ANNEX 1

of the Commission implementing Decision on the Annual Action Programme in favour of Palestine[1]

Action Document for Palestine

1. IDENTIFICATION

Title/Number	PEGASE: Direct Financial Support to Recurrent Expenditures of the Palestinian Authority 2015 – part 1 CRIS number: ENI/2014/037-802		
Total cost	Total estimated cost: EUR 130,000,000 Total amount of European Union (EU) budget contribution: EUR 130,000,000		
Aid method / Management mode and type of financing	Project Approach/ Direct management		
DAC-code	16010	Sector	Social/welfare services

2. RATIONALE AND CONTEXT

2.1. Summary of the action and its objectives

Most of the European Union's assistance to the Palestinian Authority (PA) is channelled through PEGASE[2], the financial mechanism launched in 2008 to support the Palestinian Reform and Development Plan (2008-2010) and the subsequent Palestinian National Development Plans (PNDP) developed for the periods 2011-2013 and 2014-2016 with the aim to build strong governmental institutions as the basis for the future independent Palestinian State. These national plans set out medium-term agenda for Palestinian reform and development and contain a framework of goals, objectives and performance targets.

The protracted crisis situation linked to the stagnation of the Middle East Peace Process and the fact that Palestine has not yet attained 'statehood' continues to require specific temporary support measures to contribute to maintaining the viability of the two-state solution. Those cover the PEGASE Direct Financial Support (to the PA) and support to UNRWA (United Nations Relief and Works Agency) interventions for Palestinian refugees sustaining the delivery of basic services to the entire Palestinian population.

Through PEGASE Direct Financial Support (DFS), the EU has contributed substantially to the recurrent expenditure of the Palestinian national budget (over

[1] This designation shall not be construed as recognition of a State of Palestine and is without prejudice to individual positions of the Member States on this issue.

[2] *Mécanisme Palestino-Européen de Gestion de l'Aide Socio-Economique.*

EUR 1.7 billion since 2008), with systematic, predictable and unconditional contributions to the payment of PA civil servant's salaries and pensions (window 'CSP') and of social allowances to the poorest and most vulnerable Palestinians families (window 'VPF'). Through the new window for East Jerusalem hospitals ('EJH') set-up in 2013, the EU provides a crucial support to avoid the collapse of those hospitals, which are amongst the few remaining Palestinian institutions in East Jerusalem and are providing key medical services to the Palestinian population. This contributed substantially to State building as well as to social cohesion, economic and security stabilisation.

Consistently, the EU has been supporting the PA to implement certain policy reforms aiming at enhancing its fiscal sustainability and improve the accountability, integrity, and transparency of the public finance system (public finance management, fiscal reforms such as reduction of the net lending, health medical referrals, civil service reform), as well as to improve service delivery (social protection).

In December 2013 the Court of Auditors published a report on PEGASE DFS[3] where it recognised that the European External Action Service and the Commission had succeeded in implementing direct financial support to the PA in difficult circumstances. The report also concluded that the control measures put in place are robust and that there is no sign of mismanagement or diversion of funds.

Furthermore in July 2014 the conclusions of an external evaluation of the EU co-operation with Palestine[4] were published. This evaluation endeavoured to assess the efficacy of the overall EU strategy towards Palestine against the overarching objective of moving forward in the two-state solution and, to this end, building the institutional capacity of the Palestinian Authority. The evaluation concluded that while the EU co-operation undoubtedly led to significant achievements, inter alia in terms of preventing fiscal and economic collapse, fostering stability and building capacity for state institutions, it had little impact in removing the obstacles imposed by the Israeli occupation, namely restrictions on access and movements.

2.2. Context

2.2.1. Country context

2.2.1.1. Economic and social situation and poverty analysis

The outlook in Palestine is deteriorating dramatically given the collapse of the Peace Process negotiations in April 2014, the unclear reconciliation between the West Bank and Gaza and lastly after the war on Gaza in July. The latest conflict and humanitarian tragedy in Gaza has put further stress on the fiscal situation of the PA. Notwithstanding the additional expenditures resulting from the Gaza conflict which is expected to significantly widen the financing gap5, The PA's total deficit is expected to amount to USD 1.825 billion by the end of 2014, while aid to the public

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[3] European Union Direct Financial Support to the Palestinian Authority - European Court of Auditors Special Report No 14 - 2013 -

[4] Evaluation of the European Union’s Co-operation with the occupied Palestinian territory and support to the Palestinian people – contract No 2012/307554.

[5] The "National Early Recovery and Reconstruction Plan for Gaza" presented at the Cairo Conference in October 2014 refers to a total cost of USD 4 billion for relief, recovery and reconstruction, in addition to an estimated USD 4.5 billion support to the PA budget in 2014-2017.

sector for recurrent and development spending is projected at USD 1.467 billion, leading to a financing gap of around USD 350 million.

Without a political solution the Palestinian economy will continue to be unsustainable and dependent on donor aid.6 The decreasing political prospect for a viable two-state solution and the lack of intra-Palestinian reconciliation progress despite the announcement made in May further increases donor's fatigue. Although approximately USD 5.4 billion were pledged at the Cairo Conference on 12 October 2014 (half of which is to be dedicated for the reconstruction of Gaza) the actual volume and speed of these contributions remains to be confirmed. The PA's capacity to implement its "National Early Recovery and Reconstruction Plan for Gaza 2014-2017", released in the aftermath of the devastating conflict of July 2014, with the current level of Israeli's restrictions is also unclear at this stage.

The economy of Palestine has been marked by the disruption of more than forty years of occupation, during which the economic development path has paralleled political developments. Restrictions on movement and access imposed by Israel have deterred socio-economic development and resulted in an economy highly dependent on the Israeli market and donor aid. Obstacles are multiple and many-sided: limited access to land, water and other natural resources in the West Bank; segregation from the East Jerusalem market and inadequate public investment in East Jerusalem by the Jerusalem Municipality, as well as limited access to Area C (60% of the West Bank); de facto ban on exports from the Gaza Strip; severe restrictions on import of products considered by Israel to be of "dual use"; disrupting effects of settlement activity and settlers, notably in Area C; difficulty and uncertainty of obtaining movement permits for both Palestinian and foreign nationals.

After a period of sustained economic recovery between 2007 and 2011 with average yearly growth exceeding 8% (albeit largely driven by government spending, in turn, funded by aid flows), the Palestinian economy has significantly slowed down since 2012. It is expected to further decrease in the coming years –in the absence of successful peace negotiations. The International Monetary Fund (IMF) and the World Bank baseline forecasts for 2014 point to alarmingly low levels of real gross domestic product (GDP) of -3.7%, accompanied by an increase of unemployment rates reaching 30%. Furthermore, the latest data from the Palestinian Central Bureau of Statistics indicate that, in 2011, the poverty rate was reaching 39% in Gaza, and 18% in the West Bank. Data also show many people living on the edge of poverty. The recent conflict has since pushed many Gaza families into (deeper) poverty.

The PA has limited control of its revenues, remaining dependent on clearance revenue transfers from Israel (Israeli collects border revenues on behalf of the PA, which represent more than 65% of the PA’s national budget revenues). In contravention of the provisions of the Paris Protocol[7], Israel deducts from the sums transferred the cost of utilities owned by Palestinian municipalities ('net lending') and the cost of health referrals to Israeli hospitals. Following President Abba's decision to join the International Crime Court on December 31 2014, Israel has announced its intention to halt the transfer of clearance revenues, as it had previously done from November 2012 to March 2013. This decision, which violates Israel's contractual

6 World Bank report to the AHLC, September 2014.

7 The Protocol on Economic Relations, also called the Paris Protocol, was an agreement between Israel and the Palestine Liberation Organisation, signed on 29 April 1994.

obligations under the Paris Protocol, will negatively impact on the PA's ability to carry out its financial obligations and to reassert its authority in Gaza.

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Consequently, the PA continues to accumulate considerable debts to the banking sector and arrears to the private sector, with net arrears accumulated during the first half of 2014 amounting to USD 400 million (54% are owed to the private sector and the majority of the rest to the pension fund). Health services have also been greatly affected. As a result of the PA's accumulated unpaid arrears, hospitals in East Jerusalem have recurrent difficulties in paying salaries and are highly indebted to medical suppliers.

2.2.1.2. National development policy

In April 2011, the PA introduced its National Development Plan (NDP) entitled "Establishing the State - Building our Future", covering the period 2011-2013. In May 2014, the PA released the Palestinian National Development Plan 2014-2016 "State Building to Sovereignty". The programme builds on the previous tri-annual national plans and focuses on four key sectors: 1) economic development and employment, 2) good governance and institution building, 3) social protection and development and 4) infrastructure.

In early October, the PA has released its "National Early Recovery and Reconstruction Plan for Gaza 2014-2017" in the aftermath of the devastating conflict of July 2014.

2.2.2. Sector context: policies and challenges

Efforts aimed at enhancing fiscal sustainability remain a top priority. This, among other things, requires structural reforms that reduce the size of the fiscal deficit (notably in terms of wage bill, net lending, health referral, fuel subsidies, and arrears to the private sector), strengthen institutions (notably in terms of public finance management and public administration reform), and enhance the delivery of essential public services. Nonetheless, the PA will need to rely on significant inflows of donor aid as long as the Israeli occupation remains, and as long as there is a large discrepancy between PA's expenditures in Gaza and tax revenues it collects from Gaza (currently 43 percent of expenditures and 3 percent of revenues). This second point needs to be monitored in the framework of the recent reconciliation process.

In 2014, a total of EUR 168 million was committed from the 2014 EU budget, through PEGASE, to help the PA with the payments of PA salaries/pensions, allowances for poor Palestinian families and arrears for medical referrals to East Jerusalem Hospitals.

These funds were complemented by contributions from EU Members States, through PEGASE, including: SEK 40 million (equivalent to EUR 4.3 million) from Sweden for salaries/pensions, EUR 3 million from the Netherlands for salaries/pensions (earmarked to the justice sector), a total of EUR 1.5 million from Ireland for PA salaries/pensions (EUR 1 Million) and social allowances (EUR 0.5 million), EUR 2.5 million from Finland for arrears to East Jerusalem hospitals, EUR 1.8 million from Spain for social allowances, EUR 1.25 from Austria (through assigned revenues) for social allowances and EUR 1 million from Luxembourg for PA salaries/pensions.

By October 2014, other donors (including EU Member States) had also provided an additional EUR 424,872 million in support to the PA budget, either directly to the PA budget or via the World Bank Trust Fund (including EUR 312, 281 mllion from Arab donors, EUR 113 million from the World Bank Trust Fund and EUR 7,8 million from France).

2.3. Lessons learnt

The PEGASE DFS programmes build upon the successful experience of the Temporary International Mechanism in 2006-2007, and are implemented in full co-ordination with the Palestinian Authority and in close co-operation and transparency with EU Member States, the European Parliament and other donors. It is particularly appreciated by the Palestinian Authority for its flexibility and its catalytic nature in attracting funds from other donors without multiplying transaction costs.

The mid-term review of PEGASE conducted in 2009 highlighted the flexibility in planning and implementation, the highly competent and professional staff and the use of well-proven management systems while continuously innovating – which contributed to the success of this mechanism. The final evaluation, covering the period February 2008- February 2011, confirmed these findings.

In December 2013 the Court of Auditors published a report on PEGASE DFS providing recommendations. Many have already been addressed to (using the competitive tendering for technical assistance, review of the mechanism aiming at its simplification or introducing performing indicators); other are still under discussion with the Palestinian Authority and require a careful assessment of the situation, which has in the meantime changed due to the reconciliation process and the consequent formation in June 2014 of a "Consensus Government".

Early 2013, the EU, together with the other direct financial assistance donors, has started working towards a 'results-oriented framework' which would cover both (1) *policy reforms* (including fiscal issues related to domestic revenue mobilisation, net lending and health referral costs; public finance management issues, with a focus on transparency and accountability; civil service reform) and (2) *service delivery* (education, health and social protection). Under this framework, donors intend to further co-ordinate their support (in term of funding, technical assistance and policy dialogue) Both the December 2013 Court of Auditors and July 2014 external evaluation of the EU co-operation with Palestine confirmed the relevance of the shift towards a more results-oriented approach.

This results-oriented framework (which will be accompanied by a risk-management framework) will be aligned with the new PNDP 2014-2016 and related sectors strategy, building on the 'EU Sector Fiches' finalised in October 2014 under the umbrella of the EU local Development Strategy, as a step towards EU joint programming. The framework is scheduled to be finalised and effective by the end of the year, in close collaboration with the PA. Civil society will be consulted in the design and yearly monitoring. A pilot-phase of 6-months will allow further alignment with the World Bank-managed Budget Support Palestinian Reform and Development Plan (PRDP) Trust Fund's next Policy Matrix design due first half of 2015.

2.4. Complementary actions

The Annual Action Programme 2014, in line with the new Single Support Framework 2014-2015, was approved on August 2014 for a total of EUR 52 million, for the following support priorities: governance at local and national levels, private sector and economic development, water and land development. An additional EUR 168 were made available for PEGASE direct financial support to recurrent expenditure of the PA and EUR 80 million for UNRWA's General Fund in 2014.

Capacity building assistance ongoing/ under preparation and policy dialogue relevant to this action include, in terms of (1) policy reform: a) domestic revenue mobilisation – through a support to the PA's Taxpayer Awareness Programme (pipeline); b) support to the PA efforts in reducing the burden of net lending (ended in July 2014 – additional support could be envisaged in co-ordination with other donors); c) health referrals; d) civil service reform; e) strengthening of civil oversight of the national budget and f) gender budgeting; (2) service delivery: through a support to the Ministry of Social Affairs. Other EU Member States provide complementary capacity building support in relation to policy reforms and service delivery (education, health).

The PRDP-Trust Fund (PRDP-TF) is managed by the World Bank, and its main donors include the UK, France, Norway, Australia and Kuwait. The release of funds is untargeted, while conditional on the implementation of key reforms for a) improving the PA’s fiscal sustainability; and b) improving public financial management and accountability.

2.5. Donor co-ordination

Local donor co-ordination has been streamlined in accordance with the conclusions of the Ad-Hoc Liaison Committee (AHLC) meeting held in December 2005, following a proposal by the European Commission, the World Bank and Norway to reform the Aid Management Structures. The EU continues to play a leading role in these structures at all levels. Relevant platforms include: (i) the Fiscal Working Group (co-Chaired by the Ministry of Finance and the International Monetary Fund); (ii) the Public Administration and Civil Service Sector Working Group (co-Chaired by the Ministry of Planning and Administrative Development and the UK/DfID); (iii) the Social Protection Sector Working Group (co-chaired by the Ministry of Social Affairs and the Office of the European Union Representative in East Jerusalem (EUREP)); and (iv) the sub-group on Health Referrals under the Health Sector Working Group.

The EU plays a leading role in local EU Member States co-ordination. Complementarity and co-ordination with other EU actions are assured through regular co-ordination meetings at Headquarters and daily contacts between staff working in the EUREP. An EU Informal Group on PEGASE DFS was also set-up in early 2013 as a forum for discussions around PEGASE DFS related topics (such as fiscal issues, policy reforms, service delivery), and will, as of January 2015, be the main forum to jointly monitor the progress of the results-oriented framework. Through 2013 and 2014, increased co-ordination with other direct financial assistance donors (mainly the World Bank and the contributors to the PRDP-TF) has taken place.

3. DETAILED DESCRIPTION

3.1. Objectives

The overall objective of this temporary EU support is to maintain the viability of the two-state solution by avoiding the fiscal collapse of the PA and sustaining basic living conditions of the whole Palestinian population.

The specific objective is to support the Palestinian national development agenda and in particular:

(1) to support the PA to deliver to the Palestinian population essential basic services by maintaining the functioning of the administration;

(2) to improve the economic opportunities of poor, vulnerable and isolated population and;

(3) to support the PA in reducing its budget deficit and implementing its reform agenda while increasing the PA's transparency and accountability.

3.2. Expected results and main activities

Three categories of public expenditure are in principle eligible for support under this action, for a total amount of EUR 130 million which follows previous Decisions committed on 2008, 2009, 2010, 2011, 2012, 2013 and 2014 funds.

<u>Component 1: Supporting Palestinian administration and services (indicative allocation EUR 77 million)</u>

The EU will contribute to the payment of salaries and pensions to the PA civil servants in Palestine (West Bank and Gaza Strip). The objective of this activity is to support the PA to maintain the functioning of the administration and thus deliver to the Palestinian population essential basic services. The objective of this activity is to allow the administration to function and thereby to provide services to the Palestinians in the West Bank and Gaza Strip. The regular contribution to the funding of the wages expenditure for civil servants also reinforces the PA’s public finance management and public finance reform implementation.

<u>Component 2: Supporting the Palestinian social protection system (indicative allocation EUR 40 million)</u>

The EU will contribute to the quarterly payment of social allowances to poor and vulnerable Palestinian families in the West Bank and the Gaza Strip through the PA's national cash transfer programme (CTP). The objective of this activity is to ensure the continued assistance to Palestinian families living in extreme poverty, who are dependent on financial aid from the PA. This activity also reinforces the reform of the social protection system and the social cohesion among Palestinians.

<u>Component 3: Support to East Jerusalem Hospitals (indicative allocation EUR 13 million)</u>

The six Palestinian hospitals in East Jerusalem form an integral part of the network of health provision for Palestinians. The Israeli annexation of East Jerusalem, although not recognised by the international community, and the construction of the separation wall has had the effect of making access to these hospitals particularly difficult for Palestinians living outside the capital. In addition to the importance to the health network, these hospitals are also a symbol of continued Palestinian presence in East Jerusalem. The financial difficulties of the Palestinian Authority have resulted in a situation where many of the hospital bills underwritten by the Ministry of Health, and validated by the Ministry of Finance, remain unpaid. The hospitals are therefore, and to differing degrees, themselves in and/or worsen the PA financial crisis.

3.3. Risks and assumptions

It is expected that contributions from EU Member States and other donors will be made available during the implementation period to complement the proposed funds. Fluctuations in the exchange rate may have an impact on funding needs.

Full co-operation with the Palestinian Authority is essential. This co-operation needs to be maintained, in particular for the identification of eligible beneficiaries and timing of payments and for the identification of eligible expenditure.

All actions under this special measure require that no additional restrictions are imposed under the occupation. The ongoing dramatic crisis in Gaza will add a substantial fiscal strain on the PA's national budget, which extent is still uncertain at this stage. It is also expected that the level of poverty in Gaza will increase.

A comprehensive risk-management framework will be drafted by early 2015, alongside the results-oriented framework, covering political, macroeconomic, developmental, public finance management/fiduciary and reputational risks.

3.4. Cross-cutting issues

Good governance principles are applied to the implementation mechanism and ownership on the part of the Palestinian Authority is assured. The actions proposed provide services vital to the social and economic rights of the Palestinian population.

The EU also intends to support complementary capacity building activities focussing on the strengthening of the accountability, integrity, and transparency of the public finance system, by supporting 'checks and balances' aspects, tackling both the supply and the demand-side. The EU also intends to ensure the gender mainstreaming of the coming results-oriented framework.

3.5. Stakeholders

The direct beneficiary of the action is the Palestinian population. Eligible beneficiaries and expenses are identified through a system based on strict and objective criteria set by the European Union and based upon requests and information provided by the Palestinian Authority.

PEGASE DFS programmes will be implemented in close co-operation and full partnership with the Ministry of Finance, the technical Ministries and other relevant Departments and Agencies of the PA.

All donors supporting the PEGASE DFS will also be key stakeholders.

4. IMPLEMENTATION ISSUES

4.1. Financing agreement

In order to implement this action, it is foreseen to conclude a financing agreement with the partner country, referred to in Article 184(2) (b) of the Financial Regulation.

4.2. Indicative operational implementation period

The indicative operational implementation period of this action, during which the activities described in sections 3.2. and 4.3. will be carried out, is 18 months from the date of entry into force of the financing agreement or, where none is concluded, from the adoption of this Action Document, subject to modifications to be agreed by the responsible authorising officer in the relevant agreements. The European Parliament and the relevant Committee shall be informed of the extension of the operational implementation period within one month of that extension being granted.

4.3. Implementation components and modules

Direct management will be applied for all components.

PEGASE DFS programmes will be implemented by the Commission through the EUREP in East Jerusalem, in close co-ordination with EU Member States officials and with the Palestinian Authority.

Disbursements will be made by the Commission directly to the eligible beneficiaries of the PEGASE DFS programmes detailed in Section 3.2 above, following eligibility checks and verification and control procedures by external experts and international audit firms.

Subject	Type	Indicative number of contracts	Indicative trimester of launch of the procedure
Support to the recurrent costs of the Palestinian Authority (*PEGASE DFS*)	Direct Financial Support	3	2015/Q1

4.4. Scope of geographical eligibility for procurement and grants

Subject to the following, the geographical eligibility in terms of place of establishment for participating in procurement and grant award procedures and in terms of origin of supplies purchased as established in the basic act shall apply.

The responsible authorising officer may extend the geographical eligibility in accordance with Article 9(2b) of Regulation (EU) No 236/2014 on the basis of urgency or of unavailability of products and services in the markets of the countries concerned, or other duly substantiated cases where the eligibility rules would make the realisation of this action impossible or exceedingly difficult.

4.5. Indicative budget

Module	Amount in EUR thousands	Third party contribution
Component 1: Supporting Palestinian administration and services	77,000	N/A
Component 2: Supporting the Palestinian social protection system	40,000	N/A
Component 3: Support to East Jerusalem hospitals	13,000	N/A
Total	**130,000**	**N/A**

The aforementioned allocations are indicative and may be changed depending on the needs expressed by the PA and the funds received from other donors for specific areas covered by PEGASE DFS programmes. It is anticipated that, as in earlier years, other donors will make contributions.

Funds for the necessary technical assistance, evaluation, audit and visibility actions have already been, or will be, made available under separate Decisions.

4.6. Performance monitoring

A comprehensive monitoring, control and audit system will continue to be applied in the framework of the implementation of PEGASE DFS programmes, to provide reassurance over the use of funds, and the efficient and effective provision of support to the Palestinian authority and population while fully protecting donor interests.

Payments will be executed in accordance with Commission regulations. A sophisticated quarterly financial reporting system is in place and will continue to be implemented, giving detailed information on all operations processed. Individual beneficiaries as well as businesses will be uniformly checked against international sanctions lists.

While disbursement remains unconditional, a results-oriented framework will be drafted to guide the policy dialogue and monitor/report on progress achieved by the Palestinian Authority in the key policy areas identified. A quarterly and yearly operational reporting system will thus be put in place, built on internal and external reviews, notably reviews by the World Bank on key policy/fiscal reforms progress, and by the International Monetary Fund (IMF) on macroeconomic issues.

4.7. Evaluation and audit

Financial experts and qualified auditors will be involved in the implementation of PEGASE DFS programmes, which will be complemented by Commission and EU Member States specialists and international or local experts.

Advanced monitoring, control and audit systems are set up for all of PEGASE DFS programmes. All donors contributing to PEGASE DFS programmes have full access to the corresponding monitoring and audit reports on the basis of which their contributions are disbursed.

In addition to the regular verifications and audits of eligible expenditures to identify and validate payments, annual ex-post audits of PEGASE DFS programmes will be undertaken in accordance with international standards, to provide the maximum level of assurance which will be contracted on other decisions related to the PEGASE DFS activities. Donors will be invited to participate. Contributing donors may also carry out ex-post audits of expenditures covered by their payments.

A comprehensive evaluation report covering the first three years of implementation of the PEGASE DFS programmes (2008-2011) was carried-out in 2012. An evaluation covering the period 2011-2013 was launched. Mid-term evaluations will be performed every 18 months and final evaluation after a 3-year implementation period in line with the PA development planning cycle.

4.8. Communication and visibility

The action will follow the EU visibility guidelines.

Progress of implementation will be communicated regularly to all stakeholders through quarterly financial and operational reports. Regular meetings are held with EU Member States in Brussels as well as locally (EU Heads of Co-operation and EU Informal Group on PEGASE DFS meetings).