

**Working Group on
Budgetary Assistance
to the Palestinian Authority**

**Draft conclusions
by Mr Laschet**

Working Group on Budgetary Assistance to the Palestinian Authority Draft Conclusions

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Introduction

On 13 March 2003 the Conference of Presidents of the European Parliament decided to set up a Working Group (WG) consisting of 13 full and 13 substitute members equally drawn from the Committees on Foreign Affairs (AFET), on Budgets (BUDG) and on Budgetary Control (CONT), and representing all political forces. The Working Group meetings were chaired, on a rotating basis, respectively by Mr. Laschet for AFET, Mr. Wynn for BUDG and Mrs. Theato for CONT.

The WG's terms of reference were to analyse and monitor EU Direct Budgetary Assistance (DBA) to the Palestinian Authority (PA). The period under examination runs from the end of 2000 to the end of 2002. Further to this main task, it was decided that the WG would also cover the destruction of infrastructure financed by the EU and destroyed by Israeli Defence Forces (IDF), as well as allegations made about EU funds being used to pay for Palestinian schoolbooks containing inciting passages.

In practical terms, the WG was called to:

- a. assess whether the Commission had properly implemented decisions taken with regard to the direct budgetary assistance to the PA and whether it had correctly managed such assistance;
- b. establish, as far as possible, whether allegations stating that EU assistance to the PA had been diverted to finance terrorist activities were founded;

In its monthly meetings from May 2003 to March 2004 the WG discussed evidence given by invited experts. It heard presentations by the European Commission, representatives of International Financial Institutions, OLAF, diplomats, academics and intelligence specialists of the Israeli defence establishment. An *ad hoc* delegation, composed of the three co-Chairs, went to Israel and to the Palestinian territories in March 2004. They held meetings with the Minister of Finance of the PA, representatives of the Intelligence and Terrorism Information Center related to the Israeli Defence Forces (IDF), with high ranking officials of the Israeli Ministry of Foreign Affairs and Ministry of Finance and with representatives of the IMF and the World Bank.

I. Emergence of the problematic situation - chronology of events and factual context

Date	Overall context in the Middle East	Specific issue of direct budget assistance
11-24 July 2000	Failure of the Summit of Peace in Camp David, between President Clinton, Yasser Arafat and Ehud Barak	
28 September 2000	Ariel Sharon, Head of Likud goes to the esplanade of the Mosque in Jerusalem with Israeli police presence, viewed as provocation by the Palestinians	
29 September 2000	Clashes between Israelis and Palestinians in Jerusalem, hundreds of people injured	
31 September 2000	Clashes in the West Bank and the Gaza Strip resulting in 15 fatalities, the Intifada al-Aqsa (second Intifada) has started.	
October 2000		The Israeli government freezes the monthly transfers of tax revenue collected on its behalf to the Palestinian Authority
4 December 2000		General Affairs Council requests the Commission to provide financial assistance through a Special Cash Facility in order to maintain the proper functioning of the Palestinian Authority administration, including basic public services. The Commission released the first tranche of €30 million in January 2001.
28 December 2000	Summit scheduled in Charm al-Sheikh cancelled	
21-27 January 2001	Negotiation talks in Taba (Egypt) fail	

6 February 2001	Ariel Sharon elected Prime Minister of Israel.	
27 February 2001		The General Affairs Council asked the Commission to develop a longer-term strategy to allow the Palestinian Authority to cope financially with the overall economic and budgetary effects of the economic collapse caused by freeze of transfers and the closures.
23+24 March 2001		The Stockholm European Council reaffirmed the EU's determination to make its contribution to peace, stability and future prosperity in the Middle East. International donors were asked to join the EU in pledging funding in support of the Palestinian budget. Israel was invited to resume tax transfers and to lift closures.
21 May 2001	Mitchell Report on peace process rejected	
May 2001		It was decided that the Special Cash Facility be converted into a direct budgetary assistance.
May-October 2001		The European Council, the European Parliament and the General Affairs Council stated on several occasions the EU's willingness to contribute to finding a solution to the conflict and to maintain aid to the Palestinian institutions and economy
June 2001		Alongside other donor's assistance, the Commission started to disburse Direct Budgetary Assistance consisting of monthly payments of an amount of €10 million against the compliance with clearly defined conditions.
13 December 2001	EP Recommendation on the crisis in the Middle East	

	and the role of the EU in the region	
11 February 2002	Letter from the Spanish EU Presidency concerning Israeli compensation for destroyed EU financed projects	
March 2002	United Nations Security Council Resolutions No 1397 and 1402 mentioning for the first time the co-existence of two states within safe and internationally recognised borders and asking Israel to withdraw from Palestinian territories	
End March-June2002		<p>Operation Defensive shield carried out by Israeli Defence Forces and seizure of documents from the PA. Publication of the report by Mr Naveh, Israeli Minister without portfolio, containing allegations of misuse of Palestinian direct budgetary assistance funds</p> <p>Debate in the European Parliament on the situation in the Middle East and decision to freeze budgetary transfers to the PA for several weeks. Allegations of misuse for terrorist actions in European and American newspapers</p>
June 2002		New Palestinian Authority government. Mr Salam Fayyad, Minister of Finance
July 2002		Progressive resumption of the Israeli fiscal revenue transfers
September 2002		Creation of the Palestinian Investment Fund, paving the way for the process of disclosure of Palestinian Authority commercial operations and concessions, first step towards the privatisation of existing public monopolies

December 2002		The European Commission decides to stop Direct Budgetary Assistance to the Palestinian Authority
13 March 2003		EP Conference of Presidents decides on the creation of an Ad Hoc Working Group with the mandate to monitor the EU direct budgetary assistance to the Palestinian Authority
Spring 2003	Creation of the Prime Minister's post in the Palestinian Authority	
29 February-3 March 2004		Ad Hoc Delegation of the three co-chairs of the Ad Hoc Working Group mission to Israel and the Palestinian Authority
31 March 2004		Ad Hoc Working Group to adopt and forward to the Conference of Presidents its final conclusions

The second Intifada in September 2000 and the consecutive freezing by the Government of Israel of the monthly transfers of the tax revenues agreed between Israel and the PA in the Paris Protocol brought about a rapid deterioration of PA's public finances. These transfers amounted to, approximately, two thirds of PA revenues.

With the continuation of political unrest an economic crisis with severe social consequences affected the Palestinian population. The EU decided to grant support to the Palestinian budget aimed at avoiding the collapse of the PA and to sustain the already faltering peace process.

The EU decided to opt for Direct Budgetary Assistance. This was a political decision. The strategy was formulated by the Council and implemented by the Commission. The Commissioner showed his best intentions in order to stabilise the situation and to encourage the reform of the PA institutions in a very difficult context.

II. Nature and Sources of the Allegations Made

As a starting point, clear distinction should be made between rumours, suspicions, allegations and evidence. The allegations made deal specifically with misuse and diversion of Palestinian Authority financing and are based on Israeli military intelligence and captured documentation as a result of military operations.

Allegations can be subdivided as follows:

- Palestinian Authority support of terrorist activities
- President Arafat's support to the families of the suicide bombers
- President Arafat's support to terrorist activists
- Inclusion of terrorist activists within the PA (payrolls, financial support)
- Financing of Fatah and its relationship with the Al-Aqsa Martyr's Brigade

Other allegations of fraud, corruption with or without link to alleged terrorist activities, as well as allegations of financing the publication of schoolbooks used in Palestinian schools that promote incitement and hatred were also brought forward.

The WG has examined the above mentioned allegations.

1. Sources of the allegations

Allegations have come to public knowledge basically through two types of sources:

- Israeli Minister Naveh's Report stating that Palestinian money, among which money given by the European Union in the form of Direct Budgetary Assistance, was misused in order to finance terrorist activities.
- Allegations made in European and American Press, more specifically Die Zeit and the Wall Street Journal in Spring 2002.

These allegations have been extensively circulated, largely taken up by media and are also to be found on the Internet.

Most of the allegations are based on military intelligence and reports by the Israeli Defence Forces (IDF). Such reports are, at least partially, based on documents seized during the operation "Defensive Shield" (late March-April 2002) and/or other operations.

2. Determination of Validity

Some specific allegations that were made can be easily discarded through common sense and elementary understanding of the mechanisms at stake:

- **Individualising EU Funds**

Specific allegations claiming that EU funds have been misused for terrorist purposes are not viable since the funds at stake in Direct Budgetary Assistance are fungible. In fact, all contributions from international donors flow into the same Shekel Single Treasury Account on the day of transfer. It is therefore virtually impossible to trace back every single euro once it has mingled with other funds in the budget.

- **Shadow Budget**

The Palestinian Authority's budgetary system requires that all revenues and expenditures are channelled through the Ministry of Finance's single treasury account at the Arab Bank in Gaza. This includes payments made by Israel, the EU and other international donors. All revenues and expenditures are reflected in the overall Palestinian Authority budget. It is therefore virtually impossible that the Palestinian Authority could maintain an unofficial shadow budget based on a system of double bookkeeping. Indeed, there is no evidence to support claims to that effect. **However, should such a budget exist, it is quite clear that there is no European Direct Budgetary Assistance flowing into it.**

- **Exchange Rate Speculation**

The €10 million, which the EU transferred to the Palestinian Authority on a monthly basis, were transferred to the Shekel Single Treasury Account of the Ministry of Finance at the Arab Bank in Gaza. The Arab Bank immediately converted the funds upon their arrival into NIS at the market exchange rate. The International Monetary Fund (IMF) monitored these transactions within its general mandate. EU transfers have never been carried out in US dollars, even before the introduction of the Euro as a general means of payment. The monthly payments were always carried out in Euro using the above-mentioned conversion method. **This mechanism excludes the possibility that EU funds could be used for exchange rate speculation or that funds could have been diverted by the means of exchange rate speculation.**

III. Possible Ways of Misusing Funds in the System in Place

International institutions clearly stated to the co-chairs that there is no system of budgetary support which is entirely safe. Minister Fayyad also admitted to the co-chairs that there is always a possibility of misuse in any system of public finance.

1. **Macro-Monitoring versus Micro-Auditing of the Direct Budgetary Assistance, especially concerning payrolls and transfers to individuals (so called "social requests")**

Since the beginning of the EU Direct Budgetary Assistance, the IMF has provided macro-economic information to help the Commission make decisions regarding the disbursements of such assistance (monthly comfort letters – documents which were submitted to the Working Group). The close examination of fiscal developments in the Palestinian Authority enabled the IMF to form a comprehensive and up-to-date macro-economic picture of the evolution of the Palestinian Authority's public finances.

The review of fiscal developments covered:

- revenue developments
- the evolution of employment and wages bill
- capital expenditures financed by the Palestinian Authority
- disbursements of external budgetary support
- the evolution of domestic bank financing for the Palestinian Authority
- the economic policy decisions by the Palestinian Authority pertaining to the fiscal area (consolidation of budgetary revenue, control of employment growth).

It is important to note that the IMF has not been monitoring the final use of funds granted by international donors, including the budgetary support granted by the European Union, nor can it ascertain whether a particular spending commitment has in fact been disbursed for the reported purpose. By definition Direct Budgetary Assistance is non-targeted aid and monitoring it would require a process of auditing, which would have had to be performed by independent auditors and which goes beyond the IMF's original mandate. IMF senior representatives confirmed this both to the Working Group in Strasbourg and to the co-chairs during their visit to Jerusalem.

2. Transfers from the Palestinian Authority Presidential Budget and the Evolution of its Control Over Time

Since July 2002, the Ministry of Finance of the Palestinian Authority also monitors the Presidential Budget.

President Arafat's budget has been reduced from \$103 million in 2002 to \$73 million in 2003 and to \$41 million in 2004 by taking out such areas as social assistance, education, medical treatment, etc., and putting them in the relevant ministerial departments. This was confirmed directly to the co-chairs by Minister Fayyad.

According to Palestinian sources, the Presidential Budget was mainly used for maintaining the Presidential Office and staff as well as the funding of a few specific agencies, such as planning institutes, various academies, etc., that report directly to the President.

President Arafat's signature and transfers from the presidential or general budget

Israeli captured documents show a wide range of requests of payments signed by President Arafat and which are of different types. Most of them are "social requests", i.e. requests by individuals for healthcare or material benefits, purposes which are clearly stated in the request. Minister Fayyad explained that usually a far smaller amount was paid than the one actually requested or even than the one authorised by

President Arafat. Some social requests were not answered at all, especially when their object did not fit into the thematic priorities of the government. Israeli sources claim that some of these requests were coming from people linked to terrorist activities or from their families. According to them, a total sum of 2.5million US\$, broken down into various amounts –often not superior to a few thousands dollars to be divided between several if not numerous individuals- was transferred.

However, evidence of approvals of transfer followed by a proven execution of payment remains more difficult to obtain. According to Israeli sources, this amounts to 39,000 US\$. The picture that emerged from the examination of the documents by the European Commission showed that payments to alleged Fatah activists had been authorised for a sum of US \$ 21.500. New documentation presented to the WG in November 2003 identified an additional amount of US \$ 17.500 as having been authorised, the total amount thus reaching some \$ 39, 000.

While no evidence of actual payments being made have been provided for the first amount, such evidence exists for the \$ 17.500. The IDF claim that the amount was paid to a person allegedly involved in terrorist activities. The Ministry of Finance of the PA confirmed the payment made and stated that the amount was paid for medical treatment.

3. Fatah Membership

Israeli allegations claim that the Palestinian Authority President's Office transfers on a monthly basis vast amounts of money to Fatah activists called "Al Aqsa Martyrs Brigades". Israeli allegations further assert that there is a "Fatah tax" withdrawn from security personnel salaries regardless of Fatah membership. The IMF, however, states that the Fatah levy is in fact exclusively paid by Fatah members. According to Israeli sources, the total operating expenditure of Fatah reaches NIS 10 million, constituting another source from which funds could be re-transferred to terrorist organisations. Any link between the Palestinian Authority budget structure and the financing of Fatah is difficult to clearly picture. Further, given the fungible nature of EU budgetary support, it is not possible to link any salary payment - and thus any Fatah levy - to EU funding.

IV. Internal Financial and Budgetary Reforms of the Palestinian Authority - Role of the European Contribution to Improvement of the System

In the above-mentioned political and crisis context, **Direct Budgetary Assistance**, consisting of monthly payments, was chosen. This instrument was accompanied by conditionalities relating to budget implementation. These aimed at fostering the move towards more comprehensive financial reforms in addition to the Single Treasury Account (STA) which was established at the insistence of the EU. The funds provided to the PA over the period under examination amounted to € 246 million.

1. Possible Alternatives to Direct Budgetary Assistance

Possible alternatives to Direct Budgetary Assistance could have been:

- Food aid programmes
- Cash pay for welfare

- Labour-generating programmes.

A World Bank 2003 study on the impact of different types of emergency measures clearly shows that Direct Budgetary Assistance is the best available instrument not least because of its positive political impact. International monetary institutions also state that although earmarking amounts within Direct Budgetary Assistance provides a sense of comfort, there is no real added value in terms of safety of budget execution.

2. Relevance and Appropriateness of the Direct Budgetary Assistance Instrument

Direct Budgetary Assistance is used as a form of support in many EU and other donor programmes throughout the world. As non-targeted financial support, it is impossible to control Direct Budgetary Assistance completely.

By definition, funds provided under Direct Budgetary Assistance are not attributed to any specific expenditure or transaction but serve to finance public expenditures as determined in the budget. Public expenditure controls for the entire budget are executed via the internal and external control systems of each country. This is also the case for the Palestinian Authority.

Representatives of International monetary institutions (World Bank and IMF) back the Commission's argument by saying that providing general budgetary support to the Palestinian Authority was essential. It was in order to keep the Palestinian Authority functioning. The EU decision to provide funding was a determinant, as well as a catalyst, for the generating of funding by Arab States. The Commission states that there have been many positive consequences of EU involvement for the ongoing reforms in the Palestinian Authority.

Although the Palestinian Authority financial accountability assessment is far from perfect, it is clearly better than that existing in most other countries in the area that benefit from international monetary institution funding. The problem is however that in no other area in the world to whom DBA is granted, individuals of the recipient countries are involved in terrorist activities against neighbours.

Granting DBA was a political decision, opting for a mechanism which was a technically and financially satisfactory way of proceeding, but which in terms of political image may have paved the way for legitimate suspicions.

V. Obstacles to Obtaining Material Proof of Misuse

A difficulty that surfaced during the discussions of the WG concerned the question related to what was to be considered as evidence of funds having been misappropriated, or allegedly diverted to finance terrorist activities.

This point was raised during discussions the WG had with OLAF as well as in the discussion that followed the presentation made by the expert of the Israeli Intelligence and Terrorism Information Center which is related to the IDF.

OLAF launched an external investigation on allegations over EU funds being diverted to finance terrorism on February 2003, which is still open. OLAF investigators visited on two occasions (November 2003 and January 2004) Israel and the Palestinian territories in the context of that investigation. They held meetings with both the Israeli and the Palestinian side. On two occasions (October 2003 and March 2004) OLAF briefed the WG on progress made in its investigations. It took note of OLAF's preliminary findings. The OLAF investigation into this matter is still not completed/ closed.

The answer that emerged from the discussions with OLAF was that in order to back allegations that DBA funds were diverted to finance illegal activities, including terrorism, there should be conclusive evidence (i.e. one that could be accepted by a Court in the processing of a case).

This is OLAF's way of proceeding. However, from a political point of view, the numerous documents with President Arafat's signature and authorising the payment of monies cannot be discarded.

1. Documents captured by the Israeli Defence Forces and information delivered by captured Palestinians

During the presentation made to the WG in Strasbourg by the expert of the IDF, documents stating that there is proof that funds from the PA budget were diverted to finance terrorism were presented. During the meeting the *ad hoc* delegation had in Tel Aviv with the IDF representatives, the latter suggested that there exists an organised, institutionalised pattern for money to be transferred by the PA to terrorist elements. In further IDF documentation sent to the co-Chairs subsequent to the visit it was added that to the extent that EU financial assistance went to the "one cash box" of the budget of the PA, EU assistance became a component to finance terrorism and its infrastructure.

Documents captured by the Israeli Defence Forces and presented as evidence also include transcripts (in Hebrew and/or Arabic) of interrogations of Palestinian activists currently detained in Israel were submitted by the Israeli Defence Forces to the co-chairs and sent on to the Commission and OLAF for examination. **The Israeli authorities have been sending new documentation to the Working Group until recently, however without clear evidential backup. Provision of documents is likely to go on since the Israelis have not to date analysed all the documentation captured from the Palestinian Authority administration and intelligence, consisting of 4000 boxes, which the co-chairs had the opportunity to see during their visit.**

2. Understanding of cultural patriarchal (feudal) mechanisms operating in Palestinian Authority society - grace and favour (cash) payments

It was confirmed by Minister Fayyad's collaborators and by observers from international institutions that archaic practices of allegiance were, and to some extent still are, in place within the Palestinian Authority, and especially when dealing with the President's office. A commonly accepted system of reward, grace and favour allows the President to allocate money to individuals for specific social needs which is then dealt

with at the level of a competent regulatory ministry. However, in recent years considerable reforms have taken place and have thus drastically reduced the risk of money misappropriations and made the system less dependent from the will of the President.

3. Missing evidence of clear links between order of payment and proof of payment

Israeli authorities did not capture any documentation at the Palestinian Ministry of Finance. As a consequence, documents showing that orders of payment captured from the President's office have actually been executed are usually not available. **It is therefore extremely difficult to establish clear links between orders and executions of payments.**

4. Reforms of the Palestinian Authority system

- One main reform, which is still much of a work in progress, is the inclusion of all employees of the Security Apparatus on monitored payrolls and the subsequent abolition of cash salary payments.
- Improvements in external and internal auditing, with the help of the European Union (training, reinvigorating the General Control Institute).

VI. Further Recommendations

1. Preliminary Conclusions

Considering that all Palestinian Authority budget revenues, from all sources and including EU Direct budget support, were channelled into the Single Treasury Account (STA) in order to cover total expenditure, it is not possible to make a link between any specific revenue (funds), including European budget support, and payments made. Misuse of Direct Budgetary Assistance Funds (including EU funding) may have occurred, given the non-targeted nature of this type of aid and the mandate of the IMF restricted to overall monitoring. Given the fungible nature of Budgetary Assistance, it is impossible to prove that misused money was European money;

There is no conclusive evidence, to date, that the EU non- targeted Direct Budgetary support was used to finance illegal activities, including the financing of terrorism. However there is evidence that payments have been authorised;

There is no evidence that EU budget support has not been fully transferred into the PA budget or that it was used outside the budget;

The resumption by Israel of transfers of tax revenues to the PA budget through the Single Treasury Account - following the reforms achieved by the PA through the facilitating action of the international community, especially the US State Department - would seem to confirm that the Israeli authorities attach importance to the furthering of the reform process of the PA and to supporting the reform efforts undertaken by Minister Fayyad; it may also suggest that sufficient certainty now exists for the Israeli authorities that these funds would not be misused or diverted to illegal purposes,

including the financing of terror. **However, this could mean that during the time when Israel stopped payments and the EU started granting DBA, the system was not as safe;**

2. Precautions to be taken for possible future Direct Budgetary Assistance

Given the monitoring difficulties inherent to its nature, it is legitimate to consider that despite of its technical advantages, Budgetary Assistance was not the most appropriate financial instrument to be implemented, at least not under the conditions of 2000-2002, in an area of great instability, lack of State regulation, well known corruption and, more pertinently, in an area of terrorist actions;

Should the Palestinian Authority need further Direct Budgetary Assistance from the European Union in future, this should take place only in the framework of an accurate, all-encompassing and transparent mechanism of external and internal auditing and to which the European Union officials would be closely associated;

The option of DBA should only be chosen for providing urgent aid and financial support if the population (i.e. those most in need of assistance) can effectively benefit from such support and where there is certainty that such funds cannot be diverted to terrorism;

Recommendations on the conditionalities for further DBA could include:

- Comprehensive reform of the financial sector – banks, insurance and financial (capital) markets. Setting standards for internal and external auditing.
- Increasing transparency and deepening the reporting system. That should include detailed budgetary reporting for every ministry (including the financial administration of the PSS – Palestinian Security Services), monthly reports of the Palestinian Investment Fund (including reporting on every change of holdings, assets realisation, ownership transfers).
- Preparing reform programs for local authorities, in line with Salam Fayyad's reforms at national level.

With a view to ensuring better monitoring of the effectiveness of the financial support provided to the PA, as well as to guaranteeing an on-going assessment of how the situation on the ground evolves and on whether new needs have emerged, a mechanism should be introduced allowing the European Commission to report to the European Parliament on a regular basis (every 3-6 months) on the status of implementation of the financial support, on any significant developments and/or on any emergencies which might require fine-tuning or re-direction of funds;

More generally, in the context of politically highly sensitive situations, it is imperative that the European Parliament be informed *ex ante* of any decisions taken by the Council to grant financial assistance to a specific country, in order to be given the opportunity of holding a full debate on the issue at stake and give its recommendations when appropriate.

3. Recommendations that should be taken up in the context of the current targeted Budget assistance:

Strengthening the audit function: to be developed in a consistent manner encompassing both the Internal Audit structures in the Ministries and the External Audit function which should be performed by an independent Body accountable before the Legislative Authority (PLC);

Abolition of the use of cash in Government transactions and payment of salaries to all staff on the payroll, without exception, through bank accounts;

Introduction of management control standards: clear rules and procedures should be set and implemented by all Ministries aimed at enhancing the control of expenditures with the introduction of risk assessment;

Consolidation into the Palestinian Investment Fund (PIF) of all past commercial operations and of the benefits thereof, including monopolies, as well of past investments made;

Continuation of the already existing effort to reduce the size of the Presidential budget to the appropriate level of funding necessary for the function and the related staff; establishment of a monitoring system to ensure that the President's budget only covers his legitimate office expenditure; all other expenditure should be redirected to the competent Ministry budget section;

