

ANNEX 1

of the Commission implementing Decision on the Annual Action Programme 2014 part 2 in favour of Palestine¹

Action Document for Palestine**1. IDENTIFICATION**

Title/Number	PEGASE: Direct Financial Support to Recurrent Expenditures of the Palestinian Authority 2014 – part 2 CRIS number: ENI/2014/037-579		
Total cost	Total estimated cost: EUR 32,450,000 Total amount of EU budget contribution: EUR 32,450,000 This amount includes a contribution of EUR 1.5 million from Austria.		
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 PEGASE², the financial mechanism launched in 2008 to support the Palestinian Reform and Development Plan (2008-2010) and the subsequent PA National Development Plan (2011-2013), which aimed to build strong governmental institutions as the basis for the future independent Palestinian State. In May 2014, the PA released Palestinian National Development Plan (PNDP) for the period 2014-2016. These national plans set out medium-term agenda for Palestinian reform and development and contain a framework of goals, objectives and performance targets.

Over the past years, the EU has been providing direct financial support to the PA and the United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA) to maintain the viability of the two-state solution and sustain the delivery of essential public services to the entire Palestinian population. Through PEGASE Direct Financial Support (DFS), the EU has contributed substantially to the Palestinian national budget recurrent expenditures (over EUR 1.6 billion since 2008),

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.*

with systematic, predictable and unconditional contributions to the payment of PA civil servant's salaries and pensions and of social allowances to the poorest and most vulnerable Palestinians. 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 policy reforms in public finance management, and on specific fiscal issues (such as reduction of the net lending), as well as to improve service delivery (social protection and civil service reform). Through the PEGASE DFS programme for East Jerusalem hospitals, set-up in 2013, the EU is also able to provide 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 support also enables the EU to push for policy reforms in the health sector, with a focus on the PA's system of medical referrals.

In December 2013 the Court of Auditors published a report on PEGASE³ 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 financial 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 cooperation with Palestine⁴ 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 cooperation 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 economy of Palestine has been marked by the disruption of more than forty years of occupation and conflict, 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 for economic development are multiple and many-

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 Cooperation with the occupied Palestinian territory and support to the Palestinian people – contract No 2012/307554.

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.

Figures highlight the continuous deteriorating economic situation in Palestine. 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 particular in the absence of successful peace negotiations. The International Monetary Fund (IMF) and the World Bank estimated that growth fell to around 2% in 2013 and preliminary baseline forecasts point to alarmingly low levels of real gross domestic product (GDP) with negative growth of -3.7%, accompanied by an increase of unemployment rates reaching roughly 30% in 2014. Furthermore, a quarter of the population still lives in 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 response to the Palestinian's bid for non-member state status at the UN on 29 November 2012, Israel stopped transferring these clearance revenues in December and January 2013 – worsening the PA's fiscal situation and creating instability in the economy. On 25 March 2013, Israel resumed transfers, but it continues to deduct from the sums transferred, in a rather opaque manner, the cost of utilities owned by Palestinian municipalities ('net lending') in contravention of the provisions of the Paris Protocol⁵.

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 around USD 400 million (out of which over 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.

In the short term, the PA will continue to depend on donor aid to cover its recurrent deficit. Overall donor financing in 2014 is assumed to be at the same level of 2013, i.e. USD 1.3 billion, and the resulting financing gap will amount to about USD 349 million. This gap has reportedly already been financed through arrears accumulated between January and June 2013 exceeding USD 400 million. The PA is therefore expected to have sufficient financing to cover all of its expenditures in the second half of the year, if current trends continue. However, several fiscal risks and eventualities could arise and widen the financing gap, notably the anticipated spending pressure in Gaza, following the national reconciliation agreement and the

⁵ The Protocol on Economic Relations, also called the Paris Protocol, was an agreement between Israel and the Palestine Liberation Organization, signed on 29 April 1994.

recent conflict, and increased Israeli deductions from clearance revenues due to rising electricity debts.⁶

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. The plan focused on the legal framework, organisational structures and processes, the use of technology in government, the management of financial resources and the management of human resources in civil and security sectors based on 23 sector strategies. 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.

2.2.2. *Sector context: policies and challenges*

In spite of the PA's reform effort in institution-building and the delivery of public services, achievements continue to be jeopardised by the lack of progress in the peace process. As a result, the PA's fiscal sustainability continues to be a serious concern and, as mentioned above, an increased spending pressure in Gaza is expected.

In 2013, EUR 168 million were provided for recurrent expenditures from the EU Budget through PEGASE DFS programmes. These funds were complemented with funds from EU Member States. Contribution from EU Member States included: Denmark (DKK 75 million for PA salaries/pensions, out of which DKK 40 million are earmarked for payments in 2014), Sweden (SEK 40 million for PA salaries/pensions), the Netherlands (EUR 2 million for PA salaries/pensions and EUR 1.5 million for salaries to the PA Civil Police/Defence), Finland (EUR 2 million for PA salaries/pensions), Luxembourg (EUR 0.7 million for PA salaries/pensions), Italy (EUR 1 million for PA salaries/pensions) and Ireland (EUR 1 million for PA salaries/pensions and EUR 0.5 million for social allowances). Other donors, including EU Member States, also provided support for direct financial assistance through non-PEGASE channels, either directly to the PA budget or via the World Bank Trust Fund, for a total amount of around ILS 3.6 billion.

A first tranche of EUR 137.05 million from the 2014 EU budget was made available during the first semester, through PEGASE, to help the PA with the payments of PA salaries/pensions, allowances for poor Palestinian families and arrears for medical arrears to East Jerusalem Hospitals. This first allocation will be completed by funds under this Decision, to reach an annual contribution of EUR 168 million in 2014.

These funds are also complemented by contributions from EU Members States, through PEGASE, with so far EUR 1 million from Luxembourg for PA salaries/pensions, EUR 1 million from Spain for social allowances and EUR 1.25 from Austria (through assigned revenues) for social allowances. Additional contributions from the Netherlands (EUR 3 million for salaries/pensions earmarked to the justice sector), Ireland (EUR 1 million for PA salaries/pensions and EUR 0.5

⁶ Palestinian Reform and Development Plan Trust Fund World Bank Review, June 2014.

million for social allowances), Spain (EUR 0.8 million for social allowances) and Finland (EUR 2.5 million for arrears to East Jerusalem hospitals) are in the pipeline. It is hoped that further contributions from EU Member States and other donors to PEGASE will be received before the end of the year. By July 2014, other donors (including EU Member States) had provided an additional ILS 1.4 billion in support to the PA budget, either directly to the PA budget or via the World Bank Trust Fund.

The EU remains actively involved in key fiscal issues, such as net lending and arrears for medical referrals and cooperates closely with key development partners such as the World Bank and the Department for International Development of the UK (DfID) on these matters on mutual interest.

2.3. Lessons learnt

The implementation of the PEGASE DFS programmes builds upon the successful experience of the Temporary International Mechanism in 2006-2007. PEGASE DFS programmes are implemented in full co-ordination with Palestinian partners and in full co-operation and transparency with EU Member States, the European Parliament and other donors.

It is particularly appreciated by the Palestinian Authority for its alignment with the three years national development plans and the strong sense of ownership on the part of Palestinians, as well as for its flexibility and its catalytic nature in attracting funds from other donors without multiplying transaction costs.

The mid-term review of PEGASE, launched by the Commission in late 2009, highlighted the flexibility in planning and implementation of the programmes, 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.

Many of the recommendation of the Court of Auditors have already been addressed to (using the competitive tendering for technical assistance 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 of the two factions Fatah and Hamas and the consequent formation of a Consensus Government.

This complies also with the suggestions of the external evaluation of EU cooperation with Palestine, as regards to developing a comprehensive, clear, measurable and outcome-oriented results framework, focusing inter alia on changes related to policy reform, service quality, transparency and accountability, inclusion, ownership and capacity-building.

In line with the evaluation recommendations and with the recommendations expressed by the Court of Auditors, the EU, together with the other direct financial assistance donors, has started working towards a 'results-oriented framework' which would cover both fiscal/policy reforms and service delivery. Under this framework, donors intend to further coordinate their support (in term of funding, technical assistance and policy dialogue) to the education, health and social protection sectors, as well as to help the PA in addressing key fiscal issues (such as net lending and health referral system), and policy reforms (such as public finance management and

civil service reform). The definition of the results-oriented framework indicators is aligned to the new PNDP 2014-2016 indicators and related sectors strategy.

2.4. Complementary actions

In 2013, a total of EUR 300 million were committed in support to Palestine from the European Neighbourhood and Partnership Instrument (ENPI), out of which EUR 168 million for PEGASE support to recurrent expenditure of the PA and EUR 80 million for United Nations Relief and Works Agency's (UNRWA) General Fund. EUR 52 million were allocated for projects aimed at socio-economic development and to support the institution-building agenda delineated in the Palestinian National Development Plan (2011-2013), under three focal sectors (Governance/Rule of Law; Private Sector Development and Water and Sanitation). UNRWA also received an additional allocation of EUR 10 million from the Food Security Budget Line to support its Social Safety Net Programme in 2012-2013, with the objective to provide nutrition for those refugees living in absolute poverty (95% of the funds were disbursed to date). Support to civil society initiatives was also made available through the European Instrument for Human Rights and Democracy and the thematic line Non State Actors and Local Authorities in Development. 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.

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 14 December 2005 in London following a proposal by the Commission, the World Bank and Norway to reform the Aid Management Structures. The Commission 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); and (iv) the sub-group on Health Referrals under the Health Sector Working Group.

The Commission 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 Office of the European Union Representative (EUREP) in East Jerusalem. An EU Informal Group on PEGASE DFS was also set-up in early 2013 as a forum for information sharing and discussions around PEGASE DFS related topics (such as fiscal issues, policy reforms, service delivery). Through 2013 and 2014, increased co-ordination with other direct financial assistance donors (mainly the World Bank and the contributors to the Trust Fund) 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 32.45 million which follows previous Decisions committed on 2008, 2009, 2010, 2011, 2012 and 2013 funds.

Component 1: Supporting Palestinian administration and services (indicative allocation EUR 19.20 million)

The EU will make available an additional contribution to the payment of salaries and pensions to the PA civil servants in the Occupied Palestinian Territory (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 (including the Palestinian refugee population) essential basic services. The regular contribution to the funding of the wages expenditure for civil servants reinforces the PA's public finance management and public finance reform implementation. At the same time, it allows the administration to function and thereby to provide services to the Palestinians in the West Bank and Gaza Strip.

Component 2: Supporting the Palestinian social protection system (indicative allocation EUR 11.75 million + EUR 1.5 million from Austria)

The EU will contribute at regular intervals to the 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.

Component 3: Support to East Jerusalem Hospitals (indicative allocation EUR 0 million)

The six Palestinian hospitals in East Jerusalem form an integral part of the network of health provision for the Occupied Palestinian Territory, in particular the West

Bank. The Israeli annexation of East Jerusalem, although not recognised by the international community, and the construction of the separation wall/barrier has had the effect of making access to these hospitals particularly difficult for Palestinians living outside the city. 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. Although no additional commitment is added to this component⁷, the component remains open for EU Member States' and other donors' contributions.

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 by the Israeli Government, for example on financial transactions, including transfer of funds between the West Bank and Gaza Strip. 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.

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.

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 Prime Minister's Office, the technical Ministries and other Departments and Agencies of the PA.

PEGASE DFS programmes will be co-ordinated locally with the EU Member States, other international donors and international organisations. In order to do so, full use will be made of the existing local co-ordination groups already in place such as the

⁷ EUR 13 million were committed through Decision C(2014)2692.

Local Development Forum, the AHLC structures, the co-ordination meeting between EU Member States and the Office of the EU Representative.

All donors supporting the mechanism 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 (<i>PEGASE</i>)	Direct Financial Support	2	4 th trimester of 2014

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(3) 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	19,200	N/A
Component 2: Supporting the Palestinian social protection system	13,250	N/A
Component 3: Support to East Jerusalem hospitals	0	N/A
Total	32,450	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 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 administration and population while fully protecting donor interests.

Monitoring arrangements also include reviews to take stock of other donor contributions, reviews by the World Bank on key policy/fiscal reforms progress, reviews by the International Monetary Fund (IMF) on budget execution as well as other relevant political developments.

Payments will be executed in accordance with Commission regulations. A sophisticated and uniform 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.

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. The recommendations were taken into account in the implementation of the different programmes. 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, including through a monthly bulletin. Regular meetings are held with EU Member States in Brussels as well as locally (EU Informal Group on PEGASE DFS).