

EXPLANATORY MEMORANDUM ON A COMMUNICATION FROM THE EUROPEAN COURT OF AUDITORS:

Special Report No. 14/2013 - European Union direct financial support to the Palestinian Authority

Submitted by the Department for International Development

Date 3 February 2014

Subject Matter

1. This report from the European Court of Auditors examines the effectiveness of the implementation of European Union Direct Financial Support to the Palestinian Authority. The audit was carried out from July to December 2012.
2. The European Union (EU) is the biggest multilateral donor to the Occupied Palestinian Territories (OPTs), providing around £2.4billion between 2007 and 2012. The overall objective of the aid programme is to support progress towards a two-state solution. EU development programmes in the OPTs focus on three sectors: rule of law; private sector and trade; and infrastructure, particularly for water. The EU also provides substantial support for the UN Relief and Works Agency (UNRWA) to assist Palestine refugees.
3. The main focus of EU assistance, however, has been direct financial support to the Palestinian Authority (PA): this accounted for 47% of total assistance between 2007 and 2012. The EU supports the PA to build up the institutions of a future democratic, independent and viable Palestinian State living side by side with Israel and its neighbours. Reliant on donor support for around 40% of its budget, the PA has made important progress in statebuilding in recent years: in 2011, the World Bank, International Monetary Fund and UN assessed the PA's governmental functions as sufficient for a functioning state. The leadership remains an important moderate voice and is committed to making peace.

4. EU Direct Financial Support (DFS) to the PA is delivered through the Pegase mechanism. Since 2011, the European External Action Service (EEAS) and the European Commission's DG Development and Cooperation (EuropeAid) have been jointly responsible for its administration. An international organisation has been contracted since the start of the programme to assist with the programme's management.
5. The objectives of Pegase DFS are: (a) to help the PA to meet its obligations towards civil employees, pensioners and vulnerable Palestinian families; (b) to maintain the functioning of the administration and the provision of essential public services to the population; and (c) to implement public finance management (PFM) reforms and reduce the budget deficit (including reducing net lending and arrears due to the private sector). It is in line with the Palestinian National Development Plan (2011-2013).
6. There have been five components to this support during the timeframe covered by the audit: payment of civil servant and pensioner salaries; cash assistance to vulnerable individuals in the West Bank and Gaza; provision of fuel to the Gaza Power Plant (suspended at the end of 2010); payment of private sector arrears; and financial support for businesses destroyed or damaged during the Israeli 'Operation Cast Lead' offensive of 2008 (since December 2009).
7. EU funds are transferred to a PA treasury sub account from which salary payments and social transfers are made directly to PA employees. Audit firms contracted by the Commission screen the beneficiaries in accordance with agreed upon procedures to mitigate the risk of funding ineligible beneficiaries or terrorist activities.
8. The audit concluded that "the Commission and the EEAS had succeeded in implementing direct financial support to the PA in difficult circumstances, but that a number of aspects of the current approach are increasingly in need of an overhaul." In particular, it questioned the sustainability of some of the results, especially without further PA reform and enabling actions from Israel. Moreover, the approach has come under increasing pressure as donor funds have declined and the number of beneficiaries has increased. In Gaza, the audit found that

salaries were being paid to large numbers of beneficiaries who were not working due to the political situation.

9. The report recommended that the EEAS and European Commission undertake a major review of Pegase, taking into account the following specific recommendations:
 - a. Strengthen the future programming of Pegase DFS, for example by linking it more explicitly to the new EU-PA action plan and planning allocations on a multiannual basis;
 - b. Reduce administrative costs of running the programme by simplifying the management system and using competitive tendering for audit firms where possible;
 - c. Make future funding conditional on the PA making progress on civil service reform;
 - d. Discontinue funding civil servants in Gaza;
 - e. Further engage with Israel to encourage them to take the steps necessary to help make Pegase DFS more effective.

Ministerial Responsibility

10. The Secretary of State for International Development is responsible for UK policy on EU development matters.

Interest of the Devolved Administrations

11. The UK's Foreign Affairs, Defence, and International Development policies are reserved matters under the UK's devolution settlements and no devolved administration issues arise in these fields.

Legal and Procedural Matters **LEGAL ADVISOR TO COMPLETE**

12. Legal basis: The report is produced in accordance with Article 287(4) TFEU.

13. Voting procedure: Not applicable.

14. Impact on UK law: None.

15. Application to Gibraltar: None, although EU law on development issues does apply to Gibraltar.

16. Application to the European Economic Area: None.

17. Subsidiarity: No issue of subsidiarity arises from this Report.

18. Fundamental Rights Analysis: No fundamental rights issue arises.

Policy Implications

19. The Commission and the EEAS welcomed the Court's findings that they have succeeded in implementing support to the PA in spite of the difficult circumstances. They pointed to the importance of supporting the PA as part of efforts to achieve a two-state solution to the Israeli-Palestinian conflict. This is especially important in a context where Israeli movement and access restrictions severely restrict the Palestinian economy. The World Bank has recently estimated that easing the restrictions on Area C (which makes up more than 60% of the West Bank) could provide additional output amounting to at least \$2.2 billion per annum in value-added terms – a sum equivalent to 23% of 2011 Palestinian GDP.¹

20. A number of recommendations from the report have already been taken forward. From 2013 onwards, the EU has been supporting civil service reform through support to the PA. Performance indicators are going to be established, although these will acknowledge the potential impact of external factors outside of the PA's control. In efforts to reduce administrative costs, competitive tenders were or will shortly be launched for both audit and management services. The Commission also reports ongoing efforts to improve cooperation with Israel.

21. However, they strongly disagreed that a 'major' revision of Pegase is needed. They firmly rejected the need to attach conditionality to their support. In terms of

¹ West Bank and Gaza: Area C and the Future of the Palestinian Economy, October 2013, World Bank

coordination with Israel, the Commission has accepted that, absent meaningful enabling actions from Israel, progress on Palestinian development will always be limited: “Sustainability can only be ensured through political progress on reconciliation and the ending of the occupation.” The EU and its member states continue to engage with Israel on these issues. The Commission strongly defended the payment of PA civil servants in Gaza who are not able to work. This has been part of a deliberate political decision to support the moderate Palestinian leadership and help to maintain the unity of a future Palestinian state.

22. The UK is supportive of the EU’s approach to funding the PA. The UK, like the EU, supports the PA to enable it to perform the functions of a future state and be a stable, prosperous and effective partner for peace with Israel. Through our own bilateral Palestinian programme, DFID is providing up to £122million in direct funding to the PA from 2011-2015.

UK Position

23. We welcome the report’s findings that the EU has succeeded in providing support to the PA in difficult circumstances. The auditors found absolutely no evidence of corruption or mismanagement. In fact, the report clearly states that robust processes are in place to ensure that funds reach the intended beneficiaries.

24. Our own approach to funding the PA - through the World Bank’s Palestinian Reform Development Plan (PRDP) Trust Fund - is arguably even more robust. A Memorandum of Understanding (MoU) governs the UK’s aid relationship with the PA. The MoU sets out mutual commitments around shared principles (poverty reduction, human rights, sound financial management and accountability). The MoU is reviewed on a regular basis. We have agreed with the PA that it will use British funding specifically to pay the salaries of Palestinian civil servants. The list of approved recipients is subject to vetting processes and independent audit.

25. The EU is right to defend payments to civil servants in Gaza. The political situation in Gaza is unique. Hamas, the de facto authority in Gaza, is considered by both the EU and the UK to be a terrorist organisation. This is in contrast to the moderate Palestinian leadership based in the West Bank. Supporting the PA to

retain a presence in Gaza by paying civil servant salaries has been a conscious political decision to help counter instability and achieve the long-term goal of a peaceful two-state solution. The alternative would be to fund West Bank expenditure only, essentially endorsing Hamas authority in Gaza (which the UK and international community has deemed illegitimate since the violent coup in 2007), and reinforcing the West Bank-Gaza divide. This is completely contrary to UK policy to bring about a negotiated two-state solution.

Impact Implications: (Impact to UK businesses or Civil Society)

26. None

Financial Implications:

27. None – support to the PA is part of the UK development budget to the EU.

Consultation: (please indicate any cross-HMG consultation)

28. This report and our approach to supporting the PA have been discussed and agreed with the Foreign and Commonwealth Office

Timetable / Council

29. This audit covered the period from July to December 2012 and was published in December 2013.

A handwritten signature in black ink, appearing to read 'Lynne Featherstone', with a long horizontal flourish extending to the right.

LYNNE FEATHERSTONE
PARLIAMENTARY UNDER-SECRETARY OF STATE
DEPARTMENT FOR INTERNATIONAL DEVELOPMENT

ANNEX ONE
SCRUTINY HISTORY

DOC

TITLE

DATE