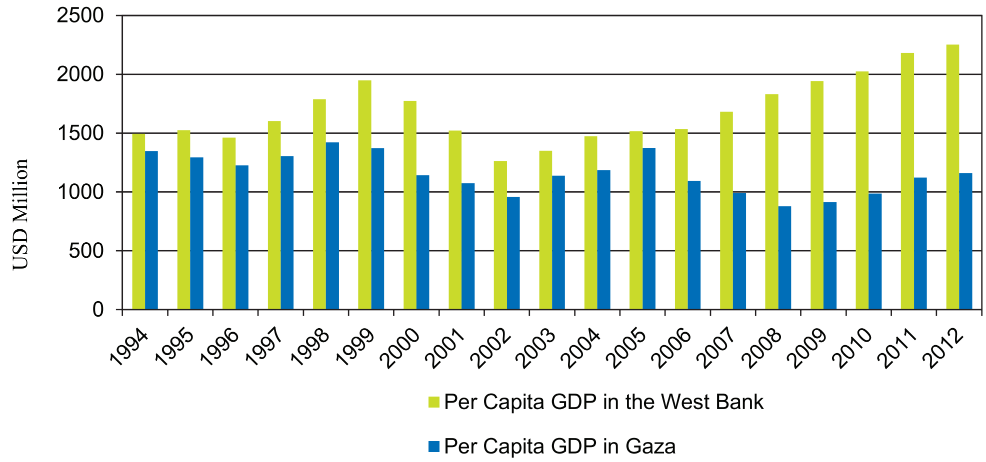
Figure 2. Decelerating growth and Gaza contraction



9. **The crackdown on illicit tunnel activity in mid-2013 put Gaza's economy under additional stress**. The precise size of the tunnel economy is difficult to quantify, but some estimates suggest that the volume of tunnel trade[3] may have exceeded that of officially registered trade. Tunnels were a particularly large source of construction materials. Their closing therefore led to a strong decline in the size of the construction sector—until then a major contributor to growth in Gaza. As a result, construction activity contracted by more than 70 percent between Q2 2013 (just before the tunnels were closed) and the first quarter of 2014 (latest available data).

3 Gisha – Legal Center for Freedom of Movement Database.

Figure 3. Per capita GDP in the West Bank and in Gaza



10. **With the unfolding recession, unemployment is reaching a new high**. According to the PCBS, unemployment jumped to 45 percent in Gaza during Q2 2014 (three times higher than that in the West Bank). The slight reduction in the West Bank's unemployment rate (to 16 percent in the second quarter from 18 percent in the first quarter of 2014) appears to be due to seasonality and some increase in the number of workers employed in Israel. Youth unemployment is of particular concern in Gaza where 63 percent of those in the labor force are unemployed. Labor force participation in the Palestinian territories suffers from a severe gender gap: participation of males was about 72 percent in the second quarter of 2014, while it was only 19 percent for females.

Table 1: Labor Force Statistics, second quarter 2014 (percent)

Indicator	Palestinian territories	West Bank	Gaza
Unemployment	26.3	16.0	45.1
Underemployment	6.4	5.7	7.8
Labor force participation	45.8	46.4	44.7
Youth unemployment (15 to 29)	39.5	25.3	63.3
Youth labor force participation	39.7	40.6	38.3
Female Unemployment	39.6	26.9	60.8
Female Labor Force Participation	19.4	19.0	20.1

Source: Palestinian Central Bureau of Statistics (PCBS)

11. **Since poverty is highly correlated with labor market outcomes, it is not surprising that a quarter of the Palestinian population lives in poverty, with the rate in Gaza twice as high as that in the West Bank.** The latest data from PCBS indicate that, in 2011, the poverty rate was reaching 39 percent in Gaza, and around 18 percent in the West Bank. Data also show many people living on the edge of poverty. It is almost certain that the recent conflict has pushed many of them into poverty.[4]

4 The poverty and unemployment rates in Gaza were both in the same range in 2011; since then, unemployment increased by 5 percentage points. Thus, poverty has almost certainly increased as well.

12. **Projections for the whole of 2014 suggest that the Palestinian economy may shrink in 2014, by close to 4 percent, driven by a recession in Gaza and stagnation in the West Bank**. Even though reconstruction efforts may start reviving economic activity in the fourth quarter of the year, this will not be enough to drive Gaza's economy out of recession: come the end of 2014, the economy in Gaza may well have contracted by 15 percent. In the West Bank, the overall decline in confidence and the Israeli military activity in and around the city of Hebron in June-July 2014 are expected to have had a damaging effect on economic activity during the first three quarters of the year. A slight recovery in the fourth quarter is expected to push full year growth rates in the West Bank back to around 0.5 percent.

13. **If the international community responds to the need for reconstruction in Gaza, growth could be expected to rebound to more than 4 percent in 2015.** Gaza in particular could grow by 11 percent in 2015 (a rate that would still leave economic activity below its pre-conflict level), while growth would reach 2.3 percent in the West Bank.

b. Fiscal Situation

14. **The PA continues to tackle its grim fiscal situation, where the impact of economic slowdown has compounded that of a reduction in donor aid, and the internal political and administrative divide between the West Bank and Gaza.** External budget support has significantly declined from its peak in 2008. Although there has been a substantial fiscal adjustment in response, the PA has struggled to meet the reduction in aid flows.

15. **The PA's revenue performance has been improving**, but it remains handicapped by the low amount of revenues collected by the PA from Gaza compared to expenditures there. The tax base in the West Bank, despite the increase of 5,000 additional taxpayers since 2014, also remains narrow due to inefficiencies in both enforcement and policy, and the sharp slowdown in growth since 2012 has not helped. Still, revenue efforts have gathered pace during the first half of 2014, exceeding the prorated budget target to reach a level 23 percent higher than during the same period last year. This is due to a significant growth in clearance revenues[5] and front-loaded domestic revenues driven by financial incentives to pre-pay taxes.[6]

16. **The performance of clearance revenues has been particularly strong in 2014.** During January-June 2014, they were more than 30 percent higher than in the first half of 2013, exceeding their midyear budget target by 12 percent. This is mainly due to higher collections from customs, VAT and petroleum excise which grew by 26, 22 and 40 percent, respectively, in the first half of 2014 relative to the same period in 2013. Part of the increase in clearance revenues came as a result of the PA's customs officials' field campaigns to deter Palestinian merchants from undervaluing their import declarations. It is also due to larger imports of Israeli fuel into Gaza as access to the cheaper Egyptian fuel was interrupted following the destruction of the tunnels connecting Gaza to Egypt. Based on historical trends, growth in clearance revenues is usually higher in the second half of the year which suggests that they will continue to exceed the budget target throughout the year. It is important that GoI continues to transfer these revenues consistently and on time in order to avoid an additional stress on an already challenging fiscal situation.

5 Clearance revenues are VAT and import duties that are collected by the GoI on behalf of the PA

6 Normally, frontloaded revenues would not be counted in fiscal accounts produced on commitment basis using the Government Finance Statistics (GFS) 2001 methodology. The PA uses a hybrid version of this methodology and adds advance revenue payments to its budget execution reports.

Table 2: Palestinian Authority's Revenues, January – June 2014

(NIS million)	Jan–Jun 2013	Jan-Jun 2014	Y-o-Y change	Prorated 2014 budget	Percentage difference budget & actual
Total net revenues	**4097.8**	**5052.5**	**23.3**	**4655.5**	**8.5**
Gross domestic revenues	1672.4	1754.6	4.9	1663.0	5.5
Tax revenues	1137.8	1251.1	10.0	1164.5	7.4
Non-tax revenues	534.5	503.5	-5.8	498.5	1.0
Clearance revenues	2810.2	3667.6	30.5	3272.5	12.1
Tax refunds (-)	384.8	369.6	-4.0	280.0	32.0
Fuel	331.0	324.7	-1.9	240.0	35.3
Other	53.9	44.9	-16.7	40.0	12.3

Source: Palestinian Authority Ministry of Finance (MoF)

17. **Domestic tax collection may struggle to keep up during the second half of this year.** In the first quarter of 2014, domestic tax revenues grew by 24 percent in comparison to the same period in 2013. The PA introduced an 8 percent discount on early VAT payments in 2014 on top of the property and income tax incentives that apply to tax receipts in the first 90 days of the year. As a result, a number of large companies and major banks pre-paid their tax obligations. Growth in domestic tax revenues in the first quarter can, therefore, be mainly attributed to advance payments rather than a significant widening of the tax base. Starting in April, 2014 and following the expiration of the early payment tax invectives, domestic revenue started to slow down. The second quarter's collections were 49 percent less than in the first quarter and were also 27 percent lower than the prorated budget target. This is an indication that stronger effort needs to be carried out by the PA to continue to widen the tax base and enhance compliance.

18. **Energy subsidies, in the form of tax refunds, are also hampering revenue efforts.** They were 32 percent over budget during the first half of 2014. These subsidies are probably the largest source of inefficiency in the PA's budget. They are provided as tax rebates to gas stations when they purchase liquid fuels from the Palestinian Petroleum Authority, the only entity authorized by the PA to import fuel into the West Bank and Gaza. International experience shows that fuel subsidies not only have distortionary effects on economic activity, but they also disproportionally benefit better-off segments of the population. To its credit, the PA has gradually reduced these subsidies from about NIS70 million per month in the beginning of 2014 to about NIS50 million in June, but much remains to be done. Ultimately, the PA should aim to eliminate fully these subsidies and rely on the existing well-targeted cash transfer system to offset the impact of any price increase on the living standards of the poor.

19. **Recorded under the item "net lending," subsidies for water and electricity continue to form another major drag on the budget.** In the first half of 2014, they ran 71 percent above the prorated target and grew by 59 percent when compared to the same period last year. While this may in part reflect the timing and pattern of payments to Israel, a recent study conducted

by the World Bank reveals that the underlying problems lie with the deteriorating efficiency of the electricity distributors, increasing electricity losses, and decreasing collection from customers, particularly in the West Bank. According to the Israeli Electricity Company (IEC), debt owed by the PA on the account of unpaid electricity bills amounted to NIS 1.7 billion as of August 2014.[7] Recently intensified reform efforts by the PA such as (i) the creation of an inter-ministerial special committee to monitor and address net lending issues; and (ii) the adoption of a decision to impose penalties on electricity distributors not paying their bills to IEC are encouraging and deserve strong support from the international community. Effective and direct collaboration between the PA and the GoI is important to ensure a successful and sustainable implementation of some of these reforms.

20. **Recurrent expenditures have also been running high, but this reflects largely a welcome rundown of arrears to the private sector.** While recurrent spending increased by 11 percent year-on-year through June, due to higher nonwage expenditures as arrears to the private sector were repaid. Wage spending was kept within its budget target.

21. **The wage bill has been kept on a tight leash.** It remained 1.4 percent below its prorated budget target due to a delay in paying some allowances. This offset the increase that resulted from the growth in the net number of employees which totaled 830 in the first half of 2014.[8] The PA reports that this increase is only temporary and it is caused by the fact that new recruitments usually take place earlier in the year while most retirements and other departures occur towards the end of the year. The PA has put in place a zero net hiring policy in late 2012 and has maintained it since. Even so, the wage bill absorbs about half the recurrent budget, and, at 17 percent of GDP, remains high by international standards.

22. **Transfers, the second biggest recurrent expenditure item, were also kept below their midyear target.** They were about 12 percent below expectations because the Ministry of Social Affairs (MoSA) lacked funds to increase the number of new households benefiting from the National Cash Transfer Program (NCTP), as it had earlier planned. However, the conflict in Gaza has created an urgency and transfer payments in July 2014 were twice as high as in June.

23. **In addition, the PA has provided immediate assistance to alleviate the impact of the war in Gaza.** A large number of injured during the recent conflict in Gaza were treated in East Jerusalem and Israeli hospitals. While the exact cost of these treatments is not clear yet, it will be covered by the budget of the PA. Furthermore, the PA also provided fuel for generators to meet urgent needs for electricity during and immediately after the conflict. The PA also committed to temporarily extend financial assistance to an additional 20,000 poor people in Gaza, who were affected by the recent conflict.

24. **Also, with past arrears to suppliers beginning to be cleared, cash spending on goods and services significantly exceeded the prorated budget**. This was particularly the case at the Ministry of Health, where about NIS190 million in arrears accumulated in previous years on health referrals were cleared in the first half of 2014.

7 This amount is disputed by the PA.

8 Specifically, 1100 employees were hired in the West Bank while 289 departed from the PA's labor force in Gaza. In addition, employment in the national fund and in the number of deputy positions was reduced by 326 while it was increased by 345 in the embassies.

Table 3: Palestinian Authority's Expenditures, January – June 2014

(NIS million)	Jan–Jun 2013	Jan-Jun 2014	Y-o-Y change	Prorated 2014 budget	Percentage difference budget & actual
Total expenditure & net lending	**6574.8**	**7321.5**	**11.4**	**6958.0**	**5.2**
Wages	3436	3581.8	4.2	3632.6	-1.4
Social contributions	319.8	329.9	3.2	327.65	0.7
Use of goods and services	837.3	1430.0	70.8	968.5	47.7
Transfers	1478.4	1396.5	-5.5	1581.0	-11.7
Minor capital	10.8	19.2	77.8	38.0	-49.5
Interest	169.7	51.8	-69.5	110.0	-52.9
Net lending	322.8	512.3	58.7	300.0	70.8

Source: Palestinian Authority MoF

25. **Despite having to incur additional expenditures to provide immediate assistance to the conflict-stricken people in Gaza, the PA has managed to keep its finances under control**. Based on the current projections and thanks to unexpectedly strong revenue performance, the PA is expected to reduce its large stock of arrears to the private sector by roughly USD100 million in 2014, which will inject some welcome liquidity into the struggling Palestinian private sector.

26. **The PA's fiscal position for the remainder of the year remains highly vulnerable.** The total deficit is expected to amount to USD1.825 billion by the end of 2014, while aid to the public sector for recurrent and development spending is projected at USD1.467 billion, leading to a financing gap of around USD350 million. However, spending pressures particularly related to reconstruction efforts and expanding service delivery in Gaza are expected to significantly widen the financing gap.

c. Banking

27. **Despite significant losses in Gaza, the banking sector remains healthy thanks to the efforts of the Palestine Monetary Authority (PMA).** The sector is well regulated by the PMA which has steadily been building the capabilities of a central bank. Banks in general are risk averse and profitable due to several reasons including cheap sources of deposits and healthy margins. The year-on-year growth of the sector's net assets was 15 percent in June 2014, and its net income grew by 4 percent when compared to the same period last year. The banking sector has a high credit exposure to the Palestinian Authority and its employees, and the PMA is carefully monitoring related risks. The ratio of non-performing loans to gross loans continued to be low at 3 percent; however, this is expected to increase due to the recent conflict as the capacity of some individuals and businesses to service their loan installments has significantly deteriorated. The PMA has already taken measures to deal with the effects of the latest conflict on the banking sector. It has recently reached an agreement with banks to reprogram loans (principal and interest payments) for six months and wave some fees for the people of Gaza. It has also reduced risk reserves from 2 percent of risk weighted assets to 0.5 percent.

III. Building a Resilient Economy in Gaza

28. **Future reconstruction efforts will have to address not only the emergency needs but also the pre-existing constraints to economic development.** Following the cease fire agreement, the PA and the international community are rapidly moving to provide humanitarian aid and immediate recovery support. Based on a rapid needs assessment, the PA with the help of development partners has developed the Palestinian National Early Recovery and Reconstruction Plan to provide a roadmap covering the current humanitarian crisis to long-term development. This will be presented to a donors' aid conference scheduled on October 12, 2014.

29. **Strong PA leadership in recovery efforts in Gaza is essential.** Following a PA-led damage and needs assessment, the reconstruction efforts should also be led by the PA. In some instances the PA already has experience with implementing projects in Gaza through PA agencies there. For example, the PA's agencies in the water, municipal and electricity sectors have good implementation capacity. In other sectors, the PA may decide to contract out the implementation to others. In this context, the international community would want clear assurances that resources reaching Gaza are used in an efficient manner and only for the purposes intended.

30. **The governance challenge will only be addressed in the medium and long term if the integration of two administrative systems in Gaza is tackled in parallel with the physical reconstruction.** The current situation of dual administrative systems, resulting in complicated public service arrangements, is not sustainable. A process must be put in place to address the current situation prioritizing the needs for service delivery to the people of Gaza based on best international practice.

31. **A new system of access of materials is needed that enables the PA to take the lead in implementation through private contractors while addressing GoI's legitimate security concerns.** The pre-conflict system of restrictions neither satisfied the need for Israeli security, nor the need for speedy implementation of development and humanitarian projects in Gaza. The new system has to be based on two principles: (1) allowing for efficient and speedy reconstruction by private sector entities under the PA's leadership; and (2) assuring the GoI and donors that building materials are used only for the purposes intended. Such a scheme for access of materials could form the basis for a broader discussion on improving trade and the movement of people within and among the Palestinian territories and the World.

32. **Finally, the necessary resources for budget support, reconstruction and reconciliation of two administrative systems in Gaza must be forthcoming.** As discussed above, the PA will not be able to cover the cost of recovery and reconstruction as it is already in a very difficult fiscal situation. Three areas of donor support are needed: (1) budget support to help the PA deal with the pre-existing fiscal problems and to sustain the reform effort; (2) support for additional costs related to the conflict in Gaza including both support for recurrent and development spending; and (3) support to reconcile the two administrative systems and civil services in Gaza.

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