

**WEST BANK AND GAZA
PROPOSED PUBLIC FINANCIAL MANAGEMENT REFORM TRUST FUND**

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CURRENCY EQUIVALENTS

Currency unit = New Israeli Shekel (NIS)
NIS 4.54 = US\$1 (average 2003)

WEIGHTS AND MEASURES

Metric System

FISCAL YEAR

January 1 – December 31

LIST OF ACRONYMS

CFAA	Country Financial Accountability Assessment
ESSP	Emergency Services Support Program
FY	Fiscal Year
IMF	International Monetary Fund
MOF	Ministry of Finance
NIS	New Israeli Shekel
OD	Operational Directive
OP	Operational Policy
PA	Palestinian Authority
PIF	Palestine Investment Fund
PLC	Palestinian Legislative Council
SESP	Socio-Economic Stabilization Plan
TF	Trust Fund
US\$	United States Dollar

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1. Introduction

1. The security measures that Israel has imposed in the West Bank and Gaza during the *intifada* continue to result in severe economic depression and fiscal compression. Recent economic data do show a limited recovery beginning in late 2002 and accelerating with the launching of the Roadmap process in the summer of 2003. Unemployment¹ fell from 41.3 percent of the work force in 2002 to 33.5 percent in 2003. However, these improvements do not alter the fact that the West Bank and Gaza is in deep economic crisis. Real per capita incomes are more than 30 percent below their pre-*intifada* level, and about half of the Palestinian population is currently living below a poverty line of US\$2 per capita/day (see Annex 1).

2. **Fiscal crisis.** The *intifada* has had a profound impact on the fiscal profile of the Palestinian Authority (PA). The budget deficit before external financing surpassed US\$825 million in 2001 and US\$710 million in 2002. Over these two years, donors provided US\$1,034 million in budget support, yet the combined residual deficit reached over US\$500 million. The revenue situation improved markedly in 2003, mainly due to the resumption of Israeli transfers of clearance revenues in late 2002. However, donor budget support also fell sharply, to US\$270 million, leaving the PA with a budget deficit after external financing of over US\$360 million in 2003 (see Annex 1).

3. The PA's current expenditures in 2004 are expected to amount to US\$1,306 million (see Annex 2), and PA-financed capital expenditures and PA net lending to municipalities to US\$138 million. Total PA expenditures in 2004 are thus estimated at US\$1,444 million, or US\$120 million per month (see Annex 3). Revenues (both domestically raised, and transferred from Israel through the clearance system) are estimated at US\$806 million (US\$67 million per month), resulting in a projected 2004 budget gap after other financing of US\$650 million (US\$54 million per month).² At the same time, using end-2003 arrangements and assumptions, only some US\$200-240 million in donor budget support can be anticipated for 2004. Under this scenario the PA would experience great difficulty sustaining a coherent recurrent expenditure program, and its ability to function would be imperiled.

4. In recent years, the PA has employed various strategies to cover the shortfall in the budget, including accumulating arrears to the private sector and deferring social security payments (including pensions), curtailing non-salary expenditures, and borrowing from commercial banks. While the repayment of most of the stock of withheld

¹ Based on the "relaxed" definition by the Palestinian Central Bureau of Statistics, which includes the so-called discouraged workers, i.e. working-age persons who are available for work, but have given up looking for a job.

² Including US\$12 million planned to reduce domestic bank financing (see Annex 3).

clearance revenues³ helped temporarily reduce arrears to the private sector, these have again started to accumulate. The total stock of arrears reached US\$384 million by end-2003, or 12 percent of GDP. The stock of the PA's debt to banks totaled another US\$176 million at end-December 2003, or 5.4 percent of GDP, and increased to US\$274 million by end-January 2004. By early 2004, the PA had already fallen behind in its budgeted non-wage expenditures in order to be able to meet salary payments.⁴ Clearly, this is not a viable fiscal scenario.

5. **Rationale for budget support.** The arguments for donor budget support to the PA are well established, and the PA's recent Socio-Economic Stabilization Plan (SESP) 2004-5, which is the basis for donor assistance, rightly gives top priority to this aspect of Palestinian economic strategy. Budget support is critical to providing socio-economic stability, the primary objective of the SESP.⁵ A continued fiscal crisis could lead to the termination of social and administrative services to the population and increasing poverty. In its extreme form, the PA could cease to carry out its functions and law and order would consequently deteriorate. Under the SESP, in addition to seeking US\$650 million in donor budget support for 2004, the PA also envisages external disbursements from ongoing and/or pipeline projects of US\$302 million, and US\$246 million from new project commitments. Thus the PA's total external financing request for 2004 amounts to US\$1,198 million (see Annex 4).

6. The Bank has argued that budget support is the most efficient of all the emergency assistance instruments currently employed by donors (budget support, food aid, job creation, and cash schemes), and that it has appreciable macroeconomic and welfare benefits. Budget support is simple to administer, with minimal overhead costs. It is estimated that in 2002, some 75,000 households (half a million Palestinians, or 15 percent of the population), were paid their salaries through donor budget support, and that this prevented perhaps 100,000 people from falling into poverty. Civil servants' salaries are also an important part of total consumer demand for goods and services, and in 2002 accounted for 40 percent of all domestic wage income. Budget support injected in 2002 alone is estimated to represent about 15 percent of GDP.⁶

7. **The international response.** There is great international concern at the impending budget crisis, and awareness that it could destroy the functionality of the current Palestinian government and compromise efforts to revive the peace process. At the meeting of the Ad Hoc Liaison Committee on December 10, 2003, the PA asked the Bank to create a new mechanism through which donors would be encouraged to provide pooled contributions, to be disbursed into the Central Treasury Account of the Ministry of Finance (MOF). Donors have strongly supported this request. It is felt that a common

³ The total of the stock of arrears withheld between December 2000 and November 2002 amounted to over US\$560 million, of which all but US\$180 million has been repaid (see also Annex 3). The remaining sums have been 'attached' by the Israeli courts to various pending civil court cases against the PA.

⁴ In addition, the PA has started to sell off assets from the Palestine Investment Fund. In February, the PA sold its stake in Jawwal, the local mobile phone company, for US\$42 million.

⁵ Ministry of Planning. Socio-Economic Stabilization Plan, 2004-2005, page 16.

⁶ See "Twenty-Seven Months – *Intifada*, Closures and Palestinian Economic Crisis", the World Bank, May 2003, Annex 1.

reform-oriented mechanism promising strong fiduciary oversight would result in donor budget contributions in excess of what can otherwise be expected.

8. The proposed Public Financial Management Reform Trust Fund (the “Reform Fund”) builds on the successful budget support mechanisms of the European Commission – the Special Cash Facility and the Direct Budgetary Assistance Program (Phases 1-5) – which disbursed a total of €235 million against a series of PA reforms between November 2000 and December 2002. Lessons from this assistance form an integral part of the design of the Reform Fund, which would extend a similar mechanism to a wider set of donors. Furthermore, in close collaboration with the MOF, the IMF and key donors, the Bank prepared a Concept Note outlining a program of reforms and arrangements for a multi-donor trust fund. Subsequent extensive consultations on the basis of this note with donors in the field and at capitals level have ensured that their key concerns have been incorporated in the final design of the Reform Fund.

9. **Rationale for Bank engagement.** The request by the PA, and its endorsement by donors, reflect the view that the Bank has the capacity and global reach to lead an international effort in support of the PA’s budget. The Bank has gained extensive experience in administering multi-donor trust funds, including in Timor-Leste, Afghanistan, Sierra Leone and the greater Great Lakes region of Africa. In the West Bank and Gaza, the Bank administered the Holst Fund from 1994 to 2001; this instrument served as the main conduit for PA budget support in its start-up years. This expertise would be brought to bear in the administration of the Reform Fund.

10. The Bank has recently completed a review of the PA’s public financial management system under the rubric of its Country Financial Accountability Assessment program (CFAA; see section on review of the public financial management system below). The CFAA confirms that the current systems are adequate to justify Bank budget support. It also identifies key actions needed to further improve the system; these actions have now been agreed with the PA as time-bound performance benchmarks for the Reform Fund. Lastly, the Reform Fund is an integral part of the Bank’s assistance strategy to the West Bank and Gaza.⁷

2. The Public Financial Management Reform Program

11. The PA has articulated a Public Financial Management Reform Program (the “Reform Program”), on the basis of which donors have agreed to provide budget support through the Reform Fund. The objective of this Reform Program is two-fold. First, to further improve the PA’s financial management systems within a broader national reform agenda; and second, to provide budgetary and fiduciary assurances to donors sufficient to ensure their financial support during the 2004 and 2005 budget years.

⁷ (1) Memorandum of the President to the Executive Directors. Proposed Replenishment of the Trust Fund for Gaza and West Bank; Proposed Extension of the Moratorium on Service Payments; and Proposed Amendment on Re-flows; December 18, 2003. (2) West Bank and Gaza: The Trust Fund for Gaza and West Bank: Status, Strategy, and Request for Replenishment; November 7, 2003.

12. **Review of the public financial management system.** The CFAA found that major and highly creditable improvements in budgeting and in fiscal transparency have been introduced during the tenure of the present Finance Minister. Weaknesses in financial accountability remain, related in particular to the lack of adequate public financial statements, inadequate auditing and the undeveloped oversight role of the Palestinian Legislative Council (PLC).

13. Nevertheless, the public financial management system is judged to be adequate insofar as the Bank's criteria and standards for approval of a general budget support operation (or adjustment lending) are concerned.⁸ Moreover, the major actions listed in the CFAA either are, or should in the future be, integral to the benchmarking of the Reform Fund. It should be noted that these measures have all been identified by the PA itself. A summary of recent areas of improvement and areas requiring additional improvement is provided in Annex 5.

14. **Reform measures and benchmarks.** In discussions with the Bretton Woods institutions and major potential contributing donors, the PA has specified two sets of benchmarks for 2004, each covering a period of six months, and a timetable for their implementation. These benchmarks are reflected in a Letter of Development Policy which the PA has submitted to the Bank (see Annex 6). Within a context of broader PA reform, the Letter of Development Policy specifies the PA's commitment to specific public financial reforms, monitorable indicators of achievement, and a program of fiduciary strengthening.

15. **Prior actions.** The first tranche under the Reform Fund would be authorized upon fulfillment of the following five Prior Actions (see also Annex 6):

1. Submission to the PLC and passage of the PA Budget Law for 2004.
2. Submission to the PLC of statements on the PA's fiscal operations in 2002.
3. Full implementation of the 2004 Budget Law's requirement that the salary payments of all PA security personnel be directly deposited into individual bank accounts.
4. Completion and publication of the final report of the valuation of assets of the Palestine Investment Fund (PIF).
5. Full compliance with the 2004 Budget Law in relation to public sector hiring, which should not exceed programmed net additional hiring of 3,500 personnel to be allocated as follows: (a) at least 90% of these positions to the social sector ministries (Health, Education, Social Affairs) and for Reform Program-related needs; and (b) the remaining 10% to other civil service entities.

⁸ A 2003 assessment by the IMF of the PA's fiscal system confirms the findings of the CFAA.

16. **Mid-2004 benchmarks.** Another set of benchmarks needs to be fulfilled by June 30, 2004 for disbursement of the second tranche of the Reform Fund (see section on disbursements below). The mid-2004 benchmarks are (see also Annex 6):

1. Adoption by the Council of Ministers of an Action Plan to contain the wage bill.
2. Best efforts to adhere to a minimum quarterly level of NIS 160 million in essential non-salary social recurrent expenditures.
3. Submission to the PLC of a revised External Audit Law which would ensure compliance by a new auditing institution with the provisions of the Basic Law (independence of the institution, responsiveness to the PLC), and clear responsibility for auditing all PA institutions' budget execution reports.
4. The assumption of full jurisdiction by the Department of Supplies and Tenders in the Ministry of Finance over all purchases made by PA ministries and agencies, including the Security Financial Administration.
5. Approval by the National Pension Committee of a detailed outline of a pension reform program and a draft Pension Law, including implementation regulations, setting out the parameters, institutions and management of a unified and sustainable public sector pension scheme.
6. Full implementation of the Council of Ministers' decision of June 2003 to retire PA employees at the age of 60.
7. Submission to the PLC of statements on the PA's fiscal operations in 2003, and PA commitment to their external audit by the new auditing institution (Benchmark #3 above) by end March 2005, or by external auditors, commissioned by the PA as a one-time stop-gap measure, by end-June 2005.

17. **Later benchmarks.** Presuming that donor budget support is extended into 2005 (see also section below on effectiveness and duration), a new set of benchmarks would be developed later in 2004 between the PA, the Bretton Woods institutions and major contributing or potential donors. These benchmarks would be reflected in another Letter of Development Policy, to be submitted by the PA to the Bank before end-December 2004.

3. Trust Fund Arrangements

18. The Bank would set up a single, multi-donor trust fund, the objective behind which would be threefold: first, to mobilize additional donor resources in support of the PA budget; second, to harmonize donor assistance in exchange for a commonly agreed Reform Program; and third, to simplify procedures for the PA. Donor funds would be co-

mingled and untied. Disbursement procedures would thereby be unified through the trust fund, easing the administrative burden on the PA.

19. Several donors have already indicated to the Bank and the PA that they are interested in co-financing the Reform Program, using the Bank-administered trust fund mechanism to channel direct budget support rather than providing funds on a bilateral basis.⁹ For some donors this would be the only viable mechanism.

20. **Legal context.** Operational Policy (OP) 14.40 requires that trust funds be administered in accordance with applicable Bank policies and procedures. Furthermore, in the case of the West Bank and Gaza, the Bank's engagement is set out in the September 20, 1993 Memorandum of the President: "World Bank Assistance to the West Bank and Gaza Strip" (R93-163, IDA/R93-134). The Executive Directors discussed the current Bank assistance strategy in December 2003.

21. This strategy outlines Bank analytical and operational activities until the end of 2005, and foresees the establishment of a multi-donor trust fund to support the PA budget. However, there is no Bank operation yet in place which the Reform Fund would co-finance.¹⁰ As the West Bank and Gaza is not a member of the Bank, Bank management seeks approval by the Executive Director for the establishment of the proposed multi-donor Public Financial Management Reform Trust Fund.

22. There would be two sets of legal agreements governing the Reform Fund. First, the Bank would sign a standard administration agreement with each contributing donor. This agreement would describe fiduciary oversight measures and Trust Fund governance arrangements. Second, the Bank would sign a Grant Agreement with the Palestinian Liberation Organization for the benefit of the PA which would include the benchmarks for tranche release.¹¹

23. **Expenditures under the Trust Fund.** There would be three expenditure categories: budget support, program supervision costs, and annual audits. Regarding budget support, as per OP 14.40, the Reform Fund would be governed by Operational Directive (OD) 8.60 on Adjustment Lending. Under the provisions for disbursement for policy based lending, disbursements are not linked to a positive list, but rather to the standard negative list used in Bank operations, with all of its provisos.

24. Costs for the preparation and supervision of the Reform Program are estimated at US\$520,000 over two years, including Bank staff salaries and indirect costs, consultants, and travel. These expenses would be charged to the trust fund principal, an arrangement agreed upon with prospective donors. The Bank would also charge an administration fee of US\$156,000 for central services (accounting, loans, legal, trust funds administration), and would commission (i) an annual audit of the Deposit Account (projected at

⁹ These include Canada, the European Commission, France, Norway, and the United Kingdom.

¹⁰ See chapter on Budget Support by the Bank below.

¹¹ It should be noted that the Bank cannot commit to disburse funds it has not yet received. Thus, the Grant Agreement would need to be amended each time an additional donor contribution is received in the Reform Fund, as well as for the second year of operation on the basis of the new benchmarks for 2005.

US\$30,000 annually) and (ii) an annual audit of its Trust Fund account (projected at \$30,000 annually) (see section on audits below). The costs for these audits would also be covered by the Reform Fund.

25. **Governance structure.** The Bank as Reform Fund Administrator would be responsible for supervising the implementation of the agreed reform measures, monitoring and certifying compliance with the benchmarks, and making disbursement decisions accordingly. In carrying out these responsibilities, the Bank would be assisted by a local Guidance Committee which would consist of the Bank (chair), the IMF, and a limited number of other key Reform Fund donors (actual or potential contributors).¹² The Guidance Committee would meet quarterly with the PA, or when requested by one of its members. It would review progress under the Reform Program, the PA's progress reports and the findings of Bank quarterly technical supervision missions, offering recommendations to the PA and the Bank.

26. If all benchmarks were fulfilled, the Bank would release the subsequent tranche and inform the contributing donors and the Guidance Committee accordingly. In case the PA did not comply with all benchmarks, the Bank would assess the specific situation and consult with the Guidance Committee and the contributing donors to seek their opinion on a possible waiver or adaptation of the respective benchmark(s). Should the Bank conclude that no waiver be granted, the release of the next tranche would be held back pending fulfillment of the benchmarks listed in question.

27. **Disbursements.** The Bank would disburse funds into a US Dollar Deposit Account maintained under the Central Treasury Account of the MOF. As the Palestinian Monetary Authority does not yet function as a full-fledged central bank, the Deposit Account would be held with a commercial bank, as is currently the case with the Central Treasury Account. The Ministry of Finance would convert the US Dollars into New Israeli Shekels (NIS) at the going exchange rate when needed.

28. Once the Bank can certify that the agreed prior actions or benchmarks applicable to a subsequent period have been met, an authorization to disburse funds received from donors in the period in question would be provided. Each authorization would remain current for a six-month period, with the first tranche covering the period from Reform Fund effectiveness until June 30, 2004. Bank management seeks approval that the Regional Vice President authorize tranche releases. Management would report to the Executive Directors on tranche releases.

29. Disbursements would be made on the basis of withdrawal applications submitted by the PA. Each tranche would likely feature several disbursements, depending on the timing of donor contributions. The Bank may, after consultation with the Guidance Committee and the contributing donors, suspend disbursements if the PA reversed already implemented policy actions until remedial action has been taken.

¹² Criteria for donor membership include, among others, the amount of the contribution to the Reform Fund and the importance of a donor's overall posture.

30. **Audits.** There would be three types of audits for the Reform Program and Reform Fund. First, the PA's financial statements would be audited annually by the PA's emergent external auditing institution, in accordance with a new External Audit Law. The audit of the PA's 2003 financial statements would take place by the end of March 2005, in deference to the need to constitute the new institution, and in accordance with internationally accepted auditing standards. Should this for some reason not prove possible, the PA would commission, on a stop-gap basis, an audit by an international audit firm.

31. Second, an external auditor contracted by the Bank would perform annual audits of the Deposit Account at the MOF. These audits would verify the extent to which the Bank's requirements under the grant agreement are being met, and whether the PA's procedures are adequate to achieve this result. Following streamlined disbursement procedures under OD 8.60, the Bank does not require evidence of underlying transactions. Audit reports would be submitted within four months of the end of the fiscal year. These audits would be financed under the Reform Fund.

32. Third, the Bank would commission annual audits of its separate records and ledger accounts to verify that it has administered donor funds in accordance with the administration agreements and made disbursements against agreed activities. A copy of the auditor's report would be forwarded to all contributing donors. The costs of this type of audit would also be covered by the Reform Fund. In addition, the Bank would provide the donors with an annual management assertion, together with an attestation from the Bank's external auditors, concerning the adequacy of the financial reporting for Bank-administered trust funds as a whole. The costs of such attestations would be borne by the Bank.

33. **Monitoring, supervision and reporting.** Throughout the implementation period of the Reform Fund, the Bank would consult with and remain in close contact with donors both at headquarters and in the field. Field-based Bank staff would monitor the implementation of the benchmarked actions on a regular basis. Every quarter, the PA would prepare a progress report on the achievement of the benchmarks. Using these reports, the Bank would lead quarterly technical and fiduciary supervision missions, to review progress under the Reform Program, compliance with agreed prior actions and benchmarks, budget implementation and general economic and social developments. The first joint mission is scheduled for May/June 2004.

34. After each technical supervision mission, the Bank would provide members of the Guidance Committee and contributing donors with a progress report on the implementation of the Reform Program. The first such report is due in June 2004. These reports would also include the unaudited financial statements of the Reform Fund. Within six months of the completion of the activities, or of full disbursement of the Reform Fund monies, whichever comes later, the Bank would provide a final report to each contributing donor.

35. **Effectiveness and duration.** Two actions need to be taken in order for the Reform Fund to make a first disbursement. First, the Bank needs to confirm the satisfactory implementation of the prior actions (see section on prior actions above).

Second, the grant agreement has to be signed between the Bank and the Palestinian Liberation Organization, and at least one donor contribution received.

36. The budget gap for 2005 is of considerable size; it is currently estimated in the range of US\$540-640 million, depending on the political scenario.¹³ With a continued need for extensive support, the Reform Fund is designed to operate over a two-year period. However, the Reform Fund cannot be a permanent arrangement, and donor budget support cannot substitute for political efforts to move the peace process forward. A continuation of budget support beyond this two-year period is currently considered non-viable. The termination date of the Reform Fund would, therefore, be December 31, 2005. Since the need for budget support is a function of Israeli security measures as currently applied and the economic downturn associated with them, progress towards a final settlement can be expected to result in an easing of these measures, a gradual increase in PA revenues and a diminished need for external budget support.

4. Benefits and Risks

37. The benefits of budget support include the maintenance of the PA as a functioning government, a continued capacity to manage the economy, the provision of basic services to the population and the maintenance of employment and livelihoods for public servants and their dependents, who total some 15-20% of the population of the West Bank and Gaza. By donors choosing to channel budget support through the Reform Fund and linking tranche releases to the achievement of specific benchmarks under the Reform Program, the Reform Fund also provides the PA with a strong incentive to maintain the pace of the reform agenda embarked on in mid-2002. This would in turn help address the residual weaknesses in financial accountability and hence help further reduce the fiduciary risks (see Annex 5).

38. In the absence of external budget support, the PA could collapse, both seriously exacerbating current levels of hardship as well as inducing civil chaos and severely dampening any prospects of a peace settlement in the near future. If unassisted by donors, moreover, the PA would be forced to continue unsustainable fiscal coping practices such as distress sales of investments and the accumulation of further significant arrears to the pension fund and other social assistance programs, and to accumulate salary arrears.

5. Budget Support by the Bank

39. The Bank's assistance strategy includes US\$20 million for budget support. After consultation with the PA and potential donors, Bank management decided to initiate preparation of an adjustment operation under OD 8.60, to be submitted to the Executive Directors for approval in late FY04. Funds would be disbursed to the Central Treasury Account of the Ministry of Finance against the same benchmarks and fiduciary arrangements as the Reform Fund.

¹³ Ministry of Planning. Socio-Economic Stabilization Plan 2004-2005, Annex II, Table 1.

6. The Emergency Services Support Program

40. A major challenge facing the PA is to ensure that a coherent fallback strategy is in place to provide against the likelihood that full financing of the 2004 budget deficit is not forthcoming – and that spending is managed in a way that preserves an acceptable level of PA effectiveness. The particular concern is that in protecting wages, the PA will be obliged to pare back non-wage operating costs, and that essential pro-poor expenditures will be compromised. Two of the mid-2004 benchmarks address this question – benchmark #1, whereby the Council of Ministers would adopt an Action Plan to contain the PA wage bill, and benchmark #2, which seeks to preserve a minimum quarterly level of essential non-salary social recurrent expenditures.

41. In response to the same concern, the PA in early 2002 protected essential non-wage recurrent expenditures in the core social ministries (Education and Higher Education, Health, Social Affairs) by soliciting donor support for an instrument which finances non-salary components of the recurrent budget – the Emergency Services Support Program (ESSP).

42. By the end of 2003, donors had disbursed US\$110 million to the ESSP, of which US\$65 million had come from the European Commission and European Union member states under Bank-administered trust funds, and US\$45 million had come from the Bank. The ESSP does not embody any reform benchmarks, but disburses only against contracts to procure goods and services and is thereby earmarked against specific expenditures. Eligible ESSP expenditures include: (i) basic goods, of which drugs constitute the largest expenditure item, with office supplies and spare parts also included; (ii) incremental operating costs to cover rents, utility bills, communications, transportation, cleaning contracts, etc.; (iii) service contracts, in particular for health, but also for maintenance and specialized technical assistance; (iv) repairs of schools (education), clinics (health), and rehabilitation centers (social affairs); and (v) the printing of textbooks.¹⁴ ESSP-related fiduciary oversight arrangements have been developed, and function satisfactorily.

43. Had donors not provided this support, the PA would have been unable to both pay salaries *and* maintain essential services in 2002-3. As the PA has implemented the ESSP capably and in compliance with fiduciary requirements, and due to the manner in which it ensures that a certain proportion of pledged donor funds are spent on non-salary needs, there is broad agreement between the PA and donors that the ESSP window needs to remain open in 2004-5 to enable the PA to ring-fence critical social expenditures in parallel to the Reform Fund. Estimated ESSP needs in terms of external funding for 2004 amount to US\$120 million.¹⁵ Of this, almost US\$22 million have been disbursed by end-March 2004, and another US\$38 million firmly committed. Indications of a further

¹⁴ ESSP I (2002) also featured emergency payments to municipalities, but this has subsequently been financed through other donor instruments. ESSP II (2003) featured budget support for university salaries.

¹⁵ The ESSP being a targeted form of budget support, these US\$120 million are part of the overall budget gap of US\$650 million.

US\$30-35 million in likely 2004 commitments/disbursements have been received, leaving an unfunded gap of some US\$25-30 million.

44. In the past, the Bank has entered into a series of single-donor ESSP trust funds, at high administrative cost. Whilst the Bank operations in support of the ESSP will close in FY05, for future ESSP contributions, the Bank is considering simplifying procedures through the establishment of a multi-donor ESSP trust fund. This shift would have no material impact on either the PA or donors. Bank management seeks approval from the Executive Directors for the establishment of a donor trust fund for the Emergency Services Support Program, as well as of any other donor trust fund as may be required to finance or co-finance Bank operations in the West Bank and Gaza.

Annex 1
Economic Developments, Public Finances, and Donor Assistance 1999-2005

	Actual					Estimate	
	1999	2000	2001	2002	2003	2004	2005
Economic developments							
Gross Domestic Product (GNP), real annual change	8.9%	-5.4%	-15.1%	-8.5%	5.9%	3.5%	3.5%
Gross National Income (GNI), real annual change	8.4%	-6.8%	-19.8%	-8.1%	7.0%	0.9%	3.1%
GNI per capita, US\$	1,806	1,620	1,179	958	1,037	1,008	1,031
Poverty rate (percent of population)	20%	27%	37%	51%	47%	52%	53%
Palestinian Authority finances (mill. US\$)							
Revenues 1/	942	939	273	335	701	806	849
Expenditures 2/	942	1,200	1,099	1,049	1,334	1,444	1,522
Budget balance before external financing	0	-261	-826	-714	-633	-638	-673
Budget balance after external financing	0	-207	-294	-212	-363	12	-23
Donor assistance (disbursements, mill. US\$)							
Budget support	-	54	532	502	270	650	650
Emergency assistance	-	67	223	365	350	300	300
Regular (development) support	482	428	174	197	296	250	250
Total	482	549	929	1,064	916	1,200	1,200

Sources: Ministry of Finance; IMF and World Bank staff estimates.

1/ Excluding external financing

2/ Including recurrent expenditures, PA-financed capital expenditures, and PA net lending to municipalities; excluding donor-financed investment projects.

Annex 2
Current Expenditure
(2002-4; in thousand dollars)

Entity	Actual 2002		Estimate 2003		Budget 2004		Per month
	Value	Percent	Value	Percent	Value	Percent	
Central Administration	141,073	14.72%	126,585	11.10%	106,221	8.13%	8,852
<i>President's Office</i>	103,439	10.79%	78,237	6.86%	40,941	3.13%	3,412
Public Security and Order	309,022	32.24%	389,502	34.15%	423,501	32.41%	35,292
<i>Interior Ministry</i>	12,164	1.27%	37,544	3.29%	139,897	10.71%	11,658
<i>Financial Administration (Police)</i>	276,950	28.89%	324,317	28.43%	250,319	19.16%	20,860
Financial Affairs	83,763	8.74%	95,547	8.38%	140,756	10.77%	11,730
Foreign Affairs	13,592	1.42%	17,031	1.49%	24,724	1.89%	2,060
Economic Development	35,710	3.73%	39,828	3.49%	42,650	3.26%	3,554
Social Services	340,007	35.47%	431,007	37.79%	522,846	40.01%	43,571
<i>Ministry of Education and Higher Education</i>	184,352	19.23%	235,660	20.66%	287,119	21.97%	23,927
<i>Ministry of Health</i>	84,087	8.77%	112,500	9.86%	140,157	10.73%	11,680
<i>Ministry of Social Affairs</i>	50,655	5.28%	55,864	4.90%	64,388	4.93%	5,366
Cultural and Information Services	24,954	2.60%	29,045	2.55%	31,974	2.45%	2,665
Transportation and Communications Services	10,374	1.08%	12,137	1.06%	14,084	1.08%	1,174
Total	958,495	100.00%	1,140,682	100.00%	1,306,756	100.00%	108,896

Source: Ministry of Finance.

Annex 3
Fiscal Developments
(2002-4; in thousand dollars)

	Actual 2002	Estimate 2003	Budget 2004	Per month
Revenues	335	701	806	67
Domestic	185	259	298	25
Clearance Revenue	150	442	508	42
Expenditures	1,249	1,590	1,694	141
Gross Wages	626	736	828	69
Non-Wage Expenditures	332	404	478	40
<i>Recurrent Expenditures</i>	958	1140	1306	109
Capital Expenditures (PA-financed)	24	7	18	2
Development Expenditures (donor-financed)	200	256	250	21
<i>Capital Expenditures</i>	224	263	268	22
Net Lending to Municipalities	67	187	120	10
Balance	-914	-889	-888	-74
External Budget Support	502	270	650	54
Balance Including Budget Support	-412	-619	-238	-20
Balance Including Budget Support (Excluding Net Lending)	-345	-432	-118	-10
Total Other Financing	412	524	238	20
Gross Withheld Clearance revenues	82	302	180	15
Net Change of Arrears	169	-72	-180	-15
Estimated Grants for Development Projects	200	256	250	21
Net Domestic Financing	-39	38	-12	-1
Financing Gap	0	95	0	0
Note				
PA Expenditures (without donor project financing)	1049	1334	1444	120

Source: Ministry of Finance.

Annex 4
SESP Financing Requirements for 2004

SESP Components	Total US \$ 1,000	On-going & Pipeline US \$ 1,000	New Request US \$ 1,000
1. Budget Support	650,000	0	650,000
2. Humanitarian and Social Assistance			
2.1 Food and Cash Aid	55,500	14,500	41,000
2.2 Job creation and emergency municipal support	91,800	77,000	14,800
2.3 Emergency education, health, and drinking water	14,300	4,000	10,300
2.4 Rehabilitation of ex-detainees	2,800	2,800	0
Subtotal	164,400	98,300	66,100
3. Rehabilitation and Reconstruction of Damage			
3.1 Rehabilitation of Private Building	8,000	1,000	7,000
3.2 Rehabilitation of Private Agriculture Land	8,000	1,000	7,000
3.3 Rehabilitation of Public Buildings	5,000	0	5,000
3.4 Rehabilitation of non-building assests of private sector	5,000	0	5,000
Subtotal	26,000	2,000	24,000
4. Public Infrastructure Development			
4.1 Education, higher education, and vocational training	95,640	68,740	26,900
4.2 Health	14,720	10,270	4,450
4.3 Transport facilities	24,700	0	24,700
4.4 Energy	68,000	48,350	19,650
4.5 Water, waste water, and solid waste	60,100	35,250	24,850
4.6 PNA and local public buildings	15,200	0	15,200
Subtotal	278,360	162,610	115,750
5. Private Sector Support			
5.1 Loans and Grants	34,500	19,000	15,500
5.2 Industrial Parks	1,000	1,000	0
5.3 Capacity Building and Resresearch	5,000	0	5,000
Subtotal	40,500	20,000	20,500
6. Reform and Institution Capacity Building			
6.1 PNA government reform	34,200	19,200	15,000
6.2 Institution building	5,000	0	5,000
Subtotal	39,200	19,200	20,000
Grand Total	1,198,460	302,110	896,350

Source: Ministry of Planning, Socio-Economic Stabilization Plan 2005-2005, page 19.

Annex 5 Country Financial Accountability Assessment – Summary

Recent Areas of Improvement

1. All Palestinian Authority revenues are now paid into the Central Treasury Account. This has eliminated previous non-transparent and discretionary spending from various off-budget petroleum, tobacco and alcohol excise revenue accounts.
2. The 2003 Budget process represented the first serious attempt to develop a budget that accounts for all revenues and sets meaningful (and manageable) limits on expenditure. The process was reinforced during 2004 Budget preparation. An orderly system of budgetary appropriation is now in force.
3. Reflecting these new and improved processes, budget speeches and extensive background budget data are posted on a regular basis on MOF's external website, itself a symbol of a new approach to transparency and improved budget management. The full Budget documents for 2003 and 2004, which were published, include information on economic parameters, balance of payments, monetary aggregates, external public debt and public sector employment.
4. MOF is exercising firm control over budget expenditures – with the obvious caveat that the chronic post-September 2000 shortage of Budget funds has led to strict limits on non-wage expenditures and to continuous *ad hoc* adjustments, with funds often being released by MOF on a daily basis. While far from ideal, MOF has had little other choice. One consequence of chronic revenue shortage and the erratic nature of donor budget support has been a periodic accumulation of expenditure arrears (to the PA's pension funds and commercial suppliers). These arrears and the short-term commercial bank debt that the Ministry has also contracted are, however, being transparently handled. The IMF is also regularly monitoring budget execution and the arrears and debt situation.
5. Following the integration of the separate West Bank and Gaza accounting systems, monthly budget execution reports are now being prepared and posted on MOF's external website within a few days of the end of each month. These reports appear to provide reliable information, although delays in closing some ministries' accounts each month mean that some of the information is only preliminary.
6. A program of placing in each ministry financial controllers who report to MOF has been initiated. This program is designed to ensure appropriate *ex ante* controls over expenditures. A Chief Financial Controller has been appointed in MOF to overview and manage this important function.
7. In response to the weakness in the external auditing function, MOF has launched a program to develop an *ex post* internal audit department in MOF. This program should be accelerated and given strong external technical support. The need for a clear separation of the *ex ante* financial control function from *ex post* internal auditing is now well accepted, and has led to recent clarifications. A Chief Internal Auditor is under recruitment.

8. Control over the civil service payroll has improved significantly. MOF has taken charge of the central payroll system from the General Personnel Council (GPC, the PA's central personnel agency), and is now in a position to monitor new recruitment and pay all public sector salaries, and thereby to contain civil service hiring. Civil servants' salaries have all been paid through direct deposit into personal employee bank accounts for some time. This system of direct salary deposit has recently been generalized to the entire security establishment, and full compliance took place in time for the end-March 2004 payroll.

9. In the 2004 Budget, the previous large discretionary transfer appropriation for the President's Office has been virtually eliminated (from US\$49.75 million in the 2003 Budget to US\$0.62 million in the 2004 Budget), with these funds instead transferred to relevant service ministries (Health, Education and Social Affairs).

10. The establishment of the PIF has brought all PA equity holdings, including virtually all state-owned enterprises, under MOF oversight and within the purview of centralized and commercially-oriented management. An audit and valuation of all these assets has been largely completed, with outcomes published on the PIF's external website.

11. Measures have been taken to reduce PA monopolistic tendencies in the importation of cement, while the management of the Petroleum Corporation (PC, the PA's petroleum monopoly) has been taken over directly by MOF. The PC is currently under audit and valuation. These actions have led to the capture of lost revenues and have diminished opportunities for non-transparent funds allocation or their diversion.

Areas Requiring Improvement

1. The PA has recently produced a first-ever set of consolidated financial statements; these are for the year 2002 and were published more than 12 months after fiscal year's end. The previous lack of such statements and this particular delay reflect a lack of qualified accounting personnel and the absence of documented procedures for the closing of accounts. While these statements are a promising first attempt, they have a number of limitations. The financial statements for the year 2003 offer an opportunity for improvements. Disclosures should go beyond budget execution to cover PA debt, PA arrears and contingent liabilities, and the PA's financial assets (including the investments of the PIF).

2. There is no adequately functioning system of audit, either external or internal. The General Control Institute (GCI, the external audit institution) reports formally to the President, but neither reports to nor is responsive to the PLC. While the GCI's mandate contains some desirable features of an external audit organization – such as adequate budgetary independence and the power to obtain information – its capacity is weak and the quality of its work low, and it has had no discernible effect on public accountability. New definitional legislation and a major capacity building program are urgently needed. Draft legislation currently being considered by the PLC would establish a new Council of Administrative and Financial Control to replace the GCI. The draft provides for an independent appointment and reporting process for the Head of the Council, and for

coverage of all PA entities, and is a satisfactory basis for reforming the external audit function. Desirable improvements that should be made to the draft in the course of the second and third reading by the PLC include explicit provision for auditing the PA's annual financial statements, clear reference to the international auditing standards that will be applied, and a clarification that compliance, financial and performance audits will all be carried out.

3. The PLC still lacks the information, resources and experience to play a leading role in financial accountability. The weakness of the GCI and the absence of external audit reports has been a severe handicap.

4. Notwithstanding major improvements in transparency, the PIF needs to produce quarterly financial statements and annual audited financial statements in accordance with its legal obligations. The first audited financial statements of the PIF are expected to be published in April 2004.

5. Deficiencies in budgetary control and budget implementation remain. MOF still has insufficient ability to control security service recruitment and staffing numbers.

6. Donor project financing is not well-integrated into the Budget (although some donors have created sub-accounts in the Central Treasury Account), and this limits the PA's ability to set clear spending priorities and to properly budget for the recurrent cost implications of capital expenditures. The PA has begun to address this issue through the 2004 Budget. Improving the operational linkages between the recurrent and capital components of the annual spending plan, however, is being hindered by donors' adherence to their own preferred financing procedures. Unless there are good reasons to the contrary, all donor funding should be provided through the Central Treasury Account.

7. Aggregate cash flow forecasting and management by MOF's Treasury Department requires further development. Desirable steps would include a daily rather than weekly "sweeping" of revenue and expenditure accounts, a further consolidation of public bank accounts, stricter control over commercial bank borrowing and the establishment of systematic cash planning under a committee with representatives from the Budget, Treasury and Revenue departments of MOF.

Annex 6
Letter of Development Policy and Matrix of Policy Actions

Palestinian National Authority
Ministry of Finance
Office of the Minister



السلطة الوطنية الفلسطينية
وزارة المالية
مكتب الوزير

Mof/WB/ 302/2004

No.

الرقم

Date :

4/4/2004

التاريخ

Mr. James Wolfensohn
President
The World Bank
1818 H. Street, NW
Washington, DC

Dear Mr. Wolfensohn:

The attached Statement of Development Policy and accompanying Matrix of Actions outline the program of reforms the Palestinian National Authority is currently undertaking as part of its economic development and reform agenda. These actions have been designed to provide the Palestinian people the kind of governance – transparent and accountable, particularly in (but not limited to) the arena of financial responsibility – that they demand and deserve.

I hope you will agree that the agenda referred to is ambitious, and one worthy of the encouragement and financial support of both the World Bank and the international community at large through the proposed Public Financial Management Reform Trust Fund.

Sincerely yours,

Salam Fayyad
Minister of Finance

Attachments: Statement of Development Policy
Matrix of Policy Actions in Support of the Proposed Trust Fund

STATEMENT OF DEVELOPMENT POLICY

Palestinian National Authority

Background

1. With the Intifada now in its fourth year, the situation in the West Bank and Gaza remains bleak. In addition to the continuing siege, the Government of Israel continues to build the Separation Wall on occupied territory east of the Green Line, threatening the lives and livelihoods of tens of thousands of Palestinians and the very foundation of the peace process. Ongoing widespread destruction of private homes in Gaza, particularly in Rafah Governorate, has further marginalized the most vulnerable groups in Palestinian society. Collectively these measures have strangled the Palestinian economy, humiliated the population, and produced the steepest declines in Palestinian income and social and economic indicators since the beginning of the occupation in 1967.

2. In response to this crisis, the international donor community has marshaled considerable financial resources to assist the Palestinian National Authority (PNA) in its effort of sustaining the delivery of the most basic services to the population. Such support has been instrumental in ensuring the survival of many in the growing ranks of the poor, and is gratefully acknowledged. Yet, these efforts can only partially mitigate the humanitarian need; a significant recovery of the Palestinian economy cannot take hold without the full reversal of the suffocating measures imposed by the Government of Israel since September 2000.

3. The proposed Public Financial Management Reform Trust Fund for the West Bank and Gaza recognizes the importance – and necessity – of continued budgetary support to the PNA. This Statement of Development Policy further expounds on the importance of the proposed operation in the context of Palestinian development; the Palestinian reform agenda; and the current economic and fiscal situation.

The Development Context

4. Throughout the period of emergency, the PNA has endeavored to put forward an integrated strategy that, while designed to meet the immediate humanitarian needs of the Palestinian people and to stabilize the economy, also sought to focus on institutional reform and the longer-term capacity-building and infrastructure development necessary to lay the groundwork for economic recovery should the political situation improve.

5. In February 2003, the *Emergency and Public Investment Plan 2003* (EPIP) was endorsed by the international donor community at an Ad-Hoc Liaison Committee (AHLC) Meeting in February. With the launch of the Roadmap process in April, EPIP was refocused to provide financing of immediate needs on the ground and to support the Roadmap's implementation. This *Quick Impact Intervention Program, July-December 2003 (QIIP)*, called for rapid disbursements partly to finance the short-term deficit in the PNA budget so as to maintain the health, education, and social services provided by the

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PNA. In addition the plan called for an urgent program of humanitarian and social assistance in areas such as cash and food assistance; job creation; emergency assistance for education, health, and shelter repair; repair of damages sustained by public infrastructure and buildings; and private sector relief.

6. At the December 2003 AHLC Meeting in Rome, the PNA put forward the Palestinian *Socio-Economic Stabilization Plan for 2004-2005 (SESP)*, with its twin goals of mitigating the effects of the socio-economic crisis facing the Palestinian people and maximizing the scope and pace of economic recovery in Palestine in the context of an uncertain political situation. The commitment and support of the international community for the SESP, crucial for the rebuilding of the economic, social, institutional, and psychological foundations for a just and lasting resolution to the Israeli-Palestinian conflict, was expressed by the donors and welcomed by the PNA at the Rome meeting.

7. The development of the SESP was based on a consultative process led by the PNA Ministry of Planning. Palestinian stakeholders (PNA agencies, private sector organizations, civil society associations) and donor community representatives, including the World Bank, the International Monetary Fund, the United Nations, European Commission and European Union, bilaterals, and non-governmental organizations and agencies, participated in assessing the existing situation and the development of specific program/project selection criteria that corresponded to the strategic goals and objectives of the Government.

8. Due to movement restrictions and uncertainties associated with the transition from the previous PNA government to the current one, public consultation was not as extensive as was desired. Nevertheless, using the data developed in the Participatory Poverty Assessment Program (PPAP) conducted by the Ministry of Planning in 2002 it was possible to gauge the public's priorities: The PPAP was carried out through a series of workshops convened at the local level, each with a focus on a particular theme (such as health, education, municipal services), and produced considerable qualitative data that informed the SESP planning process. In addition, donor agencies were particularly forthcoming in sharing their internal analysis of the effectiveness and impact of their on-going programs.

9. Six main categories of support were defined in the SESP: 1) Support to the PNA Budget; 2) Humanitarian and Social Assistance; 3) Reconstruction and Rehabilitation of Damage; 4) Public Infrastructure Development; 5) Private Sector Support; and 6) Reform and Institutional Capacity Building. As well as meeting specific criteria developed for each of these six categories, projects included in the SESP all satisfied three general criteria: 1) Feasibility of implementation in 2004; 2) Immediate positive impact on the Palestinian population; 3) Implementation mechanisms are already existing and proven, or in the case of new mechanisms, offer the significant prospect of increased efficiency and effectiveness in delivery.

10. The SESP identified total external financing requirements for 2004 of US\$1.198 million. Of the total resources required for 2004, US\$302 million is covered by on-going projects commitments to disburse existing at the time of SESP's release, while US\$896

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million was the value of new financing requests. Among the six categories, US\$650 million – equal to 54.3 percent of total financing and 72.5 percent of new financing – was required for budget support for 2004.¹⁶

11. The SESP was unambiguous in its endorsement of budget support. **“Supporting the budget of the PNA is by far the most important SESP components.** The PNA employs some 130,000 people who in turn support an estimated 550,000 family members. The inability to pay salaries would mean much higher levels of unemployment and poverty. PNA employees also provide critical health, education, and social services to the population in the Occupied Palestinian Territory and, thus, budget support allows the continuation of public services provision. Public sector employee’s salaries are an important part of total consumer demand for business goods and service. Budget assistance also prevents additional accumulations of PNA arrears to the private sector which, as the experience of the past three years has shown, burden the private sector with a squeeze on available liquidity. **In short, budget support provides socio-economic stability – the primary objective of the SESP.”**

The Reform Context

12. Reform has been a priority on the agenda of every Palestinian Cabinet since June 2002. The reform process, initiated by President Arafat in May of that year, culminated in the development and issuance of the **“100 Days Plan of the Palestinian Government”** on June 23, 2002, intended to make the PNA “more efficient and effective in the service of the national good” and paving the way towards an ongoing viable, consistent, and dynamic process.

13. The reform process was quickly welcomed and encouraged by the international community, with local task forces established to monitor, support, and advance the agenda in each of its seven “domains” – 1) financial accountability; 2) ministerial and civil service reform; 3) market economics; 4) judiciary/rule of law; 5) local government; 6) elections; and 7) civil society. At the international level the International Task Force on Palestinian Reform (the “Quartet plus Four” – the European Union, Russia, the United States, and the United Nations, plus Japan, Norway, the International Monetary Fund, and the World Bank) has met periodically (Paris, August 2002; Dead Sea, November 2002; London, February 2003; Rome, December 2003) to review achievements, pledge needed financial and technical assistance, and to identify the obstacles obstructing further progress.

14. From the beginning financial accountability has been at the front of the reform agenda. Of the 39 specific items in the 100 Days Plan, ten referred to items in the financial domain:

¹⁶ In addition the US\$650 million for budget support, SESP also identified US\$164 million for humanitarian and social assistance; US\$26 million for the rehabilitation and reconstruction of damage; US\$278million for public infrastructure development; US\$40 million for private sector support; and US\$39 million for reform and institutional capacity building.

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- Reform operations in the Ministry of Finance;
- Deposit all incomes of the Palestinian National Authority into a single Treasury account;
- Manage all commercial and investment operations through a Palestinian Investment Fund, subject to stringent standards of disclosure and audit;
- Limit expansion of employment in the public sector and unify payroll administration under the Ministry of Finance;
- Modernize the pension scheme;
- Strengthen internal and external auditing;
- Develop the process of preparing the general budget to include recurrent and developmental expenditure;
- Develop a monthly expenditure plan for the remainder of 2002;
- Begin preparation of the 2003 Budget; and,
- Reorganize the financial relations between the Ministry of Finance and the municipalities and local authorities.

15. By the end of 2002, significant progress had been made in all these areas and many achievements registered. Most notable among them: the submission to the Palestinian Legislative Council (PLC) of a budget for 2003; the consolidation of all PNA revenues into the Central Treasury Account (CTA) under the sole control of the Ministry of Finance; the consolidation of all PNA commercial activities into the Palestine Investment Fund (PIF); and the strengthening of internal auditing procedures and controls. In addition, payroll administration was unified under the Ministry of Finance, a critical step in controlling the expansion of employment in the public sector.

16. The submission of the draft PNA budget – consistent in both design and management with the highest international standards – for the 2003 fiscal year to the PLC on December 31, 2002, and its subsequent approval on February 1, 2003, was arguably the most significant reform in terms of transparency. The draft budget was published in its entirety; committee and plenary PLC deliberations were open to the public and the media.

17. During 2003 additional procedures were carried out by the Ministry of Finance aimed at further promoting financial accountability and transparency. Accomplishments include:

- Undertaking a valuation and auditing of PIF assets, and transferring of PIF profits to the CTA. The listing of PIF assets and their valuation (conducted by Standard

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& Poor's), along with transparency reports (conducted by the Democracy Council), are publicly available on the Ministry of Finance website.

- Reforming the operations of the public Petroleum Corporation. This involved placing the Corporation under the control of the Ministry of Finance, which eliminated its ability to undertake quasi-fiscal operations, and following a pricing strategy which, by seeking to eliminate the Corporation's profit margin, has led to a sharp curtailment of smuggling. As a consequence, officially sanctioned sales of petroleum products rose substantially (by more than 300% for some categories), thereby leading to an increase in oil tax revenues that substantially exceeded the loss of monopoly profits enjoyed prior to reform by this government entity.
- Eliminating illegal fees that were imposed on lubricant oil by the Petroleum Corporation. Previously the Corporation took fees on each container of lubricant oil (30 percent in the West Bank and 20 percent in Gaza); these fees were cancelled and the Corporation's authority revoked regarding this sector.
- Audits of payroll were initiated by the Internal Audit Department (IAD) within the Ministry. In addition, a comprehensive training program for the IAD was developed with Ernst and Young Europe and was launched in October 2003.
- Salaries of those security services personnel under the Ministry of Interior (Civil Police, Preventive Security, and Civil Defense), along with Intelligence in the Gaza Strip, started to be paid through personal bank accounts directly by the Ministry of Finance, rather than in cash. By end-2003, 23,000 security service personnel were incorporated within this system (approximately 40% of the total).
- Completion of a comprehensive grade reclassification in accordance with the Civil Service Law, further consolidating the Ministry of Finance's capacity for monitoring and controlling public sector hiring and promotion. Salary adjustments resulting from the re-grading exercise were implemented in a rolling fashion so as to minimize budgetary impact.
- Implementation of the Judicial Authority Law No. 1 (2002) regarding the payment of salaries for judges and prosecutors.
- Cancellation in July 2003 of the 6.5 percent "solidarity tax" leveled on PNA salaries, as well as the 2-3 days salary equivalent per month earmarked for job creation programs. Henceforth, funds for emergency assistance are channeled through the Ministry of Social Affairs and other budget lines.
- Issuance of a Cabinet Decree regarding implementation of the law of retirement for employees over 60 years of age, thereby allowing for employees who desired to end their service to do so, providing opportunities for employees working in the second line to be promoted.

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- Establishment of the National Pension Committee; work initiated on developing a fully-financed public sector pension system.
- Successful unification of the accounting system between the West Bank and the Gaza Strip and online integration between the Gaza City and Ramallah Ministry of Finance branches.
- The posting of monthly budget execution reports on the Ministry of Finance website in both English and Arabic. Detailed preliminary statements are usually posted in less than one week following the close of the month; final statements one month later.
- The full payment of all central government arrears to municipalities, thereby providing municipalities and other local government councils much needed support in their effort to accomplish their development plans despite their current unstable financial situation resulting from the occupation and its negative impact on local economies and revenue sources.
- Reduction of arrears to the private sector by US\$129 million between January and September 2003 on a gross basis (actually paid) and by US\$71 million on a net basis (including new arrears). All long-overdue bills have been paid; the development of new arrears in the second half of 2003 was the regrettable consequence of the shortfalls in external budgetary support.

18. At the December 11, 2003, meeting in Rome of the International Task Force on Palestinian Reform, the Prime Minister's Office presented its ***Report on Palestinian Reform*** including a ***Reform Action Plan of the PNA*** for the period through April 15, 2004. In the Area of Financial Accountability, the PNA pledged to:

- Complete the work on the establishment of a transparent and clear financial system:
 - To submit the FY 2004 budget to the Palestinian Legislative Council before the end of 2003, with the investment budget included.
 - To continue the evaluation of Palestine Investment Fund assets, and to publish the first annual report of the Fund. To audit all PIF accounts and publish a report setting forth the PNA's properties and investments.
 - To ensure that all procurement operations, particularly the security services', are made in a fully transparent manner, under the full application of the General Procurement Law in order to guarantee fairness and transparency.

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- Achieve the payroll Budget Plan of the FY 2003:
 - To limit the appointments in the Palestinian public institutions in 2003, where it shall not exceed 2772 appointments (in accordance with the budget) to be recruited in the areas of health, education, and judiciary.
 - To continue implementation of the Palestinian Cabinet's decision in accordance with the civil service law of retirement for civil servants older than sixty years of age.
- Development and Activation of Internal Control:
 - To reform and implement the internal audit and financial control procedures.
- To continue the efforts exerted towards preparing a modern and consolidated retirement system:
 - To complete the audit of the Gaza public sector pension scheme.
 - Issuance of a ministerial decision adopting particular indicators for pension reform.
- External Audit: Reform of the role of the General Control Institution (GCI):
 - It is recognized that the GCI, according to the Basic Law, should report to the President and the PLC. The independence and capacity of the General Control Institute and the Office of the Auditor General should be enhanced to conduct external auditing procedures. It should submit regular reports to the President and the Palestinian Legislative Council and enjoy full autonomy to publish its findings. To this end, the legal basis for GCI operations has to be brought in full conformity with the Basic Law (Art. 96).
- Legislation:
 - To revise the Income Tax Law and to establish a modern income tax system.
 - To adopt and sign the leasing regulations.

19. In the four months since their public pronouncement, many of these identified benchmarks have been achieved. The 2004 budget, including the capital budget, was submitted to the PLC in December 2003 and approved in January 2004. The audit of the Gaza Pension and Insurance Corporation (GPIC) financial statements has been completed; the auditor concluded that with respect to items tested, GPIC complied in all material respects with all laws, regulations, and international accounting standards.

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20. Other benchmarks have witnessed substantial progress, with complete achievement of most anticipated before the April 15 date specified in the Reform Action Plan. Publication of the PIF annual report is expected mid-April, which will include full consolidated financial statements for PIF enterprises and clearly identify any remaining gaps in coverage. A department has been established within the Ministry of Finance to ensure compliance with the General Procurement Law; procurement for the security services is now taking place through competitive bidding. Civil service employment increases were limited in 2003 to 2,320; however recruitments in the security services of 3,614 meant that the budget law ceiling was exceeded, although most of the excess was on account of re-enrollment of personnel who had been dropped from the payroll due to absenteeism during the first two years of the Intifada. Internal audit procedures have been strengthened, a structure for the Internal Audit Department has been developed and training commenced, with full establishment expected shortly. The National Pension Committee, working with the World Bank, is well advanced in its development of the parameters for the new pension system, with a target date of April/May for Cabinet approval. Finally, beginning with the March 2004 wage payment, the coverage of the direct deposit scheme was extended to cover all security personnel.

21 As noted in its *Report on Palestinian Reform* presented at Rome, significant achievements have been realized in other areas beyond financial accountability. Looking forward, the PNA pledged to focus its reform efforts in 2004 in the following priority areas as well: Rule of Law and the Judiciary – training for judges and the establishment of a judicial training institute; constructing courthouses; establishing the constitutional court; building capacity in the Attorney General's office; and enhancing the legislative process. Elections – financing preparations for national elections and support for local elections. Local Government – strengthening the capacity of the local government sector and developing an action plan for local governments. Public Administration and Civil Service Reform – supporting the restructuring of ministries and support to the Prime Minister's office and the Cabinet Office. Support for the Palestinian Legislative Council – including public administration and enhanced legislative capacity.

22. In the Rome Report, the PNA "reiterates again its full commitment to the reform process and urges the international community to help us realize our final objectives in establishing an independent, viable and democratic state, with **institutions that are efficient, transparent, accountable, and service-delivery oriented.**" These are precisely the characteristics the Ministry of Finance is endeavoring to promote in its operations, and which the proposed Public Financial Management Reform Trust Fund – requested by the PNA the Rome AHLC the day before the International Task Force on Palestinian Reform meeting – would support. As seen below, **addressing the residual needs in these areas are the subject of the benchmarks that would determine disbursement under the Trust Fund.**

The Economic and Budgetary Context

23. Following two years of steep decline, 2003 showed signs that the Palestinian economy had stabilized and recovered slightly from its low point. A good harvest,

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increases in the number of Palestinian workers in Israel, a significant fall in the rate of unemployment, and reports by businessmen and bankers all point to a modest pick up in economic activity. But the Palestinian economy remains depressed, and real GDP is still some 30 percent below its level in 1999. Whether the modest recovery in 2003 will be reversed by the continuous conflict and associated curfews and closures remains to be seen.

24. **2003 Budgetary Performance.** Despite a number of positive developments in 2003, the fiscal situation continues to be difficult. Total budgetary revenue has been remarkably strong since the beginning of the year, growing even stronger in the last few months when it reached a level only 20 percent below that before the beginning of the Intifada. Overall, PNA revenues in 2003 exceeded budget estimates by about US\$162 million.

25. Several factors accounted for this improvement. First, since their resumption in December 2002, the net regular monthly flows of clearance revenues from Israel have been steadily improving. Second, domestic revenue directly collected by the PNA was above budget expectations, benefiting from transfers to the budget from the PNA's commercial activities under the Palestine Investment Fund of a total amount of US\$32 million. The stronger-than-expected collection of revenues was mainly the result of improvements in tax administration and a major collection effort, despite the difficult situation on the ground. In addition, the takeover of the Petroleum Corporation, coupled with a change in management and pricing policy, resulted in higher sales of petroleum products and sharp increases of excise revenues.

26. The strong revenue performance did not trigger an expansion in expenditure. Rather, expenditures (excluding donor-financed capital expenditures and net lending to municipalities to cover their utility debts with Israeli providers, see below) were broadly as envisaged in the budget. This overall neutral expenditure stance was not uniform over the course of the year or across expenditure categories, however. Reflecting a progressive increase in public employment, a salary increase for security personnel (of 8 percent effective June 1) and civil servants as a result of the partial implementation of the 1998 Civil Service Law, and the appreciation of the shekel against the dollar, the wage bill increased from US\$55 million in January to US\$75 million in December, exceeding the average monthly level of US\$58 million envisaged in the budget. Civil service employment was contained, increasing by 2,320 employees in 2003, below the increased envisaged for 2003 in the budget (2,771 employees), 60 percent of which were in social sectors. However, security employment increased by 3,614 during the same period, leading to a security wage bill that exceeded the budgetary appropriation.

27. Non-wage expenditures were compressed by a monthly average of US\$8 million below budget. This cut in non-wage expenditure was particularly acute during the first quarter in anticipation of a shortfall in financing, but then began to ease after April. This cautious relaxation was necessary in order to ensure a continued smooth functioning of the public administration and services. In addition to these budgeted expenditures, the PNA was obliged to repay bills on behalf of municipalities owed to Israeli companies. The payments, which municipalities agreed to reimburse in the future, averaged US\$15

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million per month, and were deducted from the gross transfer by Israel out of the stock of tax revenues withheld by Israel in 2001-02, as well as from monthly clearance revenues for water bills. Toward the end of the third quarter there was a further tightening of non-wage expenditure that continued until year end due to a sharp decline in budget support.

28. Even with the stronger than expected revenue performance and the neutral expenditure stance, the overall fiscal situation remained very tight because of a significant shortfall in external budget support – less than half of what was anticipated in the budget – as well as the cessation in the latter part of 2003 of the transfer of revenues withheld in 2001-2, due to Israeli court attachments.

29. In spite of these developments, the Ministry of Finance made considerable progress toward the objective of reducing the stock of budgetary arrears. As outlined in the budget, the Ministry used the transfers from the accumulated stock of withheld tax revenue by Israel (net of the deductions made for the repayments on behalf of Palestinian municipalities) to repay arrears to the private sector, in so doing helping the private sector recover somewhat from the liquidity squeeze it had experienced in the last three years. These transfers of withheld tax revenues flowed at a net rate of approximately NIS 100 million (US\$20 million) from January to May, and approximately NIS 150 million (US\$30 million) in June, July, and August. At that point they ceased due to the withholding of NIS 832 million by order of Israeli courts pending resolution of claims against the PNA by private Israeli companies and individuals. Consequently, while transfer of withheld arrears were expected to amount to US\$40 million per month in the budget, the actual amount received averaged only US\$17 million.

30. In view of the shortfall in budget support, the Ministry of Finance was compelled to increase its indebtedness to the banking sector by US\$66 million over the course of the year, bringing the stock of debt to banks to a relatively high level of US\$176 million at end-2003 (some 5.4 percent of GDP). Also, while substantial arrears were repaid to the private sector, new arrears were accumulated on the pension contributions to the GPIC as well as other public sector arrears, amounting to a total stock of approximately US\$384 million at yearend. Total arrears and indebtedness thus stood at approximately US\$560 million.

31. **2004 Budgetary Outlook.** Given the centrality of political developments in Palestine, the economic outlook for 2004 depends critically on the key assumptions made concerning any political progress. In preparing the 2004 budget, several scenarios were considered – the budget assumes a status-quo political scenario under which current political instability and vulnerability persist; current levels of internal and external movement restrictions on persons and on goods are maintained; and economic growth is modest.

32. The 2004 budget assumes that the strong trend in revenue witnessed in the last half of 2003 will continue, raising the ratio of total revenue to GDP from 22 to 25 percent in 2004. This is driven by the full-year impact of the increase in revenues associated with improvements in tax administration and the efficiency and liberalization gains in the petroleum market. Nevertheless, revenues will remain below their “normal” level

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(defined as the 1999 revenue level adjusted for an average growth rate in line with population growth) because of the economic downturn during the past years.

33. Recurrent expenditure is expected to rise faster than improved revenue performance on several accounts, from approximately 35 to 40 percent of GDP. First, the wage bill share of GDP would increase from 23 to 25 percent in 2004, reflecting the carry-over of the salary increase for all civil servants, which took effect in the last quarter of 2003, and a 3,500 increase in civil service employment. Second, following their squeeze during 2003, non-wage expenditure requirements have increased above the 2003 budget level, reflecting pressing and increasing needs for operations and maintenance as well as demands on public services from a rapidly growing population, all in the context of severe dislocations resulting from both the Israeli Separation Wall and closures. Third, transfer payments would increase in line with the wage bill to reflect higher pension contributions on the part of the employer. Because the wage bill represents approximately two-thirds of current expenditure, little room is available for expenditure management.

34. Unless the assumptions of the baseline scenario are improved, leading to a significant reduction in internal and external movement restrictions and associated costs and much stronger economic growth than now foreseen, the PNA cannot cover its wage bill – let alone total current expenditure – through projected tax revenues. To fully cover the budget deficit, the PNA requires approximately US\$650 million of external budget support. As this amount is more than double the amount disbursed in 2003, an extraordinary effort on the part of donors is required; it is hoped that the proposed Public Financial Management Reform Trust Fund will make a major contribution to securing these needed funds.

35. The only other possible source of external financing is the transfer of the NIS 832 million of withheld tax revenues by Israel blocked in September 2003 pending the resolution of the issue of Israeli court attachments. As the 2004 budget indicates, however, these revenues would be entirely used to reduce the stock of domestic arrears should they become available.

36. PNA indebtedness to the banking system, already high at end-2003, is budgeted for a reduction by US\$12 million in 2004, along with a progressive repayment of the large stock of arrears; should 2004 revenues exceed budget amounts, the Ministry intends to accelerate the reduction in indebtedness to the banking system and/or in the stock of arrears.

37. **Budgetary Reforms Envisaged in 2004.** The 2004 budget is underpinned by a number of policy reforms, many of which were enumerated in the *Report on Palestinian Reform* and its *Reform Action Plan* presented by the PNA in Rome in December (see above). On the revenue side, the submission of a new income tax law to the PLC based on international best practice will be more favorable to private sector activity, while raising overall revenue.

38. Regarding expenditure management, the consolidation of all security personnel under one supervisory authority with wages paid by direct bank transfer will allow for

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improved transparency and control over hiring. Moreover, to alleviate the moral hazard stemming from payments of municipalities' utility bills by the PNA, net lending to municipalities should fall from US\$187 million to US\$120 million under a strict payment plan, as municipalities begin to make some payments and collect some fees on their own.

39. Further expected progress in other reforms in 2004 includes ongoing work, in collaboration with the World Bank, on setting new parameters of the pension system, on which a decision is expected during the second quarter of the year; a new pensions law could then be adopted by mid-2004. Pension reform should provide a unified, fully funded, and sustainable pension system. Lack of such a system has been a major impediment to civil service reform and to security organizations' retrenchment; pension reform, therefore, will be key in the effort to curb the rising trend in the wage bill in the near future. Second, measures to improve competitiveness and transparency in public procurement, including by the security services, are being enhanced. Third, the valuation and audit of all PNA assets should be completed and published, and an assessment of the amount of profits to be transferred to the budget made. Fourth, external auditing procedures should be strengthened through the adoption of a new external auditing law to ensure full independence of the office, submission of regular reports to the PLC, and comprehensive coverage of all PNA institutions. Finally, a clear and sustainable financial relationship should be established between the Ministry of Finance and the municipalities. As local authorities currently experience a very low payment rate for utility bills by the public – preventing the local authorities from paying the amounts due energy producers (in particular, Israeli utility companies) – the Ministry of Finance has become obliged to provide the needed funds through loans to the municipalities.

40. Many of these reforms will need to be encouraged and supported by donors, through continued or expanded programs of technical assistance, higher levels of direct budget support, and other forms of financial assistance. The proposed Public Financial Management Reform Trust Fund would be an effective vehicle for providing such encouragement. Accordingly, the following sets of (a) “prior actions” and (b) “benchmarks” to be completed by June 30, 2004 have been identified.

Proposed Public Financial Management Reform Trust Fund “Prior Actions”

41. The Ministry of Finance, on behalf of the Palestinian National Authority, commits itself to the fulfillment of the following five actions as “prior actions” required prior to the initial disbursements under the proposed Trust Fund, in order to enable Trust Fund disbursements during the period from Trust Fund effectiveness through June 30, 2004:

Prior Action No. 1: Submission to the Palestinian Legislative Council (PLC) and passage of the PNA Budget Law for 2004.

Prior Action No. 2: Submission to the PLC of statements on the PNA's fiscal operations in 2002.

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Prior Action No. 3: *Full implementation of the 2004 Budget Law's requirement that the salary payments of all PNA security personnel be directly deposited into individual bank accounts.*

Prior Action No. 4: *Completion and publication of the final report of the valuation of assets of the Palestine Investment Fund (PIF).*

Prior Action No. 5: *Full compliance with the 2004 Budget Law in relation to public sector hiring, which should not exceed programmed net additional hiring of 3,500 personnel to be allocated as follows: (a) at least 90% of these positions to the social sector ministries (Health, Education, Social Affairs) and for Reform Program-related needs; and (b) the remaining 10% to other civil service entities.*

Monitoring indicators that attest to the completion of these benchmarks are identified in the attached Matrix of Policy Actions.

Proposed Public Financial Management Reform Trust Fund Mid-2004 Benchmarks

42. The Ministry of Finance, on behalf of the Palestinian National Authority, commits itself to the fulfillment of the following seven benchmarks by June 30, 2004 in order to enable Trust Fund disbursements during the period July 1-December 31, 2004:

Mid-2004 Benchmark No. 1: *Adoption by the Council of Ministers of an Action Plan to contain the wage bill.*

Mid-2004 Benchmark No. 2: *Best efforts to adhere to a minimum quarterly level of NIS 160 million in essential non-salary social recurrent expenditures.*

Mid-2004 Benchmark No. 3: *Submission to the PLC of a revised External Audit Law which would ensure compliance by a new auditing institution with the provisions of the Basic Law (independence of the institution, responsiveness to the PLC), and clear responsibility for auditing all PNA institutions' budget execution reports.*

Mid-2004 Benchmark No. 4: *The assumption of full jurisdiction by the Department of Supplies and Tenders in the Ministry of Finance over all purchases made by PNA ministries and agencies, including the Security Financial Administration.*

Mid-2004 Benchmark No. 5: *Approval by the National Pension Committee of a detailed outline of a pension reform program and a draft Pension Law, including implementation regulations, setting out the parameters, institutions, and management of a unified and sustainable public sector pension scheme.*

Mid-2004 Benchmark No. 6: *Full implementation of the Council of Ministers' decision of June 2003 to retire PNA employees at the age of 60.*

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Mid-2004 Benchmark No. 7: Submission to the PLC of statements on the PNA's fiscal operations in 2003, and PNA commitment to their external audit by the new auditing institution (Benchmark No. 3, above) by end-March 2005, or by external auditors, commissioned by the PNA as a one-time stop-gap measure, by end-June 2005.

43. Monitoring indicators that would attest to the completion of these benchmarks are likewise included in the attached Matrix of Policy Actions; each quarter the Ministry of Finance, on behalf of the PNA, will submit progress reports to the World Bank on their current status. In addition, the Ministry of Finance, on behalf of the PNA and in conjunction with the Bretton Woods institutions and major contributing donors to the proposed Public Financial Management Reform Trust Fund, shall develop and agree upon a set of benchmarks to be completed by end-2004 so as to enable disbursement from the Trust Fund for the period January 1-June 30, 2005.

**MATRIX OF POLICY ACTIONS
IN SUPPORT OF THE PROPOSED
PUBLIC FINANCIAL MANAGEMENT REFORM TRUST FUND
FOR THE WEST BANK AND GAZA**

Prior Actions	Monitoring Indicators
<u>Prior Action No. 1: Submission to the Palestinian Legislative Council (PLC) and passage of the PNA Budget Law for 2004.</u>	2004 Budget Law document and PLC record of its passage.
<u>Prior Action No. 2: Submission to the PLC of statements on the PNA's fiscal operations in 2002.</u>	Documentation submitted to the PLC.
<u>Prior Action No. 3: Full implementation of the 2004 Budget Law's requirement that the salary payments of all PNA security personnel be directly deposited into individual bank accounts.</u>	A report by the Ministry of Finance on the cross-verification between Palestinian commercial banks and Ministry of Finance Payroll Department.
<u>Prior Action No. 4: Completion and publication of the final report of the valuation of assets of the Palestine Investment Fund (PIF).</u>	Published PIF evaluation report, with identification of / explanation for uncovered entities.
<u>Prior Action No. 5: Full compliance with the 2004 Budget Law in relation to public sector hiring, which should not exceed programmed net additional hiring of 3,500 personnel to be allocated as follows: (a) at least 90% of these positions to the social sector ministries (Health, Education, Social Affairs) and for Reform Program-related needs; and (b) the remaining 10% to other civil service entities.</u>	Monthly PNA employment statistics from Ministry of Finance Payroll Department, broken down by ministries and agencies. <i>Note: On-going monitoring required.</i>

Matrix of Policy Actions

<p>Mid-2004 Benchmarks (to be completed by June 30, 2004)</p>	<p>Monitoring Indicators</p>
<p><u>Mid-2004 Benchmark No. 1: Adoption by the Council of Ministers of an Action Plan to contain the wage bill.</u></p>	<p>Adoption of an Action Plan satisfactory to the World Bank.</p>
<p><u>Mid-2004 Benchmark No. 2: Best efforts to adhere to a minimum quarterly level of NIS 160 million in essential non-salary social recurrent expenditures.</u></p>	<p>Quarterly reports on PNA fiscal operations including explanation of trade-offs made between expenditure categories. <i>Note: On-going monitoring required.</i></p>
<p><u>Mid-2004 Benchmark No. 3: Submission to the PLC of a revised External Audit Law which would ensure compliance by a new auditing institution with the provisions of the Basic Law (independence of the institution, responsiveness to the PLC), and clear responsibility for auditing all PNA institutions' budget execution reports.</u></p>	<p>In the event of PLC passage of the External Audit Law, its ratification and publication in the Official Gazette will be handled by the Executive in accordance with the procedures defined in the Basic Law.</p>
<p><u>Mid-2004 Benchmark No. 4: The assumption of full jurisdiction by the Department of Supplies and Tenders in the Ministry of Finance over all purchases made by PNA ministries and agencies, including the Security Financial Administration.</u></p>	<p>Development and dissemination by the Ministry of Finance of the first of a series of regular reports on public procurement operations, with a view to ensuring transparency and competitiveness as required by the General Procurement Law.</p>
<p><u>Mid-2004 Benchmark No. 5: Approval by the National Pension Committee of a detailed outline of a pension reform program and a draft Pension Law, including implementation regulations, unified and sustainable public sector pension scheme.</u></p>	<p>Development of a pension reform program and draft Pension Law satisfactory to the World Bank.</p>
<p><u>Mid-2004 Benchmark No. 6: Full implementation of the Council of Ministers' decision of June 2003 to retire PNA employees at the age of 60.</u></p>	<p>Quarterly reports from the Ministry of Finance identifying the numbers due for retirement, the number of retirees, and the number of exemptions authorized by the Council of Ministers. <i>Note: On-going monitoring required.</i></p>

Matrix of Policy Actions

<p>Mid-2004 Benchmarks (to be completed by June 30, 2004)</p>	<p>Monitoring Indicators</p>
<p><i>Mid-2004 Benchmark No. 7: Submission to the PLC of statements on the PNA's fiscal operations in 2003, and PNA commitment to their external audit by the new auditing institution (Benchmark No. 3, above) by end-March 2005, or by external auditors, commissioned by the PNA as a one-time stop-gap measure, by end-June 2005.</i></p>	<p>Documentation submitted to the PLC; a letter from the Minister of Finance confirming the external audit arrangements for the audit of the 2003 fiscal operations.</p>