

Iraq Public Expenditure and Institutional Assessment

Volume 1

Public Financial Management in a Conflict-Affected Environment

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ABBREVIATIONS AND ACRONYMS

AGA	Autonomous Government Agency
BSA	Board of Supreme Audit
CCCI	Central Criminal Court of Iraq
COA	Chart of Accounts
COI	Commission of Integrity
CPA	Coalition Provisional Authority
CSR	Civil Service Reform
DFID	Department for International Development
GoI	Government of Iraq
IG	Inspector General
IDA	International Development Association
IFMIS	Iraq Financial Management Information System
MDAs	Ministries, Departments and Agencies
MENA	Middle East and North Africa
MfF	Minister for Finance
MoD	Ministry of Defense
MoE	Ministry of Education
MoF	Ministry of Finance
MoHE	Ministry of Higher Education
MoHC	Ministry of Housing and Construction
MoO	Ministry of Oil
MoP	Ministry of Planning
MoT	Ministry of Transport
MOU	Memorandum of Understanding
OFFP	Oil for Food Program
PEFA	Public Expenditure and Financial Accountability
PEIA	Public Expenditure and Institutional Assessment
PFM	Public Financial Management
USAID	United States Agency for International Development
UST	United States Treasury

IRAQ PUBLIC EXPENDITURE AND INSTITUTIONAL ASSESSMENT PUBLIC FINANCIAL MANAGEMENT IN A CONFLICT-AFFECTED ENVIRONMENT

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EXECUTIVE SUMMARY

Introduction

1. **The Public Expenditure and Institutional Assessment (PEIA) was motivated by a number of factors.** First, both the Government of Iraq (GoI) and its international development partners have recognized the critical importance of sound management of Iraq's substantial public financial resources. Both parties support the reform and modernization of public financial management (PFM), as articulated in the International Compact for Iraq (ICI). Secondly, international experience demonstrates the importance of establishing a baseline against which progress in PFM over time can be measured. This implies the need for an assessment which provides the information necessary to measure the performance of a country's PFM system. Thirdly, the devastating circumstances in Iraq during the past 5 years have made the institutional arrangements for PFM the subject of considerable uncertainty. New organizations have been created and significant changes have been made to the legal and regulatory framework without the full understanding and acceptance of those public officials responsible for managing public finances. Finally, the disruption to the public service caused by the conflict has given rise to a major capacity development requirement in Iraq. The PEIA can help to shape and prioritize the necessary development program.

Country Context

2. **Iraq's current circumstances are special in a number of ways.** During the last five years of conflict, much of its infrastructure, including many of its institutions and a significant part of its human capital, have been significantly weakened and in some instances destroyed. Throughout this period, there has been considerable political and administrative instability and uncertainty as interim governance arrangements under the Coalition Provisional Authority (CPA) have been succeeded, first by a transitional government, and then, by a democratically elected Government. Even before 2003, Iraq's isolation from the international community meant that many of its public management systems and processes suffered from a lack of harmonization with developments taking place globally.

3. **Economically, Iraq remains highly dependent on its oil industry for its wealth, prosperity and employment opportunities.** Non-oil economic activity remains very limited, as oil accounts for well over 90% of both Iraqi exports and government revenues. The presence of substantial amounts of oil and gas reserves has been identified as a potentially mixed blessing for a country. International experience suggests that the performance of economies that receive a large proportion of government revenue and export earnings from the ownership and taxation of natural resources is often poor when compared to similar countries without such resources. In a way, because of Iraq's commitment in its Constitution to a future as a federal state, the management of those oil revenues satisfies the needs and aspirations of all parts of Iraq. In addition, the country's demographic composition has become one of the most important issues in the public

policy arena. Efforts are still underway to continue to develop legislation that will regulate oil revenue sharing in a manner that is politically acceptable to the various interest groups. Economic activity remains primarily in the hands of the public sector, thus placing a high premium on economic and effective management of public resources. The quality of PFM is, therefore, of central importance to the Iraqi economy, public service delivery and, in the final analysis, political stability.

4. **This report presents an initial assessment of Iraq’s PFM system using the Public Expenditure and Financial Accountability (PEFA) methodology.** The assessment was facilitated by a series of workshops held at the Adnan Palace in Baghdad during the second half of 2007. These workshops brought together experienced GoI officials to work with PFM experts from the World Bank, the US Government and the UK Government. Additional material was collected through a number of workshops held outside Iraq. The most notable of these workshops took place in Amman, Jordan, two of which were with Iraq’s Supreme Audit Institution (SAI), the Board of Supreme Audit (BSA), and two with senior GoI officials from the education sector and central ministries. The workshops covered all aspects of Iraq’s national PFM system.

5. **The report is organized in two main parts.** Volume I contains a summary of the main issues to emerge from the PEFA assessment and a discussion of a number of specific PFM issues of current importance to Iraq, including: capital investment budgeting (CIB), oil revenue management, the Iraq Financial Management Information System (IFMIS), public accounting and accountability and payroll management. Volume 2 contains a detailed technical analysis behind the PEFA assessment.

The PEFA Assessment

6. Using a four-point rating scale, the PEFA assessment results in the following results summarized in Table 1

Table 1: Abbreviated Summary of PEFA Indicator Scores

PEFA Score	Number of Indicators
A	1
B	1
C	8
D	20 (note 1)
Not Rated	1 (note 2)
Total	31(note 3)

Note 1 – includes the 3 donor indicators that form part of the PEFA framework

Note 2 – due to inadequate information

Note 3 - comprises 28 system indicators and 3 donor indicators

7. **The large number of performance indicators awarded the lowest possible score (D) indicates scope for substantial improvement in the Iraqi national PFM**

system.¹ The PEIA analysis suggests that, in the first instance, attention should be paid to the following key areas of PFM reform:

- Improving budget realism and sustainability;
- Facilitating budget execution;
- Improving reporting;
- Strengthening oversight; and
- Developing PFM capacity.

8. The PEFA assessment shows that the GOI budget suffers from a lack of credibility. The main evidence to support this conclusion is provided by the significant variances (42% overspent in 2004, 27% under-spent in 2005 and 32% under-spent in 2006) between aggregate expenditure out-turns and budget over the past few years. The biggest problem has been the inability of the GoI to implement large parts of its capital investment budget. This outcome reflects weaknesses at all stages of the budget management process from preparation (over-optimistic estimates of what can be achieved) through to implementation (where many issues conspire to make execution of the capital investment budget highly problematic).

9. At the strategic level, the budget preparation process is ineffective in translating government priorities into financial allocations. A multi-year perspective in financial planning and budgeting is largely absent. Linkages between government policies and resource allocation are weakened by the lack of budget ceilings to guide service managers to produce budget estimates that are realistic and reflect government priorities. This results in budget submissions from ministries that are not in line with strategic priorities, unaffordable and, ultimately, incapable of being implemented.

10. Budget execution is constrained by a range of bottlenecks in the capital investment budgeting system. These stretch from procurement and contract management through commitment, verification, and payment to oversight. There have also been wide divergences in budget execution rates between ministries and between governorates. Only the relatively stable and more secure region of Kurdistan has been able to achieve a high level of budget implementation. One factor that does not appear to be a constraint at the national government level is cash liquidity. The evidence suggests that a large amount of cash is actually being drawn down from the Development Fund for Iraq (DFI) in New York and advanced to government spending units. However, the money is then not being spent; instead it has led to very large idle balances in the bank accounts of spending units.² Given the crucial importance of effective budget execution

¹ However, it should, be noted that a PEFA assessment is essentially a snapshot nature of the PFM process in a country at a particular point in time. The scores given to the various performance indicators do not necessarily capture improvements that may be taking place. In a number of cases in Iraq, such as budget variances, the situation has started to improve. Nevertheless, much more remains to be done. Yet, it is impossible and undesirable for any Government to try to focus on modernization on too many fronts at once.

² These have been estimated at ID 9.5 trillion at end-2007 (12 percent of GDP), equivalent to over US\$7.5 billion.

in terms of the delivery of essential public services, this area of PFM must be a priority for reform. The key issues are discussed in detail in chapter 2 of this report.

11. One of the most significant challenges facing the GoI is to improve the integration of capital and recurrent budgeting. This common problem in PFM results in insufficient attention being paid to the recurrent costs of capital schemes and, therefore, significant difficulties in operating and maintaining expensive capital assets. Institutional arrangements are found to be important, with responsibilities for different aspects of budgeting being divided between the Ministry of Finance (MoF) and the Ministry of Planning and Development Co-operation (MoP). In Iraq, these difficulties are enhanced by large parts of the investment budget being financed and executed outside the budget by donors.

12. Other issues identified by the analysis of capital investment budgeting include the following:

- Weak capital investment planning resulting from limited capacity to develop sector strategies, project feasibility studies, credible project costings and realistic project appraisals
- Continuing lack of consistency and uniformity in budget documentation and classification
- Poor co-ordination between implementing ministries and inadequate delegated authority
- Apart from the difficult security situation, a number of market imperfections including supply bottlenecks, fuel shortages, private sector constraints and difficulties in resolving land disputes
- The reluctance of officials to take decisions and authorize resource allocations for fear of allegations of corruption

13. Oil revenue management is an important issue for Iraq. At this juncture, the Development Fund for Iraq (DFI) plays de facto the role of an oil fund. All proceeds of export sales of petroleum, petroleum products, and natural gas from Iraq are deposited into the DFI. Oil revenues above the estimated price set in the budget accrue to the DFI. However, the decision-making process regarding the use of all the money that accrues to the DFI over that which goes into the budget is not clear. In similar situations, several countries dependent on hydrocarbon revenues have smoothed the revenue streams that finance public expenditures by establishing oil stabilization funds, or sovereign wealth funds. Others have set up heritage funds that pass on proceeds from natural resources to future generations.

14. Discussions about creating such a fund are underway in Iraq but are tied to the larger discussion of how revenues will be shared. According to the Constitution, strategic policy-making is a shared power between the federal level and oil-producing

governorates and regions.³ In this sense, Iraq is somewhat unusual. Many federations with significant natural resource revenues such as Canada, US, Australia and Russia, provide states with extensive ownership rights, with the federal government playing a leading and central role in all other salient aspects in relation to natural resources. The GoI has yet to decide whether these revenues will be used to minimize the transmission of oil price volatility to fiscal policy i.e. establish a stabilization fund, or, whether it will act as a savings fund and address intergenerational concerns.⁴ It is also unclear whether the funds in the DFI are being invested such that benefits are maximized. At present, the Committee of Financial Experts audits the DFI. But the audit objectives are fiduciary in nature with no focus on ensuring that the resources are effectively managed. Moreover, several past audits of the DFI have pointed out concerns regarding inadequate controls over Iraq's oil and other aspects of the DFI's operations.

15. Financial reporting, both internally to government managers and to external stakeholders, is in need of substantial reform. In the last year or so, progress has been made with the introduction of a new Chart of Accounts and budget classification system that is compliant with the IMF's internationally practised Government Finance Statistics 2001 system. However, there is still considerable variability in the extent to which the system is understood and applied by the staff of spending units. As a result, the Ministry of Finance is required to employ a mapping system to convert data supplied by spending units into a consistent format. Moreover, delays in reporting occur routinely, resulting in weak management control and supervision of spending both within the spending units and at the level of the central ministries.

16. These problems are exacerbated by the lack of a fully documented government accounting framework. The Financial Management Law introduced in 2004 by the Coalition Provisional Authority (CPA) appears to have limited understanding and ownership in some quarters of the GoI where preference has been expressed for accounting practices that were in place prior to 2003. The variable accounting practice results in poor quality and timeliness of accounting records and annual financial statements. Accounting practices urgently need to be codified, clearly documented and brought into line with modern public sector accounting standards. Financial reporting could be streamlined and improved by the successful implementation of a comprehensive financial management information system. The US Government has been supporting an important initiative in this area, which is considered in depth in chapter 3 of this report. The system comprises an application of a number of modules of the proprietary software Free Balance Financial Management Series – Financials. The FMIS was originally conceived as essentially a budget execution system rather than a full-scale financial management information system. Modules implemented to date comprise general ledger

³ Several aspects of this are left unclear i.e. does regional legislation override federal law?; which level of government would police the implementation of Article 112?

⁴ If, instead, the intention were to establish a Savings Fund, on average only the "permanent income" from the wealth would be spent keeping the wealth of the Fund constant. However, a Stabilization Fund is, to an extent, a savings Fund, although it may not be able to maintain a permanent income. Similarly, the Savings Fund can display an element of stabilization depending on how well it is integrated into the budget process.

and payments. There are plans to widen the scope of the system to include more modules like payroll, purchases, and budget preparation.

17. **An effective FMIS is badly needed in Iraq.** The periodic release of budgetary allocations during the financial year is contingent upon timely and accurate financial information being supplied to the MoF by ministries, regions, and governorates of their actual expenditure in the previous spending period. Trial balances recording expenditure need to be submitted on a monthly basis by spending units before any further funds will be released. The quality and speed of the processes by which financial information is captured and reported is therefore of paramount importance. Without their budgeted allocations being made available in a timely manner, public sector organizations are unable to deliver high-quality essential public services, nor are senior officials at Ministry level in Baghdad able to monitor effectively the levels of spending and outputs achieved with public resources. Similarly, public accountability depends upon financial reports being produced that are accurate, complete and timely. Presently, in Iraq, there are significant delays in the reporting process, causing a lack of accountability to parliament and the people of Iraq.

18. **The Bank analysed the Iraqi FMIS using two frameworks.** These are the Bank's Six Pillars to Support Successful FMIS Reform and the International Monetary Fund's Five Pre-conditions for Development of a FMIS. The analysis indicates that the FMIS is seen by the GoI as a high PFM reform priority. This has recently been evidenced by the signing of a Memorandum of Understanding (MOU) between the GoI and the US Government to continue with the FMIS project. The PEIA confirmed that the IFMIS teams have made progress, despite the difficult security context and problems with the way in which the IFMIS was originally conceived and designed. What now appears necessary is a revitalized implementation strategy.

19. **In taking the FMIS forward, it will be important to recognize a number of obstacles to progress and to take advantage of opportunities to improve implementation.** The Bank's analysis identifies the following six main obstacles:

- **Unsatisfactory project supervision** and contract management arrangements;
- **Lack of support** for and recognition of Project Management Teams;
- **Insufficient or inappropriate incentives** to promote the Government's PFM reform agenda;
- **Inadequate consultative, coordination and co-financing arrangements** to support high levels of ownership, effective partnerships and high degrees of commitment from key stakeholders;
- **Poor FMIS design** and more specifically the planning process to set the FMIS implementation strategy; and
- **The absence of a medium-term PFM reform program** that informs the prioritization and sequencing of specific PFM reform measures including development and roll-out of an FMIS.

20. The Bank’s analysis results in a range of recommendations, divided into five main themes:

- Improving supervision, contract management and co-financing
- Improving the management of FMIS implementation
- Strengthening ownership, commitment and partnership
- Enhancing design
- Setting the FMIS reform within the context of an overarching PFM reform strategy

21. There are significant challenges in the area of public internal and external financial control and public accountability. Weaknesses exist in payroll and other internal controls, including internal audit. When the size of public sector pay is considered in relation to government expenditure and Gross Domestic Product, it is clear that there has been substantial growth in the public sector wage bill in the last few years. While this has been more than matched by the growth of GDP resulting from high world oil prices, a number of weaknesses exist in the control framework for public sector employment. These include the use of different payroll applications, the widespread practice of paying public servants in cash, unclear legislation leading to varying interpretations, cumbersome reporting processes, and inefficient employee transfer procedures. The Inspector General system, imported from the USA, constitutes a major departure from former Iraqi practice and its effectiveness has yet to be demonstrated, apart from in isolated cases. In practice, there remains a lack of clarity of the respective roles and responsibilities of Inspectors General, internal audit departments that were in place under the former regime, and the Board of Supreme Audit. Coordination between the various organizations needs to be improved and all of them lack capacity. The financial management regulatory framework needs to be clarified. Procurement is a major problem area, in which procedures have been found wanting in terms of competition and controls.

22. The final link in the public accountability chain is also weak because external audit reports are not being submitted to the Council of Representatives (COR) in a timely manner. Consequently, there is no opportunity for the COR to hold the Executive responsible for its actions by means of requiring follow-up action on audit recommendations. In addition, legislative scrutiny of the annual budget law requires strengthening, although the CoR was able to secure important changes to the 2008 draft budget law. In general, there is scope for a much greater role for those “demand-side” stakeholders with an interest in improved PFM, including parliament, the media, and civil society. Overall, there is a need for greater transparency in the whole way in which public financial and other resources are acquired and used.

23. An overriding need in Iraq is to restore and enhance the capacity of the Iraqi PFM system. The events of the past five years have witnessed losses to devastating institutions, organizations, and human capital. Many experienced staff have been lost to the public service at the same time as new institutional arrangements and organizations have been created or replaced. Physical infrastructure has been destroyed and the

effective functioning of the PFM system has been severely undermined by the difficult security environment. It will take a sustained and comprehensive capacity development program fully supported by the international development community to help Iraq to overcome these problems.

24. **With this in mind, the final chapter of the report is devoted to making proposals for an integrated PFM reform program.** This needs to be led by the GoI and supported over the medium term by Iraq’s international development partners. Careful consideration should be given to ensuring a sustainable pace of reform that does not exceed the absorptive capacity of the Iraqi PFM system. International experience demonstrates the importance of properly sequenced and resourced PFM reform programs backed by political and administrative champions. It also shows the value of adopting a “building blocks” or “platform approach” to PFM reform. This minimizes the risk of embarking on the reform of PFM components before the time is right. Essentially, the underlying philosophy is one of getting the basics right before tackling more sophisticated and challenging issues. An initial platform might focus on the areas described above, namely improving budget realism and sustainability; facilitating budget execution; improving reporting; strengthening oversight; and developing PFM capacity. Later stages of reform might proceed to better accountability (including greater focus on what public spending actually achieves), improving the linkages between policies and budgeting, and, finally, integrating accountability with performance review.

PFM in the Education Sector

25. The report also takes a sectoral perspective on PFM in Iraq in the form of a case study. The sector chosen is education which provides valuable insights into expenditure patterns and system efficiency. It highlights key education financial management issues and incorporates an assessment of the PFM system in education by utilizing a selection of the PEFA indicators. This micro-level approach confirms many of the issues and challenges identified at the macro-, or aggregate level. Capital investment budget execution rates are low; there is little use of a financial planning time horizon beyond the annual budgeting process; there is limited knowledge and application of new laws and regulations; financial management capacity is weak; co-ordination of recurrent and investment expenditure is problematic; internal financial controls and audit arrangements are weak; and education expenditure is skewed towards personal emoluments.

Summary of Recommendations

26. The report contains a series of recommendations across several dimensions of PFM; these are classified below into broad PFM topics.

Budget Preparation

- Include priority-based, sectoral budget ceilings in the Budget Call Circular (BCC) to facilitate the submission of realistic budget proposals by government departments and agencies.

- Evaluate available options for improving the integration of the recurrent and capital budget formulation processes, including institutional reform measures.
- Develop a medium-term perspective as a framework for the annual budgeting exercise.
- Introduce functional classification of the budget as a step towards the eventual use of a program classification.
- Expand the scope of the information contained in the budget papers to improve transparency and accountability.
- Incorporate donor-financed activities in the national budget.
- Improve adherence to the BCC.
- Ensure that the capital investment budget employs the same GFS-based classification as the recurrent budget.

Budget Execution

- Introduce a commitment accounting system.
- Establish a system for monitoring arrears.
- Complete the production of financial regulations in support of the Financial Management Law.
- Improve cash management procedures by better cash forecasting and monitoring of idle balances in spending units' bank accounts.
- Reform and improve compliance with new procurement procedures.

Reporting and Accounting

- Document and reform accounting framework.
- Refine and expand IFMIS implementation.
- Improve timeliness and quality of in-year financial reports.
- Enhance the financial information made available to the public.
- Complete the introduction of the Treasury Single Account.
- Improve monitoring and reporting arrangements for Public Enterprises.

Auditing and Control

- Strengthen public financial control framework through clearer definition of responsibilities of public accountability organizations and comprehensive financial regulations.
- Enhance the effectiveness of internal and external audit through extensive capacity development.
- Strengthen payroll controls by establishing effective links between the personnel and payroll systems and undertaking regular payroll audits.
- Strengthen parliamentary oversight of budget and public finances by establishing a budget office in the COR.

Oil Revenue Management

- The GoI should establish an oil stabilization (sovereign wealth) fund to minimize the impact of oil price fluctuations on fiscal stability.

Public Financial Management Reform

- The GoI should develop a PFM reform strategy and action plan and actively manage its implementation with coordinated international donor support.

CHAPTER 1: AN ASSESSMENT OF THE IRAQI PFM SYSTEM

Introduction – The PEFA Assessment

27. **The Government of Iraq (GoI) has placed public financial management (PFM) reform at the heart of its development strategy as evidenced by the prominent place that PFM occupies in the International Compact for Iraq (ICI).** The Joint Monitoring Matrix (JMM) that supports the ICI includes a number of priority actions in the field of PFM, one of which is the completion of the PEIA. The PEIA is expected to form the basis for an Iraqi-led PFM reform action plan backed by the integrated resources of those international development partners with an interest in PFM reform and modernization.

28. **It is no accident that the GoI sets such store by improving its public resource management.** Iraq is not a poor country per se. It is resource-rich being the holder of the world's third-largest proven oil reserves (and perhaps more, according to recent estimates) and this endowment provides the potential for the GoI to succeed in addressing its many social, economic and political challenges. At present, the ability of the GoI to fully exploit these resources is constrained by various factors, including inadequate levels of past infrastructure investment as well as the ongoing conflict. This makes it all the more important that Iraq manages its public finances as efficiently and effectively as possible. The post-2003 conflict in Iraq has caused enormous damage to Iraq's pre-existing public financial management institutions. Even long-established bodies like the Board of Supreme Audit (BSA) have encountered many problems in discharging their responsibilities. At the same time, this period has also seen the creation of new public accountability organizations (like the Inspectors General) whose development has been hampered by the highly volatile and unstable security environment. New legislation has been enacted, much of it by the Coalition Provisional Authority (CPA) creating an uncertain and poorly understood regulatory framework for PFM. This has contributed to weak budget and resource management as well as deficiencies and inconsistencies in the delivery of essential public services, thereby exacerbating the deep inter-ethnic and inter-regional tensions and mistrust that prevail in contemporary Iraq.

29. **In a fragile state like Iraq, there are major challenges in achieving those improvements in governance that are generally recognized by the international development community as being essential for effective development and poverty reduction.** The GoI has at its disposal large amounts of financial, physical and other resources (both national and those supplied by donor agencies) with which to provide services to their citizens. It is of critical importance that these resources are well managed and used economically, efficiently and effectively. Equally important is the need for transparency and accountability in the way in which Iraq generates and spends public money. The need for sound financial management of Iraq's own resources is of paramount importance for economic growth and poverty reduction.

30. **Even in more stable environments than Iraq, international experience clearly shows that PFM reform is not easily or quickly achieved. PFM systems are a**

complex mosaic of technical, behavioral, and political factors that are influenced by a range of formal and informal institutions and practices. Reform implies change in many facets of these systems and change needs to be carefully planned and managed, given that it can be unsettling and threatening. Champions at both the political and administrative levels are essential ingredients of successful reform processes.

31. The potential pay-back from investment in improved PFM arrangements in Iraq is considerable. Returns can be expected to accrue in terms of significant positive and desirable budgetary outcomes at three levels. Specifically, good PFM will enable:

- Effective control of budget aggregates and management of fiscal risk, thereby helping to maintain fiscal discipline and macroeconomic stability
- Resource allocation in line with government priorities as expressed in public policy thus contributing to the achievement of government objectives
- Effective use of public resources leading to delivery of vital public services and achievement of value for money (VFM)

32. In the past two or three years, a refined approach to providing international support to PFM reform in developing countries has been developed, known as the “Strengthened Approach. This comprises three key elements, all of which are being developed in partnership with the GoI:

- *A country-owned, government lead PFM reform program;*
- *Integrated and sustained support to that program on the part of international development partners*
- *A common information pool that describes accurately the performance of the PFM system under review*

33. It is this last aspect of the Strengthened Approach on which this PEIA report is founded, namely an assessment of the current performance of the Iraqi national PFM system. As is rapidly become standard international practice, this assessment is based on the application of the Public Expenditure and Financial Accountability (PEFA) framework.

34. The PEIA is the latest piece of analytical work undertaken recently by the World Bank in the area of economic and financial management in Iraq. It follows and complements the Iraq Fiscal Sustainability Policy Note and Iraq Sub-National Public Financial Management Report issued in 2007.

35. PEFA assessments are, by definition, based on a detailed examination of a range of highly technical aspects of accounting, auditing and financial management. Consequently, the overall PEIA report is divided into two volumes. The first volume uses the PEFA framework to structure an in-depth assessment of the national PFM system in Iraq. The overall analysis is contained in Chapter 1. Subsequent chapters consider specific PFM issues in Iraq. A sectoral analysis of PFM in education is provided as a case

study. Volume 1 concludes with an outline of possible pathways to reform. This is likely to be of interest not only to PFM specialists but also those with an interest in the wider development of Iraq's economy and society. The second volume contains the detailed PEFA assessment. This is likely to be of most interest to public financial management specialists and practitioners within the Government of Iraq and the international development community.

36. The Iraqi national PFM system has been assessed jointly by the Government of Iraq (GOI) and the World Bank using the framework developed under the Public Expenditure and Accountability (PEFA) Program. This framework comprises 28 high-level Performance Indicators (PIs) that collectively cover all aspects of a functioning government PFM system. Each indicator comprises a number of elements, known as dimensions, which are rated along a four-point ordinal scale from A to D (where A indicates the highest level of performance). These PIs are supported by a further 3 PIs that are used to assess the performance of international donors in terms of the way in which their behavior reinforces or undermines the integrity of the recipient's PFM systems.

37. The PEFA framework structures the performance indicators into three categories, namely:

- PFM system outturns
- Cross-cutting features designed to capture the comprehensiveness and transparency of the PFM system
- Budget Cycle (of the central government)

38. The Framework attributes six critical features to an “open and orderly” national PFM system. These key PFM features as follows:

- Budget Credibility
- Comprehensiveness and Transparency
- Policy-based Budgeting
- Predictability and Control in Budget Execution
- Accounting, Recording and Reporting
- External Scrutiny and Audit
- Donor Practice

39. Accordingly, the bulk of Chapter 1 of this volume follows a similar structure, containing these 4 sections:

- PFM System Out-turns – Budget Credibility
- Cross-cutting features – Comprehensiveness and Transparency
- Budget Cycle
- Donor Practice

40. The results of the overall assessment are shown in summary in Table 2 below, which contains the scores for all 31 indicators.

Table 2: Full Summary of PFM Performance Scores

<u>PFM Performance Indicator</u>	Score	Method*
A. Credibility of the Budget		
PI-1. Aggregate expenditure out-turn compared to original approved budget	D	M1
PI-2. Composition of expenditure out-turn compared to original approved budget	C	M1
PI-3. Aggregate revenue out-turn compared to original approved budget	A	M1
PI-4. Stock and monitoring of expenditure payment arrears	D	M1
B. Comprehensiveness and Transparency		
PI-5. Classification of the budget	C	M1
PI-6. Comprehensiveness of information included in budget documentation	D	M1
PI-7. Extent of unreported government operations	D+	M1
PI-8. Transparency of Inter-Governmental Fiscal Relations	D	M2
PI-9. Oversight of aggregate fiscal risk from other public sector entities.	D	M1
PI-10. Public Access to key fiscal information	D	M1
<i>C (i) Policy-Based Budgeting</i>		
PI-11. Orderliness and participation in the annual budget process	C	M2
PI-12. Multi-year perspective in fiscal planning, expenditure policy and budgeting	D+	M2
<i>C (ii) Predictability and Control in Budget Execution</i>		
PI-13. Transparency of taxpayer obligations and liabilities	B	M2
PI-14. Effectiveness of measures for taxpayer registration and tax assessment	C	M2
PI-15. Effectiveness in collection of tax payments	D+	M1
PI-16. Predictability in the availability of funds for commitment of expenditures	C+	M1
PI-17. Recording and management of cash balances, debt and guarantees	C	M2
PI-18. Effectiveness of payroll controls	D+	M1
PI-19. Competition, value for money and controls in procurement	D+	M2
PI-20. Effectiveness of internal controls for non-salary expenditure	D+	M1
PI-21. Effectiveness of internal audit	D+	M1
<i>C (iii) Accounting, Recording and Reporting</i>		
PI-22. Timeliness and regularity of accounts reconciliation	C+	M2
PI-23. Availability of information on resources received by service delivery units	D	M1
PI-24. Quality and timeliness of in-year budget reports	D+	M1
PI-25. Quality and timeliness of annual financial statements	D+	M1
<i>C (iv) External Scrutiny and Audit</i>		
PI-26. Scope, nature and follow-up of external audit	Not Rated	M1
PI-27. Legislative scrutiny of the annual budget law	D	M1
PI-28. Legislative scrutiny of external audit reports	D	M1
D. Donor Practices		
D-1 Predictability of Direct Budget Support	D	M1
D-2 Financial information provided by donors for budgeting and reporting on project and program aid	D	M1
D-3 Proportion of aid that is managed by use of national procedures	D	M1

- * M1 scorings are based upon the lowest scored dimension making up that indicator (the weakest link determines the score).
M2 scorings represent an average of the scores for the dimensions making up that indicator.

Section 1: PFM Outturns - Budget Credibility

41. **A budget is the financial expression of a government’s policy priorities and choices.** As a financial plan, it sets out the revenues that are expected to be generated over the period in question and the ways in which those resources are to be allocated leading to the delivery of a range of public services. It both authorizes and limits public spending. It creates expectations on the part of those who manage the budget that a given quantity of resources will be made available to discharge the responsibilities of the recipient. Since a government budget comprises not only a recurrent component covering day-to-day expenses like salaries and wages, but also an investment component covering long(er)-term items like the building of schools, hospitals, and roads, it finances the infrastructure on which public service delivery depends.

42. **Given the central role of a government budget in public policy and administration, it is vital that confidence can be placed in its reliability.** The PEFA Framework employs four performance indicators to assess budget credibility. First, as a high level indicator of the performance of a PFM system, a comparison is made between actual aggregate expenditure in a given financial year and the originally approved budget for that year. The budget is deemed to be credible if the differences between these two aggregates are relatively small. Without such a favorable budgetary outcome, the achievement of operational objectives and plans is impossible. However, large budget variances impair the ability of Government to deliver the services expressed in its policy statements. A related problem arises where the proposed allocation of resources between government programs is not reflected in practice due to significant reallocations of resources during the budget year. This aspect of budget practice is measured by Performance Indicator (PI) 2, which compares the actual expenditure composition with the originally approved budget estimate. Significant differences in this respect indicate that public resources have not been allocated as intended. Repeated occurrence of both problems can lead to a lack of confidence in the ability of Government to implement its policies and keep its promises and may ultimately call into question the legitimacy of the country’s governance process. Aggregate revenue performance is evaluated using PI 3, which compares the outturn with the budget. Finally, budget credibility is assessed from the perspective of expenditure payment arrears in PI4 both in terms of the size of such arrears and the quality of their monitoring.

43. **The results of the assessment of budget credibility are summarized in Table 3 below.**

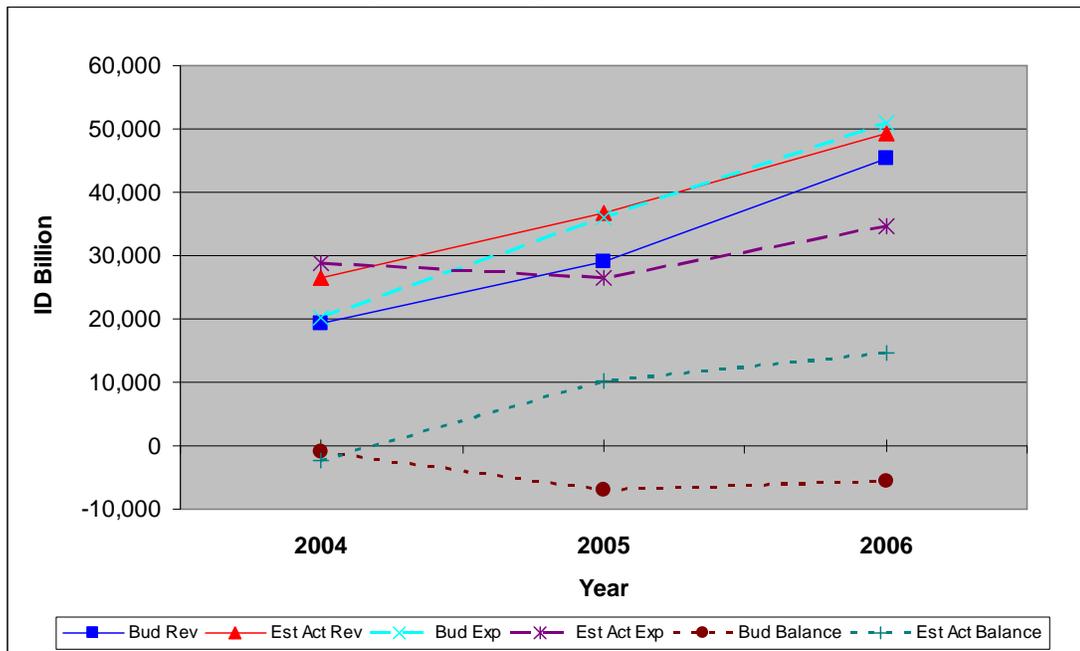
Table 3: Budget Credibility Indicators

PI-1. Aggregate expenditure out-turn compared to original approved budget	D	M1
PI-2. Composition of expenditure out-turn compared to original approved budget	C	M1

PI-3. Aggregate revenue out-turn compared to original approved budget	A	M1
PI-4. Stock and monitoring of expenditure payment arrears	D	M1

44. **The four indicators reveal a rather mixed picture.** Low scores are recorded in terms of aggregate expenditure variances and payment arrears; the expenditure composition performance is slightly better, and revenue outturn compares favorably with revenue estimates. Figure 1 below provides a graphical representation of budget outturns over the period 2004-06

Figure 1: Budget Out-turns



Source: MoF

45. **It is worth noting the importance of Government spending in the Iraqi economy.** Public expenditure is exceptionally high, representing around 75% of GDP (see IMF, 2007, 3rd and 4th SBA Reviews). Consequently, and in the absence of an enabling environment for the development of the private sector, economic growth in Iraq is determined primarily by the ability of the Government to execute an increasing annual budget. Figure 1 demonstrates that actual Government spending is on an upward trajectory with an increase of over 20% between 2004 and 2006.

46. **Finally, it is important to consider the implications of the budget credibility indicators in terms of the overall fiscal position.** Under-spending, especially on the capital investment budget, together with favourable revenue budget variances, have combined to generate large budget surpluses and large cash balances in the Development Fund for Iraq (DFI). The situation in Iraq is unlike that in some other oil-rich countries, where favourable revenue variances generated by oil exports being significantly greater in value than budgeted have led to large adverse expenditure variances and major changes in budget allocations between sectors. In Iraq, the main recent challenges have

centred on the management of large and increasing cash balances while trying to improve budget execution performance.

Budget Execution Issues

47. **The Government's wage bill has been increasing rapidly.** The GoI has the basis for an effective civil service personnel control mechanism, with ministry staffing profiles assessed and agreed during the annual budget process and reflected in published annual establishment lists. Unfortunately, budgeting performance of civil service employee remuneration and pension payments has been unpredictable.⁵ It is not surprising, however, that the operational budget overall is being implemented generally as intended, scoring a C, given that there is a generally effective system in place to budget and pay civil service entitlements.

48. **Until recent developments in 2007, the lack of a transparent and effective mid-year review process has contributed to budget execution difficulties.** Increasing cash reserves derived from prudential revenue forecasts and slow budget execution performance increase incentives for in-year variations. The Financial Management Law (FML) provides the process for a mid-year review. The Government, however, has tended to rely on the practice of making ex-post adjustments to appropriations in the following year's budget law. This practice compromises budget credibility and fiscal discipline. Furthermore, the use of large contingency reserves and in-year reallocations, while understandable in an emergency context, does not promote progress towards a credible budget. There are now signs, however, that the Government is seeking to improve the mid-year process. For example, during the third quarter review of the 2007 budget, it is understood that the BSA assisted the Ministry of Finance with analysis and withdrawal of up to 25% of budget allocations from government agencies that were showing low budget allocation rates.

49. **The fragmentation of the recurrent, investment and external budgets is a key factor that contributes to budget credibility being compromised** (see Chapter 2 on capital investment budgeting for further discussion on budget fragmentation). Improving fiscal discipline during budget preparation and budget execution phases will need to be a top priority if budget credibility performance is to improve.

50. **Other factors that have contributed to significant deviations in budget out-turns include the following:** i) an insecure environment and a lack of communications infrastructure, which makes it difficult to communicate and implement budgets safely; ii) a complex and large external budget, which makes it difficult to coordinate, monitor and evaluate sector strategies and investment projects; iii) the lack of a responsive and effective private sector, which makes it difficult to mobilize the private sector in support of Government's spending priorities; iv) a lack of sustained exposure to the international

⁵ Execution of the salary, wages and pension payment budgets has been volatile with actual payments deviating from budget allocations by 9% in 2004, 32% in 2005 and 6% in 2006 and 24% forecast for 2007 (see IMF, 2007, 3rd and 4th SBA Reviews). In the draft 2008 Budget, the Government has made strong reform statements to reverse the increase in the wage bill.

community, making it difficult to successfully adopt better practices in a timely fashion; v) a fragile political coalition for governing, making it difficult to agree on reform measures and new fiscal policies; and vi) an institutionalization of practices initiated by the Coalition Provisional Authority (CPA) and its Program Review Board (PRB).⁶

Budget Composition

51. The PEFA assessment shows that a ministry's overall budget has not been adversely affected by in-year reallocations between ministries. However, it will be interesting to see the effect in 2007 of the reallocations that took place in the mid-year review mentioned above. It is understood that MoF and MoP considered over 3,000 line-item variation requests during 2006. Preliminary analysis indicates that these variations were relatively small, reversed previous in-year reallocations and/or were predominately within administrative units (i.e. not between them). The high number of variations, however, suggests an administrative burden on line and central agencies, which could be impacting on ministries' ability to execute a budget as planned. In addition, it suggests that approved annual budgets are not well formed or grounded in a disciplined top-down and bottom-up budget preparation process.

52. **A primary cause of low levels of budget execution may be that top down approved budget allocations are significantly different to the bottom-up budget submissions of ministries.** A disciplined top-down and bottom up approach to budget allocation setting is needed. Hard administrative or sectoral ceilings, set at the beginning of the budget cycle (top-down approach), would allow ministries to prepare more detailed submissions in line with the administrative ceilings provided. Moreover, submissions could include comprehensive information on sector constraints faced when executing budgets.

Revenue Budgeting Issues

53. **Over the last three years, aggregate revenue out-turn did not go below 97% of budget revenue forecasts, thus scoring an A -, the highest possible score for a PEFA indicator.** This reflects both the Government's prudential revenue forecasting approach as well as the unanticipated sustained increase in the world price of oil, which effectively began in 2004. Revenue out-turns have consistently overshoot forecasts, although accuracy of annual forecasts have been improving

54. **In principle, budget credibility issues can arise in situations of over-budgeting or under-budgeting of revenues.** However, the PEFA framework awards low scores only in the case where actual revenues are significantly lower than budget. This recognizes the likelihood in such a situation of cash constraints impacting adversely on the ability of budget holders to execute budgets as a result of cash rationing by the central

⁶ CPA and PRB were established on April 21, 2003 and June 19, 2003 respectively. Both were dissolved on June 28, 2004. The PRB established the practice of frequent and unrecorded in-year budget variations (see IAMB reports)

authorities. In Iraq, however, cash constraints have not been a determinant of low budget execution performance in Iraq.

Payment Arrears

55. **An important issue here is the absence of reliable data on the stock of arrears for any of the last three years.** Iraq does not utilize any standard form of commitment accounting nor are there adequate systems in place to track expenditure arrears. Given the absence of data it is not possible to estimate the level of arrears with a very high level of confidence. Nevertheless, Iraq has a strong history of centralized controls in budget execution, which has probably prevented any substantial build up of uncontested arrears. Given the historical practice by Government officials to only commit public resources when funds are available and only when approvals have been provided at various levels, the stock of arrears may well be below 10%.

Section 2: Key Cross-Cutting Issues - Comprehensiveness and Transparency

56. **A set of 6 PEFA performance indicators is used to evaluate the degree to which a national PFM system displays the qualities of comprehensiveness and transparency.** These two attributes are closely linked. Comprehensiveness refers to the importance of exercising oversight of fiscal risk by ensuring that the national budget and financial statements cover all the major revenue and expenditure programs of government. Full reporting of the central government's current and potential financial relationships with sub-national government and other public sector entities, such as state owned enterprises, is essential to maintaining fiscal discipline and accountability. Equally important is transparency in the activities of government, which encompasses making user-friendly financial information available to the public and Parliament as well as employing a system of budget classification which permits meaningful analysis and interpretation of that information. A summary of the scores for these 6 indicators is provided in Table 4

Table 4: Comprehensiveness and Transparency Indicators

PI-5. Classification of the budget	C	M1
PI-6. Comprehensiveness of information included in budget documentation	D	M1
PI-7. Extent of unreported government operations	D+	M1
PI-8. Transparency of Inter-Governmental Fiscal Relations	D	M2
PI-9. Oversight of aggregate fiscal risk from other public sector entities.	D	M1
PI-10. Public Access to key fiscal information	D	M1

57. **Overall, the GoI's budget is not comprehensive but is becoming increasingly transparent.** The level of *unreported government operations is very significant*, estimated to be around 30% of Government expenditure. The classification of the budget is now based on the Government Finance Statistics (GFS) system. Two of the major

constraints faced by the GoI in progressing classification reform are the absence of multi-dimensional budgeting and accounting systems and fragmentation of the operating and investment budgets. The GoI's budget papers incorporate four of the nine best practice information items. Transparency of inter-governmental fiscal relations has improved significantly since Government now utilizes transparent and rules based systems in the horizontal allocation of resources to Sub-National Governments (SNGs). Consolidation and reporting against sectoral or functional categories, however, is pending. Oversight of fiscal position and fiscal risk of public corporations needs more attention. Improving access to fiscal information is also needed.

Budget Classification

58. Although GFS-based economic classifications are now being used during budget formulation in addition to primary administrative classifications, budget execution accounting systems used by ministries and governorates are currently using the legacy Chart of Accounts (CoA). These then need to be mapped to the GoI's new GFS-based classification system by the MoF in Baghdad, which creates a problem for the MoF, as does the consolidation of Investment Budget execution reports provided by ministries. These problems are causing difficulties and time-lags in reporting. The new system has significantly increased the workload of centrally based Government officials in both MoF and MoP. Functional reporting is not yet provided.

59. The legacy budget classification system differs from the GFS-based system in a number of areas. The primary weakness of the legacy system was the high level classification of items under the "*transferred expenditure*" budget chapter. In 2005, the transferred expenditure budget accounted for over 55% of the recurrent budget and the MoF controlled around 92% of all transferred expenditures. This level of aggregation in the budget was not transparent. It has been estimated that around 85% of the Government's "transferred expenditure" budget in 2005 would have been classified as social benefits, goods requirements or grants under a GFS based system. This level of aggregation, while not strictly GFS inconsistent,⁷ made it difficult for readers of budget statements to know where large expenditures were being allocated.⁸ Government significantly increased transparency in this area by moving to the new budget nomenclature in 2007. This not only improved external transparency, but also transparency within Government. Budget decision makers, such as the Council of Ministers and program managers, now get a clearer overview of major budget allocations.

60. The second transparency weakness is the fragmentation of the budget and the associated high level classification of "*investment budget*" items. Investment, development or reconstruction budgets are often not-termed capital budgets as a

⁷ Aggregation of economic classifications is not strictly GFS inconsistent classification if GFS-based financial statements can be constructed through direct attribution mapping. Aggregation of economic classification in financial statements, however, is strictly inconsistent with GFS recommended reporting formats.

⁸ Readers of Budget papers needed to refer to notes to the Budget to gain a deeper, though still incomplete, picture of major budget items.

significant proportion of expenditure is not for acquisition of non-financial assets. Up to 40% of the investment budget would not be classified as acquisition of non-financial assets under GFS standards. Moreover, it is understood that investment budget classifications used by the MoP are different to the Non-Financial Asset classifications used by the MoF under the new classification system.

61. Separation of the investment budget in to the same GFS-based budget classifications would increase transparency and shorten the time required for the MoF to quality assure monthly expenditure reports provided by Ministries and Governorates. The move to such separation is generally subject to the following preconditions: i) appropriate systems in place to record transactions at all levels of Government; ii) a well documented accounting framework and Chart of Accounts manual; iii) a communication and training strategy to ensure officials at the Ministry and Governorate level are aware and understand the new system; and iv) that the previous three items are complete prior to implementation at the beginning of a fiscal year.

Box 1: Six Dimensions to Multidimensional Budgeting and Accounting

1. When?

- ***Time classification*** to identify when the transaction is to be performed. Sub-dimensions can include time tracking of lapsing and non-lapsing programs and projects in a multi-year fiscal framework.

2. Who?

- ***Administrative classification*** (e.g. ministries and departments) that identifies who is responsible for making commitments or performing work on behalf of some other entity, thereby improving budget holders' accountability.

- ***Payer and Supplier classification*** to identify common revenue sources, contractors and supply chains elements.

3. What?

- ***Economic and line item/object classification*** to identify what is being bought or what type of money is being received (e.g. wages, goods, assets, oil revenue) for statistical reporting and fiscal control;

4. Why?

- ***Functional classification*** to identify the purpose for which resources are be allocated and spent (e.g. for health or education services). This facilitates historical and policy analysis.

- ***Program and sub-program classification***, to improve transparency and performance accountability for policy formulation, outputs and outcomes.

- ***Poverty reducing expenditure or fiscal priority classification*** (if different to functional and program classification) to improve linkages between a Government's overall policy framework.

5. How?

- ***Fund classification*** to track inflows and outflows of funds held for particular purposes (e.g. hypothecated revenue, stabilization, capital projects, internal service and pension funds)

6. Where?

- ***Location classification*** to identify where money is to be spent or where the benefits of spending are to be realized.

62. **One of the major difficulties in progressing classification reform is the absence of a *multi-dimensional* system for budgeting and accounting.** Modern budgeting and accounting practices require budget line items and transactions to be accounted for at the lowest level of detail. Manual systems, even with some computerization support, can not cope with the number of dimensions and sub-dimensions that require reporting. Commonly reported dimensions tracked during budgeting and accounting can be grouped into six themes: i) when; ii) who; iii) what, iv) why, v) how; and vi) where. Furthermore, these six dimensions have sub-dimensions. Consequently, the number of dimensions to be tracked can be too great without full computerization. Box 1 gives an overview of the six dimensions and is provided to underscore the complexity of multi-dimensional budgeting and accounting in a non-fully computerized system.

63. **Multiple financial and procurement management systems are also being developed by the central and line ministries.** This is causing coordination difficulties and compromising the setting of standards. There are six types of systems currently being developed by GoI agencies which are having an impact on the implementation of the new GFS based classification system: i) the legacy system; ii) the Iraqi Financial Management Information System (IFMIS); iii) the Development Assistance Database and National Investment Budget system iv) the central investment budget and procurement process management system – the Capital Budget Request and Tracking (CBRT); v) ministry specific FMIS’ (e.g. MoD); and vi) ministry specific procurement systems (e.g. MoI). Given the historical decentralized PFM arrangements in Iraq, it will be important that the Government develop a well defined implementation strategy based on standardization of budget and accounting classifications. A key first step to improve coordination will be the documentation of the accounting framework (see Chapter 4)

64. **The new budget classification system has reduced transparency for internal control in one area.** It is often recommended that a country’s PFM system should be able to demonstrate a high standard for the accounting of inputs on a cash basis prior to any move towards accrual, program or outcome budgeting. As such, most countries that are focusing on improving input accounting classify goods and services separately. The reason for this is to maintain fiscal control of the level of staffing, as the use of consultant services is frequently used to by-pass personnel hiring controls. The GoI’s new classification merged goods and services budget chapters. This is not a major concern given the relative size of the services budget in the past; however, it is an area that will need to be monitored.

Issues relating to the comprehensiveness of information included in budget documentation

65. **Four of the nine information elements of “best-practice” budget documentation are included in the GoI budget papers, but the information tends to be only partial.** These four elements are: i) key macroeconomic assumptions; ii) fiscal balance; iii) consistent reporting of current and budget year; and iv) summarized data for revenue and expenditure. While oil forecast assumptions are provided, other

macroeconomic assumptions presented have limited usefulness, as these are not used in a medium-term fiscal or macroeconomic framework, nor are they utilized by budget holders in the formulation of budget submissions. Key elements missing in the budget papers include: i) deficit financing tables, ii) debt stock; iii) financial assets, iv) prior year's budget out-turn; and iv) new policy budget implication tables. While budget papers refer to cash reserves and carryovers as financing the budget deficit, the composition and presentation is insufficient. Estimates of carryovers, outstanding letters of credits and other cash reserves should be provided. Comprehensiveness would also require that barter transactions and loans be reflected in the financing table associated with a consolidated budget.

66. **More information is needed to improve performance in this area.** The easiest, and probably the most important additional element, is the provision of the prior years estimated budget out-turn. This could be included even if the auditing of the accounts is not complete. A financial assets table and an enhanced financing table are the next easiest elements to introduce. Providing the information on debt stock levels is likely to be more difficult. Introduction of a table of financial implications of new spending, savings and revenue policies will need enhancements to the annual budget process. This would entail new budget submission templates and budget management systems. Quantifying the financial implications of major spending policies could, however, be handled centrally on an interim basis and presented in the annual budget papers.

Reporting government operations

67. **The level of unreported government operations is very significant.** For 2006, estimates of the value of oil production used to subsidize the supply of electricity supply and locally refined oil products was around 30% total expenditure, well over the 10% threshold for the lowest PEFA score of "D" (see Table 5). This is a priority area for fiscal reporting reform, as relatively simple measures will significantly increase the levels of comprehensiveness and transparency.

Table 5: Estimates of Barter Transactions and Off-Budget Subsidies (ID 'b)

Item	Year		
	2006	2005	2004
Oil related barter transactions - external	263	268	517
Oil resources used for electricity generation and fuel subsidies	10,142	6,779	5,022

Source: IAMB audits, MoF and IMF publications

68. **Estimates of the valuation of retained revenues by local and provincial councils are unavailable.** It has been estimated that some governors' offices collect less than 5% of their operating revenues from retained stamp and rental fees.⁹ However, collection and remittance of local and federal taxes and other service fees and charges is unclear. While the Government has a strong system of control for the opening of bank accounts, it is understood that there may be unmonitored Government bank accounts at

⁹ See World Bank, 2007, "Subnational Public Financial Management: A Diagnostic Report"

lower levels of government. The proposed move to a true Treasury Single Account (TSA) will greatly assist the GoI in monitoring bank balances and ensure only duly authorized accounts are opened and maintained. Further research will be needed to investigate anecdotal reports of collection of unreported and non-remittance of government revenues.¹⁰

69. Donor funded project expenditure is significant and income/expenditure information is publicly available. The level of financial information related to donor financed projects included in GoI fiscal reports is sufficient, although it is not provided in a complete and timely fashion. The latest fiscal report on donor projects produced by the GoI was tabled at the recent IRFFI conference in Bari, Italy in October 2007. Fiscal reports are available to the general public on-line using the MoP Development partner Assistance Database (DAD) though the completeness of the data is questionable.¹¹ While the budget and accounting classification system, standard operating procedures and administrative arrangements for the DAD need improvement, the main problem the Government faces is the timeliness and quality of donor aid flow information provided by development partners. It is recognized that the Government has made significant progress in operationalizing the DAD. Nevertheless, for the DAD to be effective as a resource allocation and reporting tool, increased support from development partners will be needed to ensure timely and accurate financial information is provided.

Transparency of inter-governmental fiscal relations

70. The GoI now employs transparent and rules based systems in the horizontal allocation among SNGs of unconditional and conditional transfers from central government (both budgeted and actual allocations). The system for transfers to the KRG is a population based rule after accounting for national public goods. While the system is unsustainable if applied to all regions and provinces, the transparency of inter-governmental fiscal relations has improved significantly. Horizontal allocation of certain resources to the provinces also utilizes a population based weighting method. Transparency of in-kind transfer allocations is a key issue that merits investigation and reform.

71. The status of the conditionality of sub-national transfers is unclear. While it is understood that transfers to the KRG are essentially unconditional, transfers to the Governorates seems to display characteristics of both conditional and unconditional transfers. Transfers to the KRG only require reporting of expenditure to allow MoF to consolidate reports and to facilitate the estimation of Iraq' System of National Accounts by COSIT. While the appropriation structures for transfer to Governorates imply conditionality requirements similar to ministries, the recently introduced practice of allowing governorates to retain unspent funds suggests that the transfers are essentially an unconditional grant to a general/sub national government unit. While it is common for federations to provide such grants, the policy in Iraq needs to be clarified and accounting treatment documented.

¹⁰ Public Expenditure Tracking Surveys (PETS) would assist in this regard.

¹¹ DAD access is available at: <http://www.mop-iraq.org/dad>.

72. The system for vertical allocation of resources and in-kind transfers to the governorates is essentially programmatic. The system for horizontal allocations of in-kind resources are, however, less clear than allocation of sub-national government financial resources. Most transfers of in-kind resources are considered public goods. While the system for horizontal allocation of social benefits under the Public Distribution System (PDS) and the Social Safety Net (SSN) payments are based on clear eligibility criteria and registration requirements, other systems for in-kind transfer allocations are less clear. For example, the process for allocating non-export oil and domestically produced oil products is uncertain. However, it is presumably based on need and cost factors such as supply shortages relative to other regions, and proximity to oil wells and refineries.

73. Information to the SNGs on allocations for the coming year is relatively reliable and timely. For the 2007 budget process, dialogue with the KRG and provinces occurred, although final allocations were not agreed until after the start of the fiscal year (and the same situation has obtained in 2008, with considerable political debate over the 17% allocation to the KRG). Before and during the 2008 Budget process, dialogue with the region and governorates was informed by draft resource allocation papers that were based on an agreed allocation formula and best available population statistics.

74. Difficulties in stakeholder consultation for development partner projects are causing problems for identification of all in-kind transfers to SNGs. Ministries and SNGs maintain that they are not aware of all of the projects being delivered under their portfolio. While the DAD has the functionality to help with identification of projects, the timeliness of information and the reporting system could be improved. The Government is currently undertaking consultation in this area. Enhanced dialogue with national and sub-national ministries and governments on the DAD and the information it contains will be needed to assist ministries and governorates gain a deeper understanding of resource flows at the sub-national level.

Fiscal Data Consolidation

75. While consolidated sub-national fiscal data is collected, it is not yet reported according to sectoral categories. The GoI is yet to publish consolidated sub-national fiscal data according to sectoral categories in annual reports. In 2006, fiscal data was collected using the legacy accounting system, which does not yet include functional or sectoral information. As discussed under indicator 5, mapping could be undertaken centrally to provide consolidated sectoral or functional information

Oversight of aggregate fiscal risk from other public sector entities

76. There is an absence of financial and audit reports for Autonomous Government Agencies (AGAs) and Public Enterprises (PEs), and there is no central consolidation of these entities' fiscal risks. Similarly, there appears to be no effective monitoring of AGAs and PEs fiscal position and associated fiscal risks. It is also

understood that sub-national governments can generate fiscal liabilities for the Government of Iraq.

77. Under Section 8 of the FML on Public Corporations, AGAs and PEs are required to submit fiscal information. The following are the three key reports required by these entities:

- Monthly accounts submitted to the competent ministry 10 days following the end of each month.
- Semi-annual accounts submitted to the Minister of Finance no later than July 15th.
- Audited final accounts submitted to the Minister of Finance no later than March 31st of the year following the end of the fiscal year.

78. Improving compliance with the FML by key AGAs and PES would allow the MoF to consolidate AGA and PE fiscal information. It would also allow MoF to monitor the overall fiscal position and associated fiscal risks. Introduction of certain measures, such as requests for reports, issuance of guidelines, and targeted PFM capacity development programs are likely to be useful in improving compliance by AGAs and PEs.

Public access to key fiscal information

79. The public does not have complete or timely access to key fiscal information, though the GoI does provides public access to certain fiscal information. The 2006 annual budget papers were not available to the public at the time of transmittal to the Council of Representatives (CoR), either through a citizen's guide to the budget or on a central web-site. The MoF does, however, provide access to budget documentation on request. While on-line access to the DAD is available it is understood that most Iraqis do not have access to the internet nor are they aware of the DAD facility. In year, year-end and audit reports have not been available to the public since 2003. Awards of significant contracts and information on the level of resources to primary service units are not published in one easily accessible website or published in local newspapers.

Section 3: Budget Cycle

Policy-Based Budgeting

80. Given that a government uses a budget as a vehicle for expressing its public policy priorities and choices in financial terms, as well as for defining the allocation of scarce resources, it is important to assess the way in which annual and medium-term budgets incorporate mechanisms to link financial resources to government policies. There is a particular risk that budgeting may be reduced to an incremental process which takes the previous year's budget for granted and makes no more than marginal adjustments to it without regard to either changing government priorities or the medium-term development perspective. For these reasons, the PEFA Framework incorporates two PIs focusing

respectively on orderliness and participation in the budgeting process and the time-perspective use in planning and budgeting (see Table 6 below).

Table 6: Policy-Based Budgeting

PI-11. Orderliness and participation in the annual budget process	C	M2
PI-12. Multi-year perspective in fiscal planning, expenditure policy and budgeting	D+	M2

81. **The GoI will need to reform key elements of the annual budget process if it is to improve the linkages between Government policy and the budget.** While a fixed budget calendar is enshrined in the Financial Management Law, adherence to it is weak, though improving. Approval of hard administrative or sectoral ceilings at the beginning of the annual budget process is not yet occurring and budget guidance is insufficient. Approval of the budget by the Council of Representative is becoming timelier. Much work remains to be done to establish a Medium Term Fiscal Framework (MTFF) within the context of the annual budget process.

Table 7: Budget Calendar

Financial Management Law (CPA # 95)	FML Deadline	BCC	2007 - Est Act.	Delay (days)	Comments
Finance Minister reports to CoM: Fiscal priorities for coming year Aggregate and Ministry spending limits Final accounts for previous year Progress against current year's budget	31 May		30 Jun	30	Month only specified in Law General priorities Absent Absent Absent
Finance Minister issues budget circular: Guidelines and objectives of fiscal policy Key economic parameters (from macroeconomic framework) Spending limits Spending units use budget circular as the basis for preparing their budget request	15 Jun		30 Jul	45	Month only specified in Law General guidelines Absent Absent - ceilings discussed administratively with MoF, MoPDC and line agencies Limited
Ministries send budget submission, based on budget circular, to Finance and Planning Submission includes: Recurrent and capital outlays for budget year and following two years Revenue from core activities Personnel requirements, multi-year commitments, foreign currency transactions	31 Jul	15-Aug	30 Sep	61	Month only specified in Law No forward estimates Included Staffing profiles included, multiyear commitments and foreign currency transactions absent Frequent revisions to proposed spending limits
Finance and Planning and Development Coordination Ministers hold talks with line Ministers to agree estimates If no agreement, matter referred to CoM	31 Aug	05-Sep	15 Sep	15	Month only specified in Law CoM initiated changes to proposals
Finance Minister sends draft to CoM Finance Minister submits draft Budget, as endorsed by CoM, to the Legislature. Budget Passed by the Legislature.	30 Sep 10 Oct 31 Dec		01 Nov 14 Nov 12 Jan	32 35 12	CoM initiated changes to proposals
Time for MDA Preparation: Law	6.6	Weeks	8.9	4.7	Average Delay (weeks)
Budget Preparation Manual	No	Budget Calander	Delays	Reasonable Time for MDAs	
		Unclear	Yes	Yes	Budget Circular inconsistent with FML
		Score	C		

Orderliness and participation in the annual budget process

82. **The legislative framework for the annual budget process is founded on the Constitution, the Financial Management Law, and subordinate legislation.** Section 4 of Constitution of Iraq, approved by referendum on 15 October 2005, provides exclusive authority to the federal Government of Iraq to formulate fiscal policy and prepare the national budget. Under Section three of the Constitution, the Council of Ministers (CoM) is required to submit the general budget bill to the Council of Representatives (CoR) for approval. Section three also provides powers to the CoR to reallocate proposed budget items and reduce the total budget. The CoR may recommend that the Government increase the total budget. The Presidency has the exclusive ratification authority for the annual budget law. Under section three of the Constitution, the Budget Law is considered automatically ratified if 15 days have elapsed after the CoR has transmitted the law to the Presidency, and if the Presidency has not sent the law back to the CoR for reconsideration.

83. **The Financial Management Law and Public Debt Law provides a comprehensive framework** for the conduct of fiscal and budgetary policy setting and the process for the formulation, execution and reporting of the federal budget. Through CPA

Order 100 of 28 June 2004, the Iraqi Interim Government inherited CPA Order 95. Section Six of the Constitution established that CPA Order 95 remains in force, unless annulled or amended. Some interim amendments to the CPA order 95 occurred through the passage of the 2005 and 2006 Budget Laws. Subordinate and implementing legislation for the Financial Management Law (FML) remains in development. FML implementing procedures being followed are based on ministerial and administrative instructions, historical practice and/or based on more detailed, though annulled, historical budget and financial management related legislation.

84. **A fixed budget calendar exists but adherence to it is limited.** The FML provides the key dates for the annual budget process, which provides sufficient time (just over six weeks) for ministries, departments and agencies (MDAs) to prepare detailed budget proposals (see Table 7). Delays occur in key elements of the budget calendar.

85. **The content of the Budget Call Circular (BCC) and budget guidance is deficient, although sufficient time is provided to MDAs to prepare budget submissions.** For the 2007 budget process, MDAs were provided with around two months for budget submission preparation. The BCC provides general policy direction instructions and the deadline for the submission of budget proposals to the MoF. The BCC also provides the time period (just over two months) for negotiations between the MoF and MoP and line ministries and staffing profile table and budget proposal templates.

86. The BCC is issued late and does not provide sectoral or administrative expenditure limits. An investment budget circular is also prepared by the MoP, which provides additional guidance on information requirements for investment projects. The MoP collates and approves project requests at the official level and forwards results to the MoF for consolidation, which provides process maps for Capital Investment Budget Processes and an FML based budget process map. A detailed budget manual has not been issued.

87. **The BCC could be improved** by including the following items and issuing a detailed budget preparation manual and conducting information session at BCC launch:

- ***Fiscal envelopes*** for all MDAs (or sectors). To improve input budgeting, it is useful to provide fiscal envelopes for salaries and wages, goods and services, minor capital and the investment budget. Fiscal envelopes could be adjusted by either compliance with a maximum percentage for additional budget bids or based on pre-approved new policy directions from the CoM.
- ***Background information*** on key budget data such as: updated revenue, expenditure and fiscal position estimates; National Development Strategy (NDS) and International Compact with Iraq (ICI) goals and actions; combined sources budget (i.e. development partner budgets) and sector investment packages; and project selection criteria.

Templates for budget submissions including:

- Ministry Budget Submission, which would include separate sections on key program priorities, key budget issues; key bilateral/multilateral project funding requirements, organization charts, program details and, costing summaries);
- Ministry expenditure and own source revenue according to the General State Budget and a Combined Sources Budget (i.e. including donor budgets);
- Governorate location of expenditure for federal spending as well as the special payments to the governorates and region;
- Program costings (costing justifications), covering staffing profiles and costs; overseas travel; local travel; training and workshops; vehicles costs; utilities costs (including electricity); minor capital, and Investment projects;
- Annual action plan templates; and quarterly reporting matrix templates.¹²

88. A detailed budget management calendar would help ensure compliance with the FML. A Budget Management Calendar aims to cover on a month-by-month basis all the tasks that need to be performed by the budgeting departments in the MoF and MoP to meet its essential requirements (see for an example). The key objectives of a Budget Management Calendar are to ensure: i) processes are stable and certain, with events and key dates known in advance; ii) there is a clear sequence of events; and iii) linkages between processes are well understood. The management calendar can cover a range of processes including the following:

- Planning processes;
- The Annual and Mid Year Review and resource allocation processes;
- The budget legislation planning process;
- Internal Government monitoring and review processes and reporting requirements; and
- External accountability reporting requirements (such as the Budget Papers and a Citizens Guide to the Budget).

89. Iraq's development partners are not involved in the annual budget process, even though it is clear that development partner projects have both immediate and medium term implications for the operating budget. Recurrent costs of development partner projects are discussed on ad-hoc basis, presumably with the expectation that ministries absorb immediate operating costs from current allocations. This approach may be causing difficulties in securing operational funding for development partner projects since discussions do not occur within the context of the annual budget process.

90. Recurrent cost implications are not collected by the Development Assistance Database (DAD) and a medium term fiscal framework is not yet in place. Consequently, it is difficult for the Government to identify, quantify, and budget for operational funding for development projects. The only system that collects recurrent cost implications of Government and development partner projects is the Capital Budget Request and Tracking (CBRT) tool, which is currently being developed by the MoP's Project Assistance Centre (PAC).

¹² MoPDC currently provides these for the investment budget only.

91. **Approval of the budget by the legislature did not occur before the commencement of the fiscal year in the last 4 years.** As in 2007, the 2008 Budget was not approved by the legislature until 13 February 2008.

Multi-year perspective in fiscal planning, expenditure policy and budgeting

92. **Forecasts of fiscal aggregates are prepared on the basis of main economic categories for four years.** Forecasts by function of government of sector are not yet constructed systematically. The first multi-year forecast based on economic classifications that was consistent with the Budget is documented in the International Compact with Iraq. The Government envisages that the medium-term forecasts will continue to be published within the ICI annual update reports and eventually in the Budget papers. Linkages between multi-year estimates and subsequent setting of annual budget ceilings are not yet occurring.

93. **Preparing multi-year fiscal forecasts and functional allocations within the context of the annual budget process is an important PFM reform measure.** Without this key PFM action, the budget process becomes compromised in other areas. For example, establishment of meaningful budget ceilings in budget call circulars is difficult without forward year estimates that are built from the bottom-up through the budget process. The top-down approach that estimates forward expenditures based on macroeconomic indicators such as inflation, knowledge of lapsing and ongoing programs and projects and known policy priorities is, however, a way forward pending the development of instructions, systems, and training on such systems.

94. **The most significant constraint in establishing a top-down and bottom up medium term fiscal framework is the fragmentation of the Budget.** While the Government has secured some coordination improvements between the MoF and MoP at the budget preparation phase and reform of budget classifications is progressing, the operational and investment budgets are not sufficiently integrated. Achieving budget integration in Iraq will be a complex task. Full integration requires completion of the following four elements, each with varying levels of difficulties: i) organizational and staffing integration; ii) integrated budget preparation; iii) integrated budget documentation and presentation; and iv) unified budget execution, accounting and reporting systems. This issue is discussed in detail in Chapter 2.

Scope and frequency of debt sustainability analysis

95. **On request by the GoI, Debt Sustainability Analysis (DSA) was undertaken in May 2004 by the IMF.** This analysis was primarily for external debt. However, domestic debt was also considered. It is understood that the GoI has undertaken some analysis of domestic debt¹³ in respect to large and small private creditors. The World Bank assisted the GoI in May 2007 with a fiscal sustainability assessment, which incorporated a review

¹³ Domestic debt is debt owed to creditors resident in the same country as the debtor, and denominated in local currency.

of external debt sustainability. DSA updates also occur regularly as part of the Government’s program with the IMF.

Existence of sector strategies with multi-year costing of recurrent and investment expenditure

96. **Sector strategies that are established within a multi-year costing of recurrent and investment expenditure framework are absent.** Strategic plans exist for a number of ministries (e.g. Ministry of Agriculture, Ministry of Education, Higher Judicial Council, the Juvenile Reform Department within the Ministry of Labor and Social Affairs, Ministry of Defense and the Ministry of Justice). The Rule of Law working group is progressing development of a sector strategy. Through this joint PEIA, the MoF and MoP are also in the process of developing a medium-term PFM reform program that will be costed in terms of operating and investment expenditure, with resources allocated from various sources including the Government’s Budget, multilateral agencies and bilateral arrangements. The GoI also established a general policy foundation to develop sector strategies, within the context of the NDS and the ICI. Systems are being developed by the MoP that are expected to support multi-year costing of recurrent and investment expenditure.

97. **Reform of the Government budget preparation process and integration of key elements of the Budget will be needed** to ensure that strategies that do get developed are properly costed and considered within the annual budget process.

98. **Linkages between investment budgets and forward expenditure estimates are not yet observable.** While some projects are selected based on sector plans, and some of these have recurrent cost implications estimated, these estimates are not shared during operations budgeting. Moreover, the forward estimates that do exist are not developed from such costings.

Predictability and Control in Budget Execution

99. **Two essential attributes of effective budget execution are its predictability and a rigorous control framework that enables proper stewardship of public funds.** In considering these aspects of a PFM system, the PEFA framework employs 9 indicators of performance, encompassing taxation issues, funds availability, cash and debt management, payroll controls, procurement and internal control, including internal audit. These indicators are wide-ranging, but, taken together, they enable an assessment of the degree in which the Government of Iraq’s budget is implemented in an orderly and predictable manner and how well the arrangements are functioning for the exercise of control and stewardship in the use of public funds.

Table 8: Predictability and Control in Budget Execution

PI-13. Transparency of taxpayer obligations and liabilities	B	M2
PI-14. Effectiveness of measures for taxpayer registration and tax assessment	C	M2

PI-15. Effectiveness in collection of tax payments	D+	M1
PI-16. Predictability in the availability of funds for commitment of expenditures	C+	M1
PI-17. Recording and management of cash balances, debt and guarantees	C	M2
PI-18. Effectiveness of payroll controls	D+	M1
PI-19. Competition, value for money and controls in procurement	D+	M2
PI-20. Effectiveness of internal controls for non-salary expenditure	D+	M1
PI-21. Effectiveness of internal audit	D+	M1

100. **No matter how well a budget is formulated, its effective execution depends on the existence and application of sound arrangements to collect revenues and to control disbursements, be they payment of staff or selection and payment of contractors.** Weak performance in any one of several aspects may seriously jeopardise the functioning of the PFM system and thereby the delivery of essential public services. Poor controls will increase the opportunities for fraud, error and corrupt activity. A weak framework of accountability and regulation will increase the scope for discretionary and dishonest behaviour on the part of public officials. The scores for the 9 indicators are shown in Table 8.

101. **In Iraq, taxation revenue accounts for only around 5% of Government's annually available resources, although the taxation system will increasingly be a key source of revenue for Government in the coming years.** In terms of transparency of taxpayer obligations and liabilities, Iraq's taxation system allows a relatively informed taxpayer to understand his level of tax liability, with some confidence that a fair system is in place. Controls in taxpayer registration exist and the system of penalties for non-compliance is sufficient. Tax audit and fraud investigation arrangements are, however, seriously deficient. Collection of tax arrears does not pose an immediate problem, although better systems are needed in preparation for a stronger taxation effort. Basically, sufficient arrangements for the appropriate transfer of collected tax revenue to the government from the revenue authorities are in place. However, the reconciliation systems needed to verify tax assessments, collections, arrears and transfers are appropriate need urgent attention.

102. **Predictability in the availability of funds** for commitment of expenditures is not seriously affected by the performance of the two central ministries, though predictability is undermined by systemic issues related to budget preparation, clarity, and understanding of budget execution procedures and weaknesses in existing book based recording and reporting systems.

103. **Cash and debt management practices do not pose serious fiscal risks** since Iraq has: i) well established liquidity management controls that date back to the 1940s; ii) received significant technical assistance with debt identification and reporting from international partners, such as the IMF, and iii) consistently followed its policy of not seeking any new non-concessionary loans. Fiduciary risks are emerging though in areas

of explicit or implicit issuance of government guarantees. The Government will need to pay close attention to these.

104. Payroll controls are inadequate and constitute a grave fiduciary risk and serious threat to fiscal sustainability. There is essentially no integration and reconciliation between personnel records and payroll data. Also, the timeliness of changes to personnel records and the payroll is detrimental to the Government's PFM system. Payroll auditing arrangements are only just capable of identifying and triggering responses to major payroll problems. (Payroll management is discussed in Chapter 6)

105. Procurement is an area in distress. The use of open competition for award of contracts is limited and the extent of justification for use of less competitive procurement methods is alarming. The operationalization of the procurement complaints mechanism is needed urgently.

106. Internal controls for non-salary expenditure need to be strengthened. Plans for the introduction of more effective expenditure commitment controls need to be considered now as current liquidity management systems will be seriously tested once budget execution performance improves or there is a significant down turn in the price of oil. Successful introduction of commitment controls into a long standing liquidity control environment takes time and requires proper consultation, planning, and enduring commitment. The comprehensiveness, relevance and understanding of other internal control procedures is found wanting as is the degree of compliance with existing and newly introduced rules for processing and recording transactions.

107. Internal audit arrangements are basically sufficient to provide early warning signals to responsible ministries and the central agencies, although some improvements in auditing methods are needed. The extent of management's response to internal audit findings is a major area where the Government needs to focus.

Taxation

108. Transparency of taxpayer obligations and liabilities concerns the environment in which taxation revenue administration functions. Revenue sources from most countries are from taxation activities. However, countries like Iraq present a different situation where revenue resources are mostly derived from non-tax activities (e.g. for selling petroleum and petroleum products). Therefore, it is essential that there should also be transparency surrounding the environment in which non-tax revenue is collected and reported.

109. Good tax collection systems depend on the over-all control environment that cover the following: i) clarity of tax policy, legislation and administrative procedures; ii) access to information; iii) ability to contest rulings on taxation (appellate process); iv) limitation of discretionary powers; v) cooperation from tax payers (individual and corporate sector); and vi) taxpayer education.

110. The GoI's tax revenue base represents around 5% of general revenue or approximately 2% of GDP. The Government is working towards increasing the tax base by improving the effectiveness of the tax and customs administrations. The General Commission for Taxation (GCT) and the General Commission for Customs (GCC) are responsible for revenue administration in Iraq. The Ministry of Oil, through the State Organisation for Oil Products and Gas Distribution (SOOPGD), is responsible for administering the hypothecated excise tax on sales of domestic fuels.

111. The legal framework for taxation is established around five major taxes, which represent over 90% of all tax revenue. Five additional minor taxes are also in place. Tax on international trade is the most significant source of revenue (30% of tax revenue). Reports indicate that half of all individual income tax (27%) is paid by Government officials. Corporate income tax is less than half of personal income tax collections. The existing consumption tax raises around 15% of all tax revenue but is limited to levies on services provided by deluxe and first class hotels and restaurants. A fuel excise tax on petrol, diesels and LPG is estimated to raise a further 10% of all taxation revenues. The tax is hypothecated to finance the State-owned fuel distribution network and is, in essence, a user charge.

112. Tax legislation is clear and comprehensive for three of the five major taxes. While exemptions and deduction provisions exist, they are clearly specified in legislation and discretionary powers are either strict or limited. However, the lack of procedural documentation that guides officials during assessments exposes the system to an appearance of unfairness.

113. Income and import tax payers have generally easy access to comprehensive, user friendly and up-to-date information on major taxes and administrative procedures. Bilingual websites are available and provide easy access to income and customs legislation and user friendly guidance. Half the income tax payers are civil servants, which helps with access to those without internet access. Withholding tax arrangements allows easy compliance. The GCC and GCT are both well represented throughout Iraq with offices at the Governorate level. The sales tax levied on services provided by deluxe and first class hotels and restaurants is very clear, since it is a flat 10% tax on specific hotels and restaurants. The sales tax collection process is clear and simple to administer. The excise tax on fuels is also easy to comply with, as the tax is included in the official prices for petrol, diesel and LPG. Minor taxes, such as the real estate, rental and transfer taxes, inheritance tax and agricultural land tax are not included in this assessment. However, they are understood to be more complex to administer.

114. Given that non-tax revenue represents around 95% of the Government's revenue, an assessment of the level of transparency surrounding this revenue source is warranted. Issues around the management of oil revenues are considered separately in Chapter 5 of the report.

Predictability in the availability of funds for commitment of expenditures

115. **Timely and consistent information allows MDAs to confidently commit resources¹⁴ without risk of default, inadvertently compromising the government’s cash position and/or breaching appropriation limits.** The quality of cash flow planning, monitoring and management partly determines the predictability of the availability of funds. The degree of predictability is also determined by how transparent in-year reallocation adjustment processes are, since unanticipated events that impact on actual revenue collections and expenditures often occur. Transparent processes provide incentives to budget well, plan and monitor cash requirements, and report timely and accurately.

116. **This issue focuses on MoF performance, but it also provides important information on the credibility of MDA budgets.** Predictability in the availability of funds is determined by the behaviour of both the MoF and MDAs. Credible MDA budgets facilitate realistic MDA cash requirement forecasting and reporting, which in turn, facilitates central cash flow forecasting and reporting. Credible MDA budgets also mitigate the frequency of in-year requests for adjustments to budget allocations. (See also indicator 20 for Iraq’s system of commitment controls, which is essentially through liquidity management rather than true commitment monitoring.)

117. **The FML and annually issued budget execution instructions outline the reporting processes that are critical for performance of cash forecasting and monitoring.** The FML establishes the main system for accounting and reporting as the “Treasury General Ledger” (TGL), which is required to be based on double entry principles. The following are key provisions in the FML and the Instructions for Executing the Federal Budget (2007 IEFB) that support cash forecasting.

- FML Section 9.7: MDAs are required to submit reports on realized receipts (and executed payments) to the Minister for Finance within 30 days following the end of each month. It also requires that consolidated monthly budget execution reports on receipts and payments reports be published and distributed widely.

- IEFB 2007
 - Section 1.1: Requires that agencies to provide TGL report to the MoF in “Trial Balance” form.¹⁵
 - Section 1.2: requires MDAs to provide monthly cash flow forecast reports and specifies the scope of such reports.
 - Section 1.4: MDAs are required to provide monthly unified use of funds reports to the MoF.
 - Section 4.4: Requires the MoF to report to the MoP within 30 days of the end of each month. MoP reconciles these reports with project implementation reports provided by agencies.

¹⁴ Or in other words, so that they can incur future obligations to spend money.

¹⁵ Trial balance reporting is the traditional reporting format that reconciles recorded expenditures with bank balance transactions

118. **The GoI essentially combines a top-down and bottom-up approach to liquidity management.** The top down stage utilized by the Accounts Department and Cash Management Unit of MoF in Baghdad is essentially a process of monitoring the following three elements:

- Overall cash position as reported by the Central Bank of Iraq (CBI);
- Actual and forecast cash in-flows obtained from information contained in monthly reports by the MoO, CBI, MoP and MoF departments (e.g. GCC, GCT; Debt Management Unit (DMU) and Budget Department); and
- Actual cash out-flows from cash releases by the MoF to MDA accounts held in the CBI and MoF Governorate accounts.

119. **The bottom up approach introduces two additional elements.** These elements rely on the timely provision of annual and monthly reports by MDAs and are as follows: i) actual cash spending as reported by MDAs and MoF treasuries located in the Governorates; and ii) updates to the annual and monthly cash requirement forecasts reported by MDAs.

120. **In practice, and as a MoF priority, liquidity is assessed at the beginning of the year and prior to in-year release of cash allocations.** Cash for employee compensation is automatically released on the on the basis of 1/12th of Budget appropriation allocations. Release for other expenditures are based on cash requirements and are not subject to time constraints, i.e. it is possible for an MDA to receive full access to their appropriation at the beginning of the year should a sufficient and compelling case be presented.

121. **The Government's liquidity position has not been constrained** due to the low levels of budget expenditure execution rates and overshooting of budget revenue forecasts. Rather, the opposite situation has prevailed with the Government of Iraq, drawing down from the DFI in New York and releasing to spending units far more cash than they have been able to spend, resulting in large idle bank balances. Consequently, the MoF and MDAs have had little incentive to focus on improving the quality of cash flow forecasting, even though a strengthened system would facilitate improvements in budget execution and budget preparation.

122. **A cash flow forecast was prepared for the 2007 fiscal year and key elements have been generally updated on a monthly basis.** The updates have been based on actual cash inflows and outflows reported by central agencies and MDAs. Improvements in the comprehensiveness of cash flow forecasting updates is constrained by the provision of timely and complete information from MDAs. The bottom-up cash flow forecasting approach is not yet delivering the required information. Trial balance reconciliations are also taking longer due to the implementation of the new GFS based classification system and discrepancies in reconciliations between project implementation reports provided to the MoP and TGL reports provided to the MoF by MDAs.

123. **In the case of the 2007 Budget, the Government decided that in order to improve budget execution performance, it would moderate internal controls and**

liquidity management practices. One measure was the relaxation of allocation release processes. There are two forms of allocation releases and three different allocation releases procedures. Allocations can either be in the form of: i) *cash transfer* to an MDA specified bank account held at the CBI or other authorised bank; or ii) an *authority to draw* on MoF accounts managed by central or governorate treasuries. The three types of allocation release processes are as follows:

- ***For employee compensation:*** Allocation is released automatically every month at the rate of 1/12th of the employee compensation amount as apportioned in the Annual Budget Law. The Budget Department issues the authorisation at the beginning of the year to the CMU in the Accounts Department for action. After confirming liquidity levels (and unallocated appropriations during the year) the Accounting Department issues the allocation authority.¹⁶ Changes to the 1/12th procedure are also approved by the Budget Department in consultation with the Accounts Department. The Budget Department checks the Budget establishment control list if appropriate.
- ***For other operational budget allocations:*** Releases are based on MDA requests. As a minimum, requests are included in the monthly reporting cycle through the trial balance reports, unified use of funds reports and cash forecast statements. MDAs can request allocations for any period length based on their cash forecasts and compelling justification. The process steps for the issuance are essentially the same as above except for the time periods and less involvement of the Budget Department.
- ***For investment budget allocations,*** the process involves MDAs, MoP and the MoF. MDAs provide unified performance reports to the MoF, which includes information on use of funds for investment budgets. To secure allocations and meet oversight reporting requirements, MDAs also report the MoP using prescribed forms on all approved projects in their investment budgets. MoP requires economic and technical feasibility reports of all projects and copies of correspondences related to project execution (e.g. direction to proceed and verification of works provided). Project reports are provided at the beginning of the year after the Budget has been passed and determines the initial cash and allocation requirements. These reports are tend to be quarterly, but can be updated more frequently. In-year investment budget releases are secured when the MoP writes to the MoF informing of their approval of satisfactory project progress. MoP's memorandum also prescribes the amount needed for release in accordance with the agreements with the MDA. After confirming that the project is an approved budget, that there is sufficient level of unallocated funds in the MDA investment budget and reconciliation with any unified reports received, the MoF then issues the cash transfer or authority to draw as appropriate. Once actioned, the MoF then informs the MoP.

¹⁶ Either through an instruction to: i) the CBI to transfer funds from the MoF central account to the sub-account of the MDA; or ii) an MDA treasury or MoF Governorate treasury providing the authorization to draw on MoF treasury sub-accounts.

124. There are opportunities to simplify and streamline the allocation and cash release processes. The existing process may be compromising the predictability of actual availability of funds to allow timely commitment of expenditures. It is understood that, while significant improvements have been demonstrated on allocation releases and investment budgeting, there remain reporting problems. Moreover, time-lags are occurring as a result of the time needed to resolve disagreements between the MoF, MoP and MDAs.

125. MDAs are officially allowed to plan and commit expenditure for at least six months in advance in accordance with the budgeted appropriations. In practice, however, it seems MDAs plan and commit expenditure on a quarterly basis. Current levels of predictability of resource availability appear not to be a result of low quality or untimely information provided by the MoF to MDAs but more of a systemic issue concerning planning and reporting.

126. Rules for in-year adjustments are clear. These are contained in the FML and temporary amendments reflected in the 2007 Budget Law and supported by issued instructions. Section 9.8 of the FML provides the scope and limits to in-year adjustments. Essentially, the law provides the following conditions for in-year adjustments:

- a maximum of 5% (10% as temporarily amended by the 2007 Budget Law) of an MDA's total appropriation (annual or supplemental) can be reallocated to another MDA providing that no funds are reallocated to another MDA's investment budget;
- a maximum of 5% of an MDA's total appropriation can be reallocated within the operational budget providing that no funds are reallocated from the MDA's investment budget for this purpose;
- a maximum of 5% of an MDA's total appropriation can be reallocated to the MDA's investment budget; and
- a maximum of 5% of the non-interest Budget can be provided to MDAs for urgent and unforeseen expenditures financed by the contingency reserve (the 2007 Budget Law introduced a 25 billion ID limit for each case);
- On a provisional amendment basis to the FML, an MDA's investment budgets can be reallocated to any MDA's investment budget¹⁷ if the MDA fails to execute 25% of their allocations by the end of the first half of the 2007 fiscal year (projects delayed due to security constraints are exempt); and
- A supplementary budget can be introduced to the CoR for more significant in-year adjustments "*only on the basis of a significant and unexpected change in economic circumstances or national priorities*" (FML Section 7.5).

127. While minor adjustments to budget allocations are frequent, the adjustment approval process is well administered. It is understood that over 3,000 minor in-year adjustments took place in 2006. Most of these, however, were multiple reallocations within MDAs and increases on request of MDAs. These reallocations (by value) were predominately for transfers to employee compensation financed by reduction in the goods

¹⁷ The Law is silent on whether funds can be transferred to operational budgets in this instance.

and services and non-financial assets of the respective MDA's operational budget. Two clarifications were required for erroneous presentations in the 2006 Budget table for pensions under the MoF's General Activities of the State Budget and the Ministry of Construction's Investment Budget. The high frequency and scope of within-MDA adjustments is an indicator that improvements during budget preparation and establishment list control procedures are needed. That said, the results indicate that fiscal discipline is established in terms of in-year adjustment procedural compliance.

128. **Significant decreases (by number) are rare.** Other expenditures for the MoF's General Activities of the State program represented by far, the most significant decrease at just under ID 300 billion in aggregate, representing 7% of the original allocation. There were only two other significant decreases to line items that occurred: the Other Expenditures budget of the Ministry of Interior and the Assets Maintenance budget for the General Activities of the State program. Each decreased by just over 25 billion in aggregate.

129. **Fourteen (14) MDAs had their allocations increased** in aggregate, which were basically funded by the decrease in the allocation of the MoF's General Activities of the State program. Only one minor breach of in-year budget reallocations was identified with the Ministry of Culture having their appropriation increased over the allowed limit by ID3.6 billion.

130. **Transparency of in-year adjustments can be improved** by more timely and detailed publishing of quarterly adjustment reports. Inclusion of a table containing each amendment that was approved in the quarter would make it easier for the CoR and other readers to understand the purpose of the variations, and also appreciate the technical capacity with the MoF.

Recording and management of cash balances, debt and guarantees

131. **This issue concerns the quality of public financial management system records and reports on the debt and cash position as well as the system for approvals of loans and guarantees.** Good management of public debt and government guarantees minimizes debt service costs and mitigates fiscal risks. It is common for governments to issue guarantees but they need to be recorded and monitored. Issuance of guarantees should be centralized and issuance to be made against a clearly defined criteria (transparency). The issue impacts on the three key budgetary outcomes: i) fiscal discipline; ii) strategic and appropriate allocation of resources; and iii) efficient use of resources.

132. **Poor debt management increases costs** (e.g. higher interest costs), which is inefficient and can create unnecessary fiscal risks (i.e. possible financial stress in the future). Iraq is now dealing with the effects of weak debt management practices of the past. Debt management systems are assessed against timeliness and completeness. "*Timeliness*" means that debt records are updated and reconciled on a monthly basis and

“*completeness*” means that debt management cover debt service, stock and operations of both domestic and foreign debt.

133. **The legal basis for government borrowing is defined in the Constitution and the Financial Management Law and Public Debt Law** of June 2004 (CPA Order No. 95). The Constitution provides the exclusive authority to the Government for negotiating, signing and ratifying debt policies. The FML prescribes administrative authorities and duties related to: i) the issuance of public debt and securities, ii) the payment of outstanding debt; iii) fiscal agents and depositories; and iv) matters concerning debt and securities management. The Law provides a special appropriation, which is indefinite and permanent, to the Minister for Finance (MfF) for the purpose of buying, redeeming, or refunding Government Debt Securities and for paying interest on securities.

134. **In 2005, the MoF established a Debt Management Unit (DMU)** to support the Accounts Department and senior management within the MoF. The DMU is the centralized government authority to contract new external and domestic debt. The issue and redemption of Government debt securities is managed by the CBI acting as the agent for the GoI. The Government has sought and received assistance from the IMF and the World Bank in this area. The GoI provides debt management data as part of its agreement with the IMF on a Stand-By Arrangement program.

135. **Debt management is a core Government priority** due to significant debt issued by former administrations. The Iraqi authorities agreed with the Paris Club on November 21, 2004 to a debt reduction for Iraq, equivalent to 80 percent in net present value (NPV) terms, to be achieved in three stages subject to the approval and completion of standard IMF programs.

136. **The Government has reduced its external debt stock by over 30%.** Irrevocable debt reductions totalling 60%¹⁸ of Paris Club debt were secured in 2004 and 2005 in accordance with the terms of the agreement with the Club. A remaining 20% reduction is contingent on successful completion of the final review of the third year of IMF standard programs (end-December 2008). Iraq has also resolved some of its debt to non-Paris Club creditors and most private creditors’ claims. Iraq has signed agreements with non-Paris Club creditors totalling \$3.4 billion and settled more than \$19.7 billion claims submitted by private creditors. Negotiations to resolve debt with non-Paris Club continues. The Government hopes that further negotiations will be facilitated by the Special Purpose Vehicle (SPV), which the Government established in March 2007 and provides single securitization of restructured debt to official creditors.

137. **Overall, domestic and foreign debt records are complete, updated, and reconciled quarterly.** Data quality is considered fair, but some gaps and reconciliation problems exist.

138. **The system for the consolidation of cash balances is assessed against timeliness and completeness.** “*Timeliness*” here means cash balances are consolidated daily and

¹⁸ Valued at around \$25 billion at the time of the Government’s agreement with the Paris Club.

“*completeness*” means all cash balances of the Government are consolidated. Cash balance requiring reconciliation include: a) the central cash position of the MoF; b) the cash position of other Government agencies; and c) extra-budgetary sources. A Single Treasury Account (TSA) is critical for timely and complete reconciliation. A TSA can be computerized for improved timeliness and accuracy or linked through manual systems. The GoI does not yet operate a TSA and this is a necessary key reform.

139. The GoI’s system for reconciliation and consolidation is founded on the “Trial Balance” method of reporting. Trial balance reporting is the Government’s traditional reporting format that reconciles recorded expenditures and receipts with bank balance transactions. Regular monthly reporting by most MDAs using the trial balance system allows the Government to know its essential cash position on a monthly basis, although it is understood that some difficulties are experienced with reconciliation of Governorate based accounts. Cash positions of accounts held at CBI can be provided on a daily basis. Calculation of most government cash balances take place at least monthly and the system allows for the consolidation of bank balances.

140. Public guarantees are basically a promise by the government or a government agency to carry out the contractual commitments of another in the event of default. A poor system for contracting loans and issuing guarantees increases costs and leads to inefficient use of available resources. Moreover, a good system promotes high levels of accountability (responsibility). Loans and guarantees should be clearly documented and monitored. In particular, guarantees should be: i) in writing, recorded and monitored; ii) issued centrally; and iii) issued in accordance with guidelines, rules and fiscal targets (e.g. limits established).

141. Debt management systems can be manual, computerized, simple and complex should be developed based on based on documented debt management policies. Systems are critical for timely reporting on debt portfolios and ensuring data integrity. Systems facilitate accurate debt service budgeting and timely payment of debt servicing. The Government’s system within the MoF is essentially manual, supported by spreadsheets. The system within the CBI is computerized.

142. The legal basis for issuing and contracting is defined in the Constitution and the Financial Management Law and Public Debt Law of June 2004 (CPA Order No. 95) (see the first dimension above). The Government has a debt policy that includes no new borrowing from the CBI as part of its program with the IMF. This policy has been complied with since inception. The Government does roll over treasury-bills; however, this does not constitute new lending.

143. Iraq became a member of the World Bank’s Multilateral Investment Guarantee Agency (MIGA) on October 21, 2007.¹⁹ The Government has also approved the signing of agreements with the Islamic Development Bank’s Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC). It is assumed that no guarantee has

¹⁹ Iraq will become a full member of MIGA once the ratification process is complete and its initial capital contribution is received by MIGA.

been issued recently in the Government.²⁰ Most guarantee related issues in Iraq are related to project payments and are handled through letters of credit.

144. **The DMU is the centralized government authority to contract new external and domestic debt.** The Minister for Finance is the Government authority for buying, redeeming, or refunding Government Debt Securities and for paying interest on securities. This authority is delegated in part to the DMU. The issue and redemption of Government Debt Securities is managed by the CBI acting as the agent for the GoI.

145. A program of assistance for MoF's DMU is in the early stages of development. The program is envisaged to be aimed at improving organisation and management of information on all domestic and foreign loans and guarantees. The Government anticipates that necessary software and hardware, as well as training for the staff of the involved financial institutions will be needed.

146. Central government's contracting of loans and issuance of guarantees are made within limits for total debt **and total guarantees, and always approved by a single responsible government entity.**

Effectiveness of payroll controls

147. This is an area of weakness that is discussed in detail in Chapter 6 of the report.

Procurement

148. **Transparent and systematic controls for procurement are critical for efficiency of expenditure and service delivery.** It is estimated that between 35% and 45% of expenditures go through the GoI's procurement system. Issues arise in relation to: i) use of open competition; ii) justification for use of less competitive methods; and iii) operation of procurement complaints mechanisms.

149. **An Operational Procurement Review (OPR) for Iraq was carried out by the World Bank** in early 2005. At that time, CPA Order No. 87 of 2004 was the prevailing legal basis for procurement as it suspended former regulations. The Order was generally found to provide a simple and sound basis for a new public procurement system, with the exception of a provision on negotiated contracts, and a few other shortcomings that were said would be addressed by implementing regulations. Such shortcomings included a lack of obligation to quantify evaluation criteria and acceptance of late bids under certain conditions.

150. **Established procurement procedures and practices have a number of elements that are not consistent with generally accepted public procurement practices.** These practices mostly reflect the regulations issued prior to 2003. Weak elements include the following: (i) inadequate requirements for registration of suppliers and contractors; (ii) lack of transparency and just debarment procedures; (iii) undue restrictions on access to

²⁰ Implicit guarantees may have emerged with some project agreements.

bidding documents, (iv) lack of transparency during bid submission, opening and evaluation procedures, and contract award procedures; (v) lack of effective procurement complaints mechanisms; and (vi) lack of access to information on contract awards.

151. The existing legal framework for procurement is now founded on primary and subordinate legislation. Procurement Law (CPA Order No. 87) is the primary legislation and is now supported by a CoM implementing regulation, and MoP regulations and guidelines. MoP's guidance includes: i) Purchase of Goods by Direct Invitation (Purchase Orders); ii) Minor Works; iii) Supply Requirements; iv) Contracts; and Commodities. Implementing regulations for Order No. 87 apply to central ministries, regions, and governorates. It allows five types of procurement actions and mandates procedures for bid opening, bid analysis, and contract award. It also requires that each ministry establish a contract office and provides preference for Iraqi firms in competitive international procurement. The implementing regulations are an improvement from the situation evident at the time of the first OPR. It will be important for the timely promulgation of the new Procurement Law to avoid entrenching undesirable practices.

152. The GoI has already introduced new measures to improve its public procurement system. These include: (i) drafting of a unified public procurement law;²¹ (ii) drafting of standard bidding and proposal documents; (iii) establishing of Office of Government Public Contract Policy; (iv) establishing of procurement assistance centers in Baghdad and the Governorates to provide capacity building and procurement troubleshooting to emerging procurement entities; and (v) publication of the implementing procurement regulations in the official gazette of GoI in April 2007. Procurement training on the new regulations and development of a procurement accreditation program is continuing. The Government is also considering a medium term capacity development strategy, which supports the implementation of the draft Procurement Law once it comes into force. A key component of this will be the "e-procurement"²² system which is being developed by the MoP. The Capital Budgeting and Request and Tracking (CBRT) that will be progressively rolled out over a number of years is essentially a project and information management tool and has central procurement process management capabilities. It is web-based and offers encouraging signs of added functionality and has high level ownership and support within the Government. Competition with the Development Assistance Database (DAD) is emerging.²³ It will be necessary to resolve functionality and data sharing issues in a timely manner.

153. The OECD/DAC and World Bank have developed a detailed benchmarking and measurement framework for procurement. The framework incorporates four

²¹ The MoPC envisages that the Unified Public Procurement Bill will be submitted to the Council of Representatives for review and approval early 2008.

²² The term e-procurement refers to is the transactions associated with the acquisition of goods and services using modern electronic media, particularly Internet technology.

²³ System development and effective operationalization appear to be superior with CBRT, given the DAD has said to operational for three years, although only one substantive data gather process has occurred. Moreover, CBRT system development, product support and training occur in Iraq and are planned for the governorates, where as the DAD, training and system development is almost entirely outside Iraq.

pillars for and features twelve indicators for performance measurement and monitoring (see Table 9). The purpose of the tool is to provide international standards and end the imposition of individual donor standards. It is also designed to facilitate integration of procurement reviews with the PEFA approach. A key recommendation arising out of the PEIA workshops on procurement is that the Government consider following the OECD/DAC methodology for the assessment of national procurement systems. In addition to providing a framework for the development of procurement reform policy development, the methodology provides a baseline set of indicators that will enable timely and consistent annual assessment of progress of reform efforts.

Table 9: OECD/DAC and World Bank Procurement Benchmarking and Measurement Framework

Pillar I - Legislative and Regulatory Framework	Pillar II - Institutional Framework	Pillar III - Procurement Operations	Pillar IV - Integrity of the System
Legal Framework	Integrated w/PFM	Operational Practices	Control and Audit Systems
Implementing tools	Management Capacity	Functioning Market	Appeals Mechanism
	Institutional Development Capacity	Contract Management	Access to Information
			Anticorruption Measures

Competition

154. **Open competition should be the preferred procurement method** as it: i) ensures quality and transparency of the process; ii) provides more choices to the government; iii) ensures that money is used efficiently and effectively; and iv) helps government improve service delivery. Unfortunately, insufficient data exists to assess the method used in Iraq to award public contracts. Although, it was stated in recently published regulations that, though open competition is one of the procurement methods to be used by Iraqi procuring entities, data is not yet available on the number of contracts above the threshold procured on the basis of open competition.

155. **Steps needed to enhance the use of open competition include:** i) institutionalize procurement planning and monitoring early in the budget formulation process; ii) identify and make known the governmental entity charged with data collection and analysis function for procurement; and iii) strengthen capacity for procurement implementing entities.

156. **Less competitive procurement methods such as direct contracting or single source selection should be used only in exceptional circumstances** such as for: i) standardization of equipment or spare parts; ii) proprietary equipment; iii) critical items related to performance guarantee; iv) and natural disasters. Contract extensions should also be limited to 15% in value. A risk assessment is needed on procurement processes within the context of current and changing security environment and existing and draft

legislation. Moreover, guidance on when security conditions and other situations are sufficient reason for use of less competitive methods is urgently required.

157. Justification for use of less competitive methods is however weak. Under the current implementing regulations, direct invitation requires a minimum of three bidders for invitation. This method is to be used when “warranted” by reasons such as “secrecy” or “need for speed of execution”. It is understood that these reasons are to be defined by the MoP in future instructions. Preliminary guidance issued constitutes a significant fiduciary risk. The regulations also specify that single-source is to be used only for the supply of goods or projects or for “specialized maintenance” projects and MDAs must first obtain “fundamental” approvals before commencing this form of procurement. It is unclear on what basis “fundamental approvals” would be given. Purchasing committees are used for commodities and services whose values are less than 50 million ID.

158. There are three procurement approval bodies that are required to assess justifications and processes followed for less competitive methods. 1) Executing Ministries and Provinces have “Tender Analysis and Recommendation Committee (TARC)”, which analyze tenders; and “Central Committees” chaired by Governors, deputies, and members of the concerned directorates. 2) Ministry of Planning and Development Coordination promulgates procurement, contracting and investment budget execution regulations. 3) The High Contracting Committee reviews and approves proposed contracts above a certain threshold amount. Inspector Generals and the Board of Supreme audit also undertake procurement audits. Information on the number and types of justification issued is not yet available, although MoP has indicated that the security situation is often cited for justification of project delays and procurement method selection.

159. In February 2008, the Council of Ministers has approved new regulations to improve the GoI’s execution of its capital budget. The CoM has lifted the previous ceiling on the amounts ministerial contracting committees can approve. Defense, Interior, Oil, Trade, Health, Electricity, Industry and Minerals, Water Resources, and Municipalities committees may now approve contracts worth up to \$50 million. This represents a \$30 million increase for Defense, Oil, Electricity, and Trade and a \$40 million increase for the other ministries listed above. A newly formed Central Contracts Committee chaired by the State Minister of CoR Affairs will approve contracts exceeding the \$50 million limit. This is expected to expedite rates of budget execution and project development.

160. Justifications for use of less competitive methods are listed in the recently published regulation, although they are weak. Moreover, data is not available to assess whether less competitive methods of procurement are justified in accordance with regulatory requirements.

Complaints mechanisms

161. **The recently published regulations highlight the procurement complaints process with clear time frame for resolution of complaints.** However, it has not been tested as there has been no procurement complaints submitted so far. Under Order 87, the MoP is given the role to make determinations on contractor protests and claims in accordance with existing regulations.

Internal controls for non-salary expenditure

162. **The effectiveness of expenditure commitment controls is important to ensure that the payment obligations remain within limits of forecast cash availability and budget allocations.** It is the key control that facilitates avoidance of significant levels of expenditure arrears.

163. **A commitment is stage in the budget execution process and is that point where a future obligation to pay is incurred.** For example, a commitment consists of placing an order or awarding a contract for goods or services to be received. It entails an obligation to pay only if the third party has complied with the provisions of the contract. Some “budgetary” commitments are recorded at the verification stage rather than the true commitment stage (e.g. monthly wage bills and interest payments due). In this instance the obligation to pay actually occurred earlier.

164. **At the commitment stage (financial control) it is necessary to verify** the following four elements: (i) the proposal to spend money has been approved by an authorized person; (ii) money has been appropriated for the purpose in the budget; (iii) sufficient funds remain available in the proper category expenditure; and iv) the expenditure is proposed under the correct category.

165. **The FML defines “Commitment” as “an undertaking to make an expenditure following the conclusion of a binding agreement that will result in a payment”.** This is definition is consistent with international practice. Key references to commitment in the FML are as follows.

- Section 4.5 requires that forward commitments²⁴ must be disclosed in the Budget. Contract specification rules support compliance with this even though future commitments are not specified in the budget. The rules require that contracts be specified for one fiscal year or that multi-year “strategic” contracts must have a subject to availability of funds and appropriations clause.²⁵
- Section 6.4 requires that Investment Budget submissions must include estimates of the value of outstanding project commitments.
- Section 11.1 states that Budget executors are responsible for the accounting for commitments.
- Section 11.3 requires the Minister of Finance to prescribe procedures for accounting of commitments.

²⁴ Forward commitments are commitments in the years following the budget year.

²⁵ In Iraq, multi-year projects are classified as “strategic projects”.

166. **Article 11 of the 2007 Budget Law temporarily amends Section 4.1 of the FML on the lapsing of unspent appropriations at fiscal year end.** The provision allows the MfF to approve advances up to certain amounts for operational and investment commitments, and allows the CoM to advance unconstrained amounts for investment commitments, against the following year's (2008) Budget appropriation. This treatment is part of the legacy Public Financial Management framework and is designed to resolve multi-year project and contracting constraints. The provision is not inconsistent with the FML on a prima facie basis as it is compliant with Section 6.4 on budget submission requirements. The treatment essentially formalizes a carryover estimation process that would normally form part of the annual budget process. Inconsistency or a lack of transparency may emerge though if those advances are not reported as part of the 2008 appropriation. The main benefit of the article is that it provides necessary assurances to local contractors, which have experience with the legacy PFM system, that a particular multi-year contract is valid. A gradual move from liquidity based internal control to commitment control will greatly improve contract specification and lower prices, thereby increasing value for money. It will also improve financial management generally.

167. **Law No. 28 of 1940 on Public Accounting Principles established liquidity accounting and pre-transaction audit** as the primary form of internal control to manage appropriations and cash. It is essentially a system of pre-transaction audit. This is not true commitment control, although the objectives may be similar. Basically, approvals for issuance of a purchase order from authorised officials at the program or project management level are required. These officials are responsible for checking such items as cash availability. A purchasing committee then has the management authority to procure.

168. **The Government uses a combination of liquidity management and contract specification practices to control expenditures** to ensure cash and appropriation limits are not breached. There is no formal system to track error or rejection rates. Error and rejection issues during routine financial transactions reported by the MoF, Inspector Generals and BSA indicate that the controls are only partially effective. The level of error and rejection rates is an issue to be explored further, especially in terms of provincial capacity and system design. The payment of temporary staff and allowances is allowed, however, internal control procedures appear to be absent.

169. **A computerized financial management system is critical for commitment control**, given the number of transactions involved and recognizing that introduction of one dimension to accounting classification has an overwhelming impact on workload required to maintain a book based system. Implementation of a Financial Management Information System (FMIS) commenced in 2004. The FMIS that was developed did not incorporate commitment control as part of the implementation strategy. Preparatory work needed for successful implementation within a commitment control framework did not occur. Documentation of existing accounting and internal control frameworks are pre-conditions for success.

170. **Guidance issued on true commitment controls is limited**, however, it has been communicated that commitments are to be tracked "off-line" since budget execution

systems do not record or report on commitments. MDAs have been recommended to use a “Projects Review Book” to track commitments. Follow-up actions on this recommendation are uncertain.

171. In 2006, appropriation breaches or cash constraints were not evident; however, this could be for reasons other than the strength of internal controls (e.g. low levels of budget execution mitigating cash constraints). Problems could well emerge when budget execution performance increases and/or there is a down turn in the price of oil during a fiscal year.²⁶

172. In summary, some forms of expenditure commitment control procedures exist but they are only partially effective. The controls are based on liquidity management procedures, contract specification rules, sanctions and oversight. Legacy commitment controls have been weakened to facilitate budget execution performance. The controls do not comprehensively cover all expenditures and they are occasionally violated.

Other internal control issues

173. Types of internal controls for non-salary budget execution are: i) verification control; ii) accounting (payment) control; ii) and audit. The verification stage generally occurs when goods and services are delivered. Documentary evidence that the goods have been received or that the service was actually performed should be required and verified. Accounting control occurs before payment is actually made. At this point it is necessary to confirm that (i) a valid obligation/commitment exists; (ii) a competent person has signified that the goods have been received and that the service has been performed as expected; (iii) the invoice and other documents requesting payment are correct and suitable for payment; and (iv) the creditor is correctly identified. Audit occurs after final payment is made. At this stage it is necessary to examine and scrutinize any expenditure and report any irregularity. This is assessed in the following indicator.

174. Verification rules for non-salary expenditure consist of a basic set of documentary and approval requirements. Investment budget verification guidance is issued; however, guidance on what constitutes appropriate documentary evidence is lacking. The MoP requires submission of all verification documentation and correspondence with contracting entities associated with an investment project. Multiple approvals are required (including project manager, DGs, ministers, MoP and MoF) according to the type and value of expenditure payment. Verification rules for non-salary operational budget expenditure are based on pre-transaction audit method. Current information management systems are not sufficient to cope with the number of transactions required to improve verification control and compliance monitoring.

175. Accounting (payment) controls for non-salary expenditure are also founded upon a pre-transaction approach and consist of a basic set of compliance checks. Multiple approvals are also required, though approval requirements are limited. Payment control requirements are different according to payment type. For the investment budget

²⁶ This event should be identified in or trigger a Mid-Year Review to be addressed in a Supplemental Budget.

for example, there are five different forms of payment: i) contract advances; ii) letters of credit; iii) allowable administrative costs; iv) payment of contractor invoices and return of bid or performance bonds. Investment budget payment controls consist of a basic pre-transaction review, which checks that: i) the project is in the budget; ii) sufficient funds are available; iii) the payment is consistent with the relevant contract; and iv) invoice is in the proper format. Checking that a competent person has signified that the goods have been received and that the service has been performed as expected, and that the creditor is correctly identified, does not formally occur. Key components of essential payment control systems are in place, but current information management systems are not sufficient to cope with the number of transactions required to significantly improve payment control and compliance monitoring.

176. Other key non-salary controls are undeveloped. They include; i) procurement process controls (e.g. monitoring of appropriateness of procurement method); ii) rules for the prevention and detection of mistakes and fraud (internal and external audit are assessed later); iii) the safeguarding of information and assets (e.g. lack of guidance on asset registration); and iv) specification of quality standards for accounting and reporting. Some guidance has been issued on the requirement for the safe storage of information. There are rules for allowable expenses, incentives and bonus payments; however, documentation requirements and guidance on these is limited.

177. Non-salary expenditure control rules and procedures consist of a basic set of rules for processing and recording transactions. Multiple approvals at every stage of the transaction are often required. The rules are only partially relevant. It is evident that rules are understood generally by those directly involved in their application. Some rules and procedures may be excessive, such as multiple approval requirements, while other controls are deficient, such as accurate identification of creditors and vendors. Control rules are basically relevant to Iraq's situation, however, certain high risk points are not adequately monitored (e.g. letters of credit payments and verification of valid commitment). The system does not have an excessive number of financial controllers and there is only minimal computerization involved in processes. Accordingly, the control system may be inexpensive but the level of effectiveness is unclear.

Compliance with rules for processing and recording transactions

178. Existing rules are generally complied in the majority of transactions, but simple procedures are followed and the use of emergency provisions is believed to be frequent. At the payment (accounting) control stage it is unclear whether all aspects of control procedures are properly followed. Compliance with liquidity management and payment controls rules generally applies and is monitored by the MoF. It is understood that performance varies considerably between MDAs, as well as within MDAs and Governorates. Central agencies report that there are compliance problems, due mainly civil service experience, capacity or security constraints. In addition, there appears to be a consistent lack of identification and recording of contract vendors, which constitutes a significant fiduciary risk. Compliance with letters of credit payment procedures is a key cause of payment delays, although disputes on verification requirements are often cited.

Assessment of compliance with other rules such as allowable expenditures, return of bid bonds, advance payments is difficult due an absence of documentary evidence; however, reports by the Inspector Generals and the BSA indicate that compliance is low.

179. **Verification controls for investment budget are generally followed** although documentary evidence is often lacking. Furthermore, internal procedures differ due to diverse interpretation of guidance or lack of experience. Multiple verification approvals are required. This does necessarily increase assurance that services or goods have been delivered as expected. The quality of verification is uncertain.

180. **At the verification stage of the operation budget, documentary evidence is also often deficient**, although the MoF does not require these for the operational budget since responsibility is delegated to MDAs, consistent with FML provisions.

181. **Compliance with other key non-salary controls is low.** Safeguarding of information and assets is weak. Compliance with existing standards for MDA accounting and reporting is inconsistent. There are rules for allowable expenses, incentives and bonus payments, however, documentation requirements and guidance are limited. While minor adjustments to budget allocations are frequent, the adjustment approval process is well administered. These other controls are key components of effective internal control systems.

Internal Audit

182. **According to Section 11 of the FML 95/2004, it is the responsibility of budget executors to establish arrangements for accounting and internal control of the transactions of spending units and sub-units under their jurisdiction.** The FML also empowers the MfF to prescribe internal control arrangements, accounting procedures, standards and timelines. The Minister may also issue special orders to spending units including all levels of sub-national government (SNG) for the submission of financial reports and final accounts. Within each agency, there is a Directorate that performs *ex-ante* control (or pre-disbursement “audit”). These Directorates are headed by a Director General who is meant to be independent of the minister concerned. S/he is responsible for ensuring that there is a budge allocation and of clearing each stage in the expenditure cycle (commitment and payment order) to ensure its regularity and legality according to prescribed criteria (correct documentation, proper application of procurement or wages rules, correct budget classification).

The Inspector General System

183. **The IG system in Iraq is modeled on that of the USA.** There are currently 37 IGs, of whom 31 are in ministries and 6 in other organizations like the Central Bank of Iraq. The IG is meant to provide regular assessments of the adequacy and effectiveness of the organization’s decision-making, risk minimization and internal control processes. The IG is also the main point of contact for Iraq’s Supreme Audit Institution, the Board of Supreme Audit (BSA). The IG Office is to provide information on the status of execution

of its internal audit plan, and to co-operate with the BSA in ensuring follow-up of BSA audit recommendations. The IGs are responsible for conducting internal investigations within their organization when necessary. Cases of fraud, theft, embezzlement or corruption are ported to the Commission of Integrity (COI). The IG's office acts as the conduit for any organizational documents and assistance required by the COI

184. There are currently 2,500 employed in the entire IG system. The IGs are appointed for a five-year term by the President following confirmation by a majority vote of the Council of Representatives. The five-year term can be renewed at the discretion of the President, subject to confirmation by a majority of the Council of Representatives. Before 2004, there was no system of internal audit as such in Iraq. There were General Inspectors in the previous regime; however, they were there more as informants for the regime, rather than internal auditors. The only equivalent office was a field audit unit operating within the MoF Accounting Department. At the request of the MfF, it performed ex-post audits of selected ministries and other public entities.

185. There are substantial capacity development needs in the IG departments. Although they are operational in government departments and other bodies, there are serious concerns regarding their ability at their current stage of development to apply modern internal audit practices and international auditing standards.

186. The Inspectors General issue reports with recommendations to the Minister, who may either accept or reject the report. Reports that address cases of fraud are required to be copied to the Commission of Integrity (the former Commission on Public Integrity).

187. Follow-up on IG reports appears to be limited. If the Minister rejects the report, there is no further action by the IG. Even if the Minister does accept the report and its recommendations, there is no follow up by the IG to see if the recommendations have been actually implemented

Accounting, Recording and Reporting

188. Accounting, recording and reporting are essential components of a PFM system. Without completeness, accuracy, timeliness and reliability in the accounting function, it is impossible for management to take informed decisions and to control and direct its operations effectively. Similarly, the Government as a whole will be unable to complete and submit for audit its annual financial statements in a timely manner. As a result, public accountability will be weakened in the absence of full reporting of government activity. Thus this element of the PEFA Framework uses 4 PIs to assess the adequacy of records and information that are produced, maintained and disseminated by Iraq's PFM system to assist decision-making, management and reporting. The scores for all 4 PIs are shown in the Table 10 below.

Table 10: Accounting, Recording and Reporting

PI-22. Timeliness and regularity of accounts reconciliation	D+	M2
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PI-23. Availability of information on resources received by service delivery units	D	M1
PI-24. Quality and timeliness of in-year budget reports	C	M1
PI-25. Quality and timeliness of annual financial statements	D+	M1

189. **Reconciliation processes for suspense accounts constitute a serious fiduciary risk.** In particular, procedures for the reconciliation and clearance of suspense accounts for letters of credits need to be urgently documented. Reconciliation of bank account data is adequate, although procedures need to be improved for more thorough and timely checking of accounting data and bank statements.

190. **Information on resources received by service delivery units** is not available. While relatively reliable data exists on budgets and expenditures for MDAs at the provincial level, obtaining and reporting on more detailed information is either absent or too resource intensive to collate. At the school and hospital level, data is readily available on the amount of salaries allocated and spent on teachers and health care workers. However, data on allocations and expenditures to these service delivery units for critical operating expenditures, such as pharmaceuticals, medical supplies, text books and equipment is not readily available. Some systems continue to be developed for the collection of data on cash and in-kind resources received by primary schools and health clinics. It is envisaged that it will take some time to get these systems sufficiently operational at the required level of detail. Commissioning Public Expenditure Tracking Surveys (PETS) in Health and Education sectors, while difficult to carry out, will be an important source of information that will improve transparency of resource transfers to front-line service delivery units. Support from development partners will be needed to ensure that data related to budgeted and actual delivery of resources from development assistance projects to service delivery units are routinely collected.

191. **In-year budget execution reports** are adequate since comparison between budget and budget execution results is possible for most administrative and economic classification, although only at the payment stage. Relatively complete reports are available on a quarterly basis (though there is still a significant time lag, albeit one that appears to be reducing). MDAs provide “trial balance” reports, which separate expenditures for employee compensation, goods and services and non-financial assets. The MoF is directly responsible for producing in-year reports for almost all the other economic expenditure classifications (i.e. Interest, Subsidies, Grants, Social Benefits, Other Expenditures and Pension payments). The appropriation to the KRG is treated essentially as an unconditional block grant, which does not require reclassification in the GoI’s in-year or out-turn reports.²⁷ The investment budget is aggregated in the annual federal budget. Consequently, it is not possible to compare budget and in-year performance at a more detailed economic classification level for investment budget expenditures (e.g. acquisition of non-financial assets and consultancy projects). Given current financial management systems, comparison of expenditure commitments and the budget is not yet possible. The quality of information is compromised by concerns

²⁷ Reconciliation of final deemed appropriations to the KRG is needed and depends on final revenue outturns and revenue sharing modalities and agreements.

associated with: i) fragmentation of the investment and operational budgets; ii) opaque accounting treatment for certain expenditure items (including suspense accounts); and iii) the implementation strategy for the roll-out of the new GFS-based classification system.

192. There are concerns about the accuracy of information in quarterly reports. Data quality concerns are associated with: i) fragmentation of the investment and operational budgets; ii) opaque accounting treatment for certain expenditure items (including suspense accounts); and iii) the implementation strategy for the roll-out of the GoI's new GFS-based classification system. The concerns, however, do not substantively undermine the usefulness of reports.

193. Fragmentation of the investment and operational budgets is causing some duplication in the reporting of investment expenditures. While instructions have been issued to minimise the risk of fragmentation problems in reporting, it is evident that MDAs report regularly to the MoP using different methods for expenditure accounting. Moreover, it is clear that the High Economic Committee relies on these MoP produced reports to initiate corrective action. Differences in accounting treatments include differences in time periods for reporting (MoP often receives reports for different time periods for consolidated reporting) and some differences in economic classifications associated with the acquisition of non-financial assets.

194. There are concerns that investment expenditure reports include a mixture of commitments and expenditures. Apparently, values of signed contracts may be inadvertently included as expenditure in MoP reports, due to opaque guidance. This has been evident with substantive differences between MoF unified reports and MoP reports. This issue will need to be explored as a matter of priority as, if true, the practice will seriously undermine the usefulness of the reports used during in-year budget reviews. While improving clarity on reporting arrangements and accounting frameworks will provide greater transparency and improved confidence levels in the data, integration of the budget is the long-term sustainable solution (see Chapter 2 on Capital Investment Budgeting).

195. The implementation arrangements for the roll-out of the new GFS based classification system is having unintended consequences for perceived data quality. While the legacy classification system is still being used by MDAs, the MoF is producing in-year reports using the new classification system. This does not materially impact on MDA operational expenditures, since the MoF is responsible for executing and reporting around 85% of the former "transferred expenditures"²⁸ budget chapter. Nevertheless, the lack of separation and clarity associated with the accounting for investment expenditures has increased uncertainty of data quality and has extended delays during the consolidation process.

196. The ability of a public financial management system to produces complete, timely and understandable annual reports provides a good litmus test of how well

²⁸ . Interest, Subsidies, Grants, Social Benefits, Other Expenditures (e.g. contingency reserve and compensation payments to Kuwait) and Pension payments.

the system is performing. Annual financial statements in Iraq are barely adequate. While the MoF produces a consolidated government statement annually, they are often incomplete due to MDA reporting delays, delays in closure of accounts and clearance of suspense accounts. While the BSA generally receives a set of financial statements within 6 months, there are frequent amendments to those statements after transmittal. Moreover, there is only limited disclosure of financial reporting and accounting standards followed for the preparation of financial statements.

197. Section 11.7 of the FML outlines the scope of information of annual financial statements. The section requires the following to be included:

- External audit report from the Board of Supreme Audit;
- A statement of differences between budgeted and executed receipts and payments and on the financing of any deficit or the use of any surplus;
- *A statement of spending from contingency reserves;*
- *Opening and closing balances of the Treasury Consolidated Account and a summary of movements for the year;*
- *A statement of all federal government borrowings for the year, and the total debt outstanding, including any payment arrears;*
- *A statement on federal government guarantees issued during the fiscal year;*
- *A statement on all borrowings by regional governments and governorates;*
- *A statement on outstanding amounts on capital contracts and retentions (carryovers) due on contracts;*
- *A statement on letters of credit entered into for which funds have been placed but for which goods have not been received; and*
- *A statement on all guarantees by regional governments and governorates.*

198. Section 5.4 of the Law requires that the BSA be provided with additional information on the operations of the petroleum revenue account. Since the President of the BSA is the chair of the COFE, the BSA is effectively provided with timely access to this information. Section 14 outlines what information is required to be delivered to the BSA with the financial statements and includes the following:

- Approved federal budget and any supplementary budgets, and any accompanying documents (e.g. in-year adjustments);
- Results of all internal audits;
- Quarterly and annual reports on loans, borrowings, guarantees, and debt;
- Final accounts of public corporations and the results of all audits; and
- Any other documents, information and explanation requested by the Board of Supreme Audit in connection with the performance of its audit functions.

199. A consolidated government statement is prepared annually, although it is not fully complete. Complete information on all assets and liabilities is not provided in the annual consolidated financial statement. In addition, information on revenue, expenditure and bank account balances is not always comprehensive as some accounts remain unclosed due to ongoing investigations into unresolved discrepancies associated with trial balance reports. These omissions, however, are not likely to be material. Other

information required by the FML, as indicated by *italics* in the list above, are not yet included in the reports.

200. Section 11.6 of the FML requires that annual final accounts of the federal budget be submitted to the BSA for external audit by 15 April of the succeeding year. This timeframe of 3½ months is very tight. Provision of annual financial statements for external audit within six months is considered best practice.

201. Annual financial statements are provided to the BSA within 6 months of the end of the fiscal year. However, the statements are often not sufficiently complete as a number of MoF initiated clarifications and corrections are made after the statements have been transmitted to the BSA. For the 2004 and 2005 fiscal years, substantively final statements were provided within 15 months. For 2006, substantively final accounts were provided to the BSA within 10 months.

202. Annual financial statements are presented in a consistent format over time, although with only limited disclosure of financial reporting and accounting standards followed. While the BSA has established private sector accounting standards, they have not yet been formally established as the national standards for public sector accounting.

203. Iraq’s public sector accounting and reporting standards have been developed over many years and have been reflected in different subordinated legislation, which has since been rescinded and ad-hoc guidance. The move to GFS based classification system in 2007 has also delayed the adoption of national standards for public sector accounting and financial reporting and introduced inconsistency in the presentation of financial statements.

External Scrutiny and Audit

204. The final link in the public accountability chain is forged by the work of the national Supreme Audit Institution (SAI), its reports to parliament and the follow-up action taken by the Executive as a result of this public scrutiny process. In this regard, Parliament, aided by the SAI, is acting on behalf of the general public, in holding the Executive to account for its actions, including its management of public resources. The PEFA Framework employs three PIs to assess how effective the arrangements are operating for the scrutiny of public finances and follow up by the Executive. The relevant scores are shown in the Table 11 below.

Table 11: External Scrutiny and Audit

PI-26. Scope, nature and follow-up of external audit	D	M1
PI-27. Legislative scrutiny of the annual budget law	D	M1
PI-28. Legislative scrutiny of external audit reports	D	M1

205. High quality external audit is a critical component of a country's accountability framework²⁹ as it is essential for creating transparency (clarity) in the use of public money. Full access to government accounting, financial and operational records, as well as public service personnel, is required as a basis for auditing the truth, fairness and accuracy of government financial statements and the efficiency and effectiveness of government operations. A high level of capacity within the national Supreme Audit Institution (SAI) is necessary, together with the application of modern auditing standards and approaches. At the same time, scarce audit resources need to be applied in a manner that reflects the financial, organizational and operational risks that Government faces. Audit reports need to be timely and transparent, allowing full scrutiny by the Legislature and appropriate follow-up of remedial action taken by the Executive. The SAI needs to be sufficiently independent of the Executive to carry out its duties free from political and administrative interference and constraints.

206. Iraq's SAI, the Board of Supreme Audit (BSA) is widely recognized as the country's premier public accountability institution. It has a long history, having been established in 1927, well-trained staff, and reasonable capacity to carry out its mandate. Recognizing the need to adopt modern auditing approaches, the BSA invests significant resources in research and development and is an active member of international and regional SAI bodies, such as INTOSAI and ARABOSAI. Although these activities help to mitigate the adverse effects of years of the international isolation of Iraq, BSA top and senior management acknowledge the need for support from the international development community in terms of applying contemporary government audit standards, practices, and techniques. With this in mind, donors such as the UNDP and World Bank have been supporting BSA's strategic planning and capacity development programs.

207. The BSA's mandate is far-reaching. It is empowered to conduct the full range of audits, namely certification, financial, compliance and value for money (VFM)/performance audits. Its remit extends to sub-national as well as national government and embraces public enterprises as well as civil society organizations in receipt of public funding. It covers all sectors dealing with the public funds whether income or expenditure. Discussions with the BSA's top management indicate that all these audits are carried out in a carefully planned manner and subject to stringent technical quality control from the centre. There are some constraints, however, caused not least by the harsh security environment in which the BSA has been operating in recent years. In particular, BSA's work at the sub-national level has been hampered by difficulties in accessing records and personnel in certain parts of Iraq. There are also specific issues relating to the Kurdistan Regional Government, where currently two separate BSAs operate, each of them suffering from a severe dearth of experienced auditors. These two organizations are scheduled to merge shortly, but they will continue to suffer from lack of capacity for the foreseeable future.

208. While the competence of the (national) BSA to discharge its functions is broadly sound, there has been, and continues to be, a major weakness in Iraq's

²⁹ An accountability framework is the system that holds people responsible for their actions. See Attachment 1 for an overview of Iraq's Accountability Framework.

public accountability arrangements in terms of the timeliness of submission of audit reports to the Council of Representatives. No annual audit report has been submitted to the CoR for the past 3 years thus preventing the legislature from exercising its essential scrutiny function over the Executive.

209. **Follow-up action to audit reports by the Executive is a critical link in the public accountability chain.** Given the absence of timely audit reports referred to above, this aspect of public accountability needs to be significantly strengthened. It is encouraging, therefore to note, that the BSA has expressed a strong interest in working with civil society to promote social accountability, a topic that has been discussed in two recent World Bank sponsored workshops with senior officials from the national and Kurdistan BSAs.

210. **High quality scrutiny by the legislature is a critical component of a country's accountability framework,** as it is essential for creating transparency (clarity) in the use of public money. Government's authority to spend is derived from the legislature, who must rigorously examine and debate the law.³⁰

211. **Under the Constitution, legislative authority is vested in two bodies; the Council of Representatives (CoR) and the Council of Union.** The CoR consists of 275 members who are elected for four year terms. The CoR approves federal laws, oversees the Executive, ratifies treaties, and approves nominations of specified officials. It elects the president of the republic, who selects a prime minister from the majority coalition in the Council³¹. The Council of Union, or Federation Council (Majlis al-Ittihad), is to consist of representatives from Iraq's regions. Its precise composition and responsibilities are not defined in the Constitution and are to be determined by the CoR.

Legislative Oversight

212. **The legislature's review covers details of expenditure and revenue,** but only at the stage where the Annual Budget Bill has been tabled by the Government. The Finance Committee reviews the Budget and provides a report to the CoR, which is discussed at the 2nd Reading of the Annual Budget Bill. The legislature's review covers some fiscal policies on an ad-hoc basis through reports from sector specific committees. Some fiscal policy questions are also raised by various CoR members not on a committee. Budget documentation does make it difficult for the CoR to undertake detailed analysis. The reviews do not include a detailed assessment of the Government's medium term fiscal framework or medium term fiscal priorities as a medium-term perspective is not yet included in the Budget papers and do not form part of the Annual Budget preparation process. While the CoR does review some Government programs, such as social security (PDS and SSN) and fuel subsidization, more specific reviews of program or government function (e.g. primary school education, emergency health care and maternal health) can

³⁰ Adequacy of budget documentation is assessed in PI-6 (comprehensiveness of information included in budget documentation).

³¹ During an initial period, a three-member Presidential Council elected by the Council of Representatives will carry out the duties of the president of the republic.

not be readily undertaken given the current content and structure of the Annual Budget papers.

213. The CoR has 24 standing committees; 10 providing oversight functions and 14 providing more sector specific review functions. The CoR has two primary committees for the review of the annual budget law, although all the standing committees have an interest in reviewing aspects of the Budget. While the committees' responsibilities cut across each other, the Economics, Investment and Reconstruction Committee is primarily responsible for reviewing fiscal and economic policies, while the Finance Committee is primarily responsible for reviewing budget allocations and deficit financing strategies.

214. The committees are formally provided with the Annual Budget Bill after the Bill has been introduced by the Government and after its first reading. The Committees then formally meet to discuss and agree recommendations to be presented at the plenary for the 2nd reading (see the Bylaw of Iraqi Council of Representatives). During the 2nd readings, CoR members have an opportunity to raise issues and ask the Minister for Finance specific questions concerning the Bill.

215. The Finance and Economic Committees do not yet have procedural documents that guide the review process. Tools and check lists for financial analysis have not yet been developed to support the Committees during review. Coordination arrangements with other committees, including the Legal, Oil and sector committee, are informal.

216. Some procedures exist for the legislature's budget review, but they are not comprehensive and only partially followed. The Bylaw of Iraqi Council of Representatives is the only procedural document that guides review arrangements. The Bylaw includes internal organizational arrangements and establishes standing committees. The procedures also outline crucial reporting and negotiation procedures within the CoR and between the CoR, its committees and the Government.

217. The time periods to which the CoR is to provide a response to budget proposals are enshrined in the FML and the By-Law of the Iraqi CoR. Under Section 6.2 of the FML, the Government is to submit in the month of May to the CoR "*a report on the priorities for fiscal policy for the next fiscal year, including the proposed total limit on spending and the limits for each individual spending unit*". The Budget Call Circular (BCC) is to be issued in June. This provides the CoR between 1-2 months to review fiscal aggregates early in the budget preparation cycle, which is sufficient time for the CoR to provide comments to the Government prior to the issue of the BCC. Under Section 6.8 of the FML the Government is also required to submit to the CoR by 10 October the draft Annual Budget Bill. This gives the CoR up to 2 ½ months for review of detailed budget estimates. Under Article 22 of the By-law of Iraqi CoR on Plenary Meetings, the CoR is to convene and continue sitting until the Annual Budget is approved.

218. Since 2004 the CoR has had on average just less than 2 months to consider detailed budget estimates prior to approval of the Annual Budget Law (see Table 12).

The CoR has not yet been provided with fiscal aggregates early in the budget preparation cycle in any fiscal year.

Table 12: Duration from submission to the CoR of the Budget Papers to Approval

Budget Year	Draft Budget Transmitted to the CoR (Est)	Budget Approval Date by CoR (Est)	Duration (Months)
FY08 [^]	14 Nov 2007	07-Jan-08	1.8
FY07	14 Dec 2006	08-Feb-07	1.9
FY06	01 Dec 2005	28-Jan-06	1.9
FY05	20 Nov 2004	12-Jan-05	1.8

Estimate of FY08 Budget approval date

219. **Rules for in-year budget adjustments without ex-ante CoR approval are clear.** These are contained in the FML and temporary amendments reflected in the 2007 Budget Law and supported by issued instructions. Section 9.8 of the FML provides the scope and limits to in-year adjustments.

220. **Clear rules exist for in-year budget amendments by the Government and are usually respected.** Temporary provisions, however, allow extensive administrative reallocations. The increase of 5 percentage points to 10% for the amount an MDA’s appropriation can be reallocated to another MDA is considered high. The FML’s provision is consistent with international standards (item “a” above). Similarly, the theoretical reallocation of an MDA’s total investment budget, should it not have executed 25% by mid-year, provides excessive authority for reallocation without ex-ante approval by the legislature. Expansion of the expenditure without ex-ante approval is not allowed and is respected.

Legislative scrutiny of external audit reports

221. **Authority and requirements for legislative scrutiny of the external audit reports is contained in the Constitution, Bylaws of the CoR, the FML and BSA Law.** Article 61 of the Constitution states that the CoR is the competent authority to monitor the performance of the Government. Section 11.6 of the FML requires that the BSA’s external audit report (and final accounts) for a specific fiscal year be submitted to the CoR by June 30 of the follow fiscal year. Section 11.7 specifies the details that need to be included in final accounts. Section 11.8 requires that after the CoR has approved the final accounts (and considered the BSA’s audit report) they “*be published in the Official Gazette and made publicly available*”. Section 14 of the FML requires the MfF to provide certain information to the BSA to facilitate external auditing. Article 31 of the Bylaw of the CoR requires the CoR to approve the final accounts (and review of external audit reports). Article 92 of the Bylaw also establishes the CoR’s Integrity Committee as being responsible for reviewing, monitoring and following up on audit reports. Under Article 3.4 of BSA Law of 1990 (and Section 2.5.5 of CPA Order 77/2004:) the BSA is to establish procedures for preparing and submitting to CoR, the BSA’s Annual Plan and

Annual Report within 90 days of the end of each fiscal year³². These reports alert the CoR to the non-finalization of final accounts and audits as appropriate.

222. **At the time of writing, external audit reports and final accounts had not been tabled with the CoR.** Consequently, examination of audit reports by the legislature does not take place, there are no in-depth hearings conducted by the legislature, and there are no formal recommendations being issued by the CoR

Section 4: Donor Practices

223. **The final section of the chapter reviews donor practices under the PEFA framework that support an orderly Public Financial Management (PFM) system.** Complete and timely reporting by donors on aid flows is critical for effective coordination and resource allocation. A high proportion of aid that uses national PFM systems is important to avoid diverting scarce capacity away from managing and developing national systems.³³

224. The performance of Iraq’s development partners is summarized in Table 13 below, from which it can be seen that they do not perform well in relation to the PEFA indicators.

Table 13: Donor Practices

D-1 Predictability of Direct Budget Support	D	M1
D-2 Financial information provided by donors for budgeting and reporting on project and program aid	D	M1
D-3 Proportion of aid that is managed by use of national procedures	D	M1

225. **In 2003 and 2004, Iraq received less than 1% of assistance in the form of direct budget support.** Since then, Iraq has not received any direct budget support (see Table 14). When Budget support was provided, fiscal forecasts were not given to the GoI, which was consistent with donor pledging and budget arrangements at the time. The International Compact with Iraq provides a good foundation to increase levels of budget support.

Table 14: Direct Budget Support – Committed and Disbursed by Fiscal Year (USDm)

Assistance Type/ Donor	Thematic Area	2003		2004		2005		2006	
		Com.	Dis.	Com.	Dis.	Com.	Dis.	Com.	Dis.
Direct Budget Support									
Korea	Governance and Democracy	4.7	4.7	-	-	-	-	-	-
Spain	Economic Development	-	-	5.0	5.0	-	-	-	-
Total Assistance		1,078.0	361.9	4,574.2	3,237.3	4,105.6	3,544.1	4,869.2	3,146.1

Source: DAD

³² Article 5.2.1a of BSA Draft Law 2005 extends the reporting deadline to the CoR from 90 days to 120 days at the end of each fiscal year.

³³ Direct Budget Support is the “gold standard” for aid flows that use national procedures.

226. **Financial information provided by Iraq's development partners is untimely and incomplete.** Annual reports on commitments and disbursements are provided; however, they are not delivered in line with the GoI's budget cycle or in a breakdown consistent with the Government's classification system.

227. **Iraq's development partners do not yet provide budget estimates for disbursement of project aid** at stages consistent with the government's budget calendar or in a breakdown consistent with the GoI's budget classification. Major donors also do not provide budget estimates for disbursement of project aid for the GoI's coming fiscal year, nor do they provide this information at least three months prior its start. Development partners do provide annual updates on commitments and disbursements, although reporting is not consistently classified.

228. Iraq's development partners do not provide quarterly reports within two month of the end-of-quarter on all disbursements made for at least 50% of the externally financed project estimates, **nor do they provide information consistent with the GoI's budget classification system.**

229. **National procedures are bypassed** for almost all development assistance projects and programs. Development partners are not yet using the same national procedures used for Government funds for banking, authorization, procurement, accounting, audit, disbursement and reporting. Some progress towards the use of the banking, authorization and auditing procedures has been achieved. For example, the World Bank uses Government Bank accounts for project special accounts (advance accounts), which are opened in accordance with MoF standards. The MoP and the ISRB authorize both Government and Donor investment projects, although the systems are different for donor projects. The BSA is now becoming increasingly responsible for auditing development partner projects and work is underway for the BSA (through the COFE) to take over oversight of the DFI from IAMB. Iraq's development partners are working to strengthen procurement arrangements, which should allow greater use of national procurement procedures once new legislation and systems and are operational.

230. **Government funds are channelled into donor systems.** Through the DFI, special arrangements are established that allow Government funds to be used according to non-national systems. Although, this is understandable given the need to execute a massive budget, such an approach weakens institutions and enshrines potentially inappropriate practices for an Iraqi context.

CHAPTER 2: CAPITAL INVESTMENT BUDGETING

Summary

231. **This chapter of the report addresses the critically important area of capital investment budgeting.** The importance of this issue derives from the need to have in place the infrastructure to deliver essential public services like health, education, water and electricity. All these services require capital investments like hospitals, clinics and schools. The past few years in Iraq have seen persistent under-spending of the government's capital budget, although there are recent signs that the situation may be improving slowly. There have also been wide divergences in budget execution rates between ministries and between governorates. Only the relatively stable and more secure region of Kurdistan has been able to achieve a high level of budget implementation. The chapter therefore analyzes the key factors that impact upon CIB in Iraq and makes recommendations for improved performance.

232. **The chapter finds that one of the most significant challenges facing the GoI is improving the integration of capital and recurrent budgeting.** This common problem in PFM results in insufficient attention being paid to the recurrent costs of capital schemes and therefore significant difficulties in operating and maintaining expensive capital assets. Institutional arrangements are found to be important, with responsibilities for different aspects of budgeting being divided between the Ministry of Finance (MoF) and the Ministry of Planning and Development Co-operation (MoP). In Iraq, these difficulties are enhanced by large parts of the investment budget being financed and executed outside the budget by donors.

233. **Other issues identified by the analysis include the following:**

- Weak capital investment planning resulting from limited capacity to develop sector strategies, project feasibility studies, credible project costings and realistic project appraisals
- Continuing lack of consistency and uniformity in budget documentation and classification
- A range of issues that impair timely budget execution, including bottlenecks at every stage of the process from procurement and contract management through commitment, verification and payment to oversight
- Poor co-ordination between implementing ministries and inadequate delegated authority
- Market imperfections including the unstable security situation, supply bottlenecks, fuel shortages, private sector constraints and difficulties in resolving land disputes
- The reluctance of officials to take decisions and authorize resource allocations for fear of allegations of corruption

234. **The issues concerning capital investment budget (CIB) formulation and implementation have been analyzed using the following five-component framework:**

- **Inventory of Capital Assets**
 - Before a CIB can be started, budgeters need to know what assets are in existence and what maintenance arrangements are in place.
- **Developing a Capital Investment Plan**
 - A capital plan should be based on sector plans, feasibility studies and credible costings and hard sector budget ceilings.
- **Developing a Multi-Year Capital Investment Plan**
 - Credible annual estimates for 3-5 years (or even up to 25 year to monitor useful life of assets) specifying recurrent and capital expenditure requirements.
- **Developing the Financing Plan**
 - Identifying sources of financing for the multi-year capital investment plan.
- **Preparing for Implementation of the Capital Budget**
 - Implementers need to fully understand the budget and budget execution processes for timely implementation.
 - Establishing procurement plans, effective project and contract management, supervision and monitoring and evaluation arrangements.

235. **The chapter comprises the following components:**

- **an overview of arrangements currently operating in Iraq** according to the above five elements of CIB.
- **an outline of common international problems in attempting to improve capital investment budgeting** together with an assessment of how these problems and possible solutions could apply in Iraq
- **the specification of a number of problems** associated with the execution of the capital budget.

236. As background to the chapter, Box 2 below comprises a brief historical review of CIB in Iraq

Current CIB Arrangements

Inventory of Capital Assets

237. **Iraq operates a decentralized system for the recording, monitoring and maintenance of assets** (Law No 7 of 1958 refers) Responsibility for administration of asset registers rests with individual ministries. The BSA and Inspectors General undertake audits of ministries' asset registers based on workload priorities. Under the Financial Management Law (CPA #95) the MoF is not required to report on the current stock of non-financial or financial assets, although the Minister for Finance has authority to require that stocks of assets be reported by Ministries for inclusion in the budget submissions. The MoP through its oversight role of ministry projects currently does not

require the provision of asset stock information during the appraisal process of project proposals submitted to the MoP as part of the annual budget cycle. Some ministries continue to maintain asset registers. For example, the MoE administers a registry of schools. Registries are likely to be incomplete in areas such as financial data and historical and useful life information.

Box 2: A brief History of Capital Investment Budgeting in Iraq

In the period 1951-1958 the Reconstruction Council was provided with its own budget to implement national investment projects. The Council was chaired by the Prime Minister and supported by the Secretary General of the cabinet and a combination of international and Iraqi experts. Financing for Council decisions were set by fiscal financing rules based on a percentage of oil revenue. This percentage decreased over time from 100% to 70%. The Council issued detailed planning and procurement guidance and required feasibility studies, medium term expenditure plans and financing plans prior to allocation of resources for investment projects. In addition, projects were considered within the context of whole-of-government and sector-like investment strategies.

Between the 1960's and 1980's the Government of Iraq's capital investment budgeting was administered by two central agencies. The Ministry of Planning and the Reconstruction Council were responsible for project preparation and supervision.

During the 1950s, the private sector was primarily responsible for implementation. This policy supported the development of an enabling environment for the private sector and encouraged growth.

In the 1960's, policy changed with nationalization of private companies. This corresponded to a significant deterioration in private sector performance and economic growth.

With the advent of increase conflict in the 1980's, a further deterioration occurred in investment in infrastructure and social programs as funds were diverted to military spending and patronage. Capital investment planning was also seriously effected by a trade embargo, which commenced on 6 August 1990 and enforced by a military land, air, and sea blockade. The embargo continued until the end of the 2003 war.

In 1990's significant levels of inflationary financing of the real Budget deficit was introduced and maintained. By the 1990's investment planning had effectively been abandoned.

The consequences of the centralized system, prolonged conflict, the trade embargo and use of inflationary financing were significant and include the following: i) inadequate levels of well maintained infrastructure; ii) a decimated private sector; and iii) loss of systems, work practices and capacity for investment planning and implementation.

This result is consistent with experience of other countries that emerge from conflict where a legacy of: a) unusually bad economic policies; b) weak public financial management practices; c) a withered construction sector causing procurement and planning bottlenecks; and d) real constraints on public capacity to spend money effectively.

238. **The ability of ministries to maintain whatever asset management systems that were in place before 2003 was severely affected by the loss of documentation** that resulted in the aftermath of the 2003 war. There has not yet been a serious attempt to undertake a detailed analysis of existing assets. This has been further complicated by the lack of procedures and systems to register new assets, purchased by either the Government or development partners.

Developing a Capital Investment Plan

239. Capacity is constrained and processes are weak for capital investment planning. In particular, capacity is not yet sufficient for developing strategic plans, sector investment plans and feasibility studies. Moreover, the processes needed for the production of credible investment costings are unclear. It is apparent, however, that many of the Ministries have a good idea of what investment is needed. Guidance from the centre appears inadequate, which has a negative flow-on effect to ministries. The lack of an integrated budget, a weak annual budget process and inappropriate control arrangements entrench incentives not to undertake the necessary work to develop sound investment plans. The Government, however, already recognizes this. The International Compact with Iraq provides the foundation for the development of sector strategies and supportive PFM reform measures.

Developing a Multi-Year Capital Investment Budget

240. Transforming a sector strategy and resulting capital investment plan into a credible multi-year budget is critical. This step essentially takes the capital investment plan's costings and separates them into a sequenced program of annually costed projects. Importantly, it also addresses the implications for recurrent expenditures from the projects. This often requires multi-year project plans spanning up to 25 years or more reflecting time required for operationalization of projects as well as an assessment of the estimated useful life of assets and required maintenance arrangements. The medium-term period for fiscal planning purposes is around 3-5 years, reflecting the practical time horizon of decision makers, project and program managers and Government leadership.

241. Some Government spending units, such as the Baghdad Amanat, do develop multi-year project plans with costings. Recurrent cost implications, performance targets and linkages to sector strategies are not yet incorporated in the multi-year plan. Nevertheless, those ministries where multi-year planning is already underway are well prepared to commence more ambitious sector planning processes.

242. The Government is introducing certain elements of multi-year planning as part of systems development for procurement planning and management. Given that these systems appear to have significant support within key areas of Government, there is an opportunity to undertake dialogue on system development. The view would be to improve the budgeting component with reference to envisaged budget preparation systems and the Development Assistance Database.

Developing the Financing Plan

243. This part of the CIB process identifies the source of funds for the entire project and recurrent costs. The sources of potential financing for projects are many, so due consideration is needed. Sources of finance can be combination of different forms. Primary financing options that should be considered are: i) government revenue,

including new ways to raise general revenue; ii) loans; iii) grants, iv) Public Private Partnerships; v) cost recovery measures, such as user charges; and vi) savings measure that typically result in expenditure cuts. **A fully integrated budget and a supportive approach by donors are critical** for the proper development of financing plans.

Preparing for Implementation of the Capital Budget

244. **Preparation for implementation of the approved capital budget requires development and approval of procurement plans**, establishing sound project and contract management and supervision arrangements. In addition, those officials responsible for implementing approved projects need to be fully aware of the capital budget. The best way for this to occur is for implementers to be closely involved in the budget formulation stage of the CIB. If this has not occurred, a separate seminar with implementers should be held to communicate priorities and provide costing information, which is the basis for procurement planning. CIB implementers also need to be fully aware of CIB execution procedures including accounting (commitment, verification, payment), internal control procedures and auditing (performance and financial) implications.

245. **In Iraq, approvals are required from MoP prior to the initial release of Investment Budget funds from the MoF.** Subsequent approvals are required each quarter. MoP has specific forms that line ministries are required to complete. This information is maintained in a legacy Fox-Pro system within the MoP. The MoP is currently developing a new integrated procurement reporting system, which is being designed to improve the breadth of financial and project information collected and will assist with the provision of timely reports. Work on the documentation of the GoI's existing accounting framework and internal control procedures has commenced. Once complete, these will help improve understanding of CIB implementation requirements.

Common problems when Improving Capital Investment Budgeting

246. **Iraq is like many other transition countries in that it is encountering difficulties in developing and implementing public investment programs.** While all countries face resource constraints when planning significant investments in infrastructure, health, education and other key areas, institutional and procedural weaknesses have been shown to be the key constraint. Public investment processes are often fragmented, with resource allocation and project selection being sub-optimal. To assess the CIB weaknesses, it is useful to review the three key problems facing capital investment planners:

- How should government's limited resources be best allocated?
- What process should be followed to select the most beneficial projects?
- How can governments ensure that expected results are delivered?

Resource allocation

247. **The common institutional weakness in transition economies that contribute to misallocation is budget fragmentation.** Iraq has fragmented budgets. Large parts of the investment budget are financed and executed outside the budget by donors. Moreover, the investment budget is also separated from the operational budget causing coordination difficulties and arbitrary and inconsistent funding levels. The lack of medium term planning in Iraq also means it is almost impossible to focus on the medium term implications of annual budgets and provide correct incentives for the preparation of high quality project proposals. Consequently, budget discussions focus on adjustments to the previous year's budget and little attention is given to the quality and priority of projects.

Project selection

248. **In a similar vein, Iraq is experiencing problems facing other countries when selecting the most beneficial investments.** The process and timing of investment planning is not matched with the medium-term and annual budget process. Iraq is implementing procedural solutions to improve compliance with the Financial Management Law (FML). A substantive improvement in coordination of investment planning and budgeting remains elusive. This is not surprising as coordination difficulties are often caused by general weaknesses in budget preparation guidance and compliance with budget timetables. The lack of fiscal discipline is at the heart of many coordination problems.

249. **Selecting the most beneficial investments also require that investment proposals are properly developed and analyzed.** Accurate costing of projects, developing realistic implementation schedules and assessment of benefits is critical. Some ministries seem to perform better than others. Those ministries who have sought support in project preparation, such as the MoI, MoE and Baghdad Amanat, seem to develop better quality proposals. Nevertheless, central policy, guidance and support need to be of a sufficient standard and understood by all if project selection in aggregate is to improve. That said, the Government might consider introducing competition between ministries by instituting a policy where ministries with the best project proposals that comply with guidance are rewarded with prioritized allocation of resources. In addition, consideration should be given to the establishment of a medium-term Public Investment Program (PIP)

Expected impacts of investments

250. **Assessment of costs and impacts is often unrealistic; this has been a common outcome in Iraq for the last three years.** The absence of appropriate incentives is one reason for this. Another reason is the absence of a hard budget constraint during the budget process. Consequently, final decisions have often not reflected submissions from Ministries. There have been instances where final allocations have been very different from ministry budget submissions, indicating unrealistic bids by MDAs and also reflecting political considerations. Political priorities are inevitable and appropriate in the public sector, but for the budget process to be effective, these priorities need to be set at the beginning of the budget process and only changed in a transparent manner in

exceptional circumstances. This promotes fiscal discipline and produces positive incentives for ministries.

251. **Credible cost-benefit assessments are needed.** It has been shown that, in situations of in-year investment budget savings or slow budget execution, in-year reallocation to other projects produces incentives to overestimate project costs and benefits. When assessing benefits, it is important to choose benefits that are able to be monitored, to help with accountability later.

252. **The lack of information on operational costs of proposed investments leads to inefficient decisions.** This can cause the selection of projects with lower initial investment but higher lifetime costs. The Government is now beginning to experience this, with a number of development partner projects not being able to deliver expected results due to a lack of operational financing.

Improving Capital Investment Budgeting

253. **Introducing measures to improve capital investment budgeting requires both a short and longer term approach.** The longer term approach involves working towards a fully integrated budget. A fully integrated budget will have the following features:

- Recurrent, investment and donor budgets developed together and implemented according to common national procedures;
- Budgets are developed with a medium-term perspective;
- Differential financing modalities are clear and considered during the budgeting process;
- Clear guidelines for project development and cost-benefit analysis are in place and well understood by budgeters and implementers;
- Appropriate incentives³⁴ in place for the production of realistic estimates of capital investment cost and benefits.

254. **Achieving budget integration is difficult, as it will be for Iraq.** It requires completion of the following four steps, each with varying levels of difficulties:

- Organizational and staffing integration;
- Integrated budget preparation;
- Integrated budget documentation and presentation;
- Unified budget execution, accounting and reporting systems.

255. **International experience has shown that it is possible to overcome political and bureaucratic disincentives** for integration. The critical step is discussing the principle of budget integration with the country's leadership. In this context it is encouraging to note that a high level committee within the CoM has reviewed the demarcation of roles between the MoF and MoP with regard to executing and monitoring the budget. This committee passed recommendations to the OPM in mid 07 and action is expected

³⁴ Appropriate incentives include a credible budget process, a transparent mid-year review, improved cash management practices, clear decision criteria for investment proposals and systematic ex-post evaluation of projects.

following Government consideration of this report. If the principle is accepted, it is possible to introduce either small or technical measures in support of integration or even major leaps towards it.

256. Small steps include undertaking a functional review of planning and finance ministries with a view to experimenting with pilots of certain integration support measures. The appointment of a senior Minister for Planning and Finance is a small achievable step, although the Government's fragile coalition arrangements may make this difficult without broad support. In Iraq, an envisaged small, but very useful, measure could be the establishment of small specialist organization or Independent Service Authority (ISA) for macroeconomic and fiscal forecasting. Such an institution could be based on remuneration conditions that are not constrained by current civil service constraints and could support the establishment of a specialist cadre of civil service employees. This could be supported by donors on an interim basis.

257. A more substantial leap would be the establishment of a single Ministry of Planning and Finance. This single ministry would be responsible for macroeconomic, macro-fiscal and sectoral analysis, aid coordination, medium term fiscal forecast policy and implementation, annual budgeting and treasury functions.

258. Another option which provides improved separation of core planning and finance functions is ministry restructuring. This option may be more acceptable to the authorities. It involves the transformation of:

- the current Ministry of Finance into a Government Treasury, with a primary function being quality accounting and oversight of revenue authorities; and
- the current Ministry of Planning and Development Cooperation into a **Ministry of Planning and Budgeting**, with the primary function for medium and annual budgeting as well as aid coordination.

259. Integrating budget preparation requires that budget preparation staff from MoP and MoF be brought under a single department and supervised by a single manager. Experience has shown that co-ordination measures between two budget departments seldom if ever work satisfactorily. Institutional resistance though is often encountered due to a general resistance to change, but also from a lack of reform incentives and political and donor dynamics.

260. Given Iraq's decentralized system for budget execution, there is a critical need to bring budget implementers in the Governorates and the Regions into the budgeting process. The Inspectors General and Board of Supreme Audit, however, have identified that there is lack of expertise at the governorate level and the appearance of a conflict of interest. Any reform program will need to focus on building capacity for budgeting at this level. Some important first steps have already been taken. For example, in Basra, the provisional council has developed the first provincial development strategy and the KRG have completed a review of their PFM system.

261. **The Government has already taken some steps to unify budget documentation and presentation** through reform of budget classifications and development of a Development Assistance Database (DAD). Other countries have also been able to achieve this, as integrated documentation and presentation can proceed independently of other budget integration steps. Nonetheless, more work is needed. For example, operationalizing the DAD and presenting this information in the budget papers through a consolidated budget is a relatively easy measure and would improve documentation significantly. Moreover, it would set the scene for further improvements in budget preparation.

262. **Computerized budget documentation systems have proved to play important roles in other countries' reform efforts.** However, it is important to have a properly developed implementation strategy. Some ways have included a stepwise introduction of improvements in information provided in budget papers. It should be noted that more ambitious introduction of budget preparation systems should be preceded by well defined user and functional specifications and improvements in budget preparation processes, budget guidance and application usage training. It should be noted that the timeline for application roll-out requires the all the implementation components be sequenced in line with the Budget calendar.

263. **Unifying budget execution, accounting and reporting systems is often very difficult** as a non-integrated budget usually has many disconnected processes. Budget preparation often goes through different ministries with different timetables and procedures. There can be different budget and accounting classifications. Iraq has made an important first step in this regard with GFS consistent budget classification system. A GFS consistent accounting classification system is yet to be operational. There can be different procedures at commitment, verification, payment, and oversight stages. Differential banking and cash management rules may also be in place.

264. **Donors are a major constraint for unifying budget execution, accounting and reporting systems.** Donors commonly do not use country systems as they often require recipient governments to follow donor specified execution and reporting procedures.

Capital Budget Implementation– A Systemic Problem

265. **Poor capital investment budget formulation leads to poor capital investment budget execution.** The above section addressed some of the key issues with capital investment budgeting. There are, however, other systemic problems faced during execution of the CIB.

266. **It should be noted that capital execution performance in Iraq has not always been slow.** For example, BSA reported that in 1989, of the 35 major infrastructure projects being undertaken then, 26 projects were progressing well and were disbursing according to forecast, with only four projects considered deficient and five projects deemed as failures.

267. There is general agreement among GoI officials that planning and allocation of resources for much needed investment projects did not occur over the last twenty years due to the effects of wars, sanctions, unstable security and patronage. For example, it is understood that, in 22 years, not one new hospital has been built by the private or public sector. Moreover, those non-military capital projects that were approved during the 1990's did not perform well. These projects are believed to have consistent annual budget execution rates of between 10-25%. In addition the former five-year plans that were in existence proved very difficult to execute.

268. MoP, MoF, BSA and the IGs continue to work with Ministries to identify capital budget execution problems. Bottlenecks are occurring at every stage of the budget execution process, that is, at the procurement, commitment, verification and payment and oversight stages. Capacity limitations and market imperfections are also key constraints for effective execution of authorized projects. The following provides a summary of possible reasons for these bottlenecks.

Procurement and Contract Management Bottlenecks

269. Coordination difficulties are often encountered during execution of investment projects. A single project may require coordination between up to five different ministries.

270. An inadequate level of delegated authority exists. The requirement to secure multiple approvals prior to issuance of even small contracts slows procurement. Approvals are required from project managers, contracts committees, MoP and the economic committee. In response, the Government has introduced the first elements of a "hurdle" approach to procurement and internal control with the introduction of new delegation instructions where Governors and Ministries are provided with greater levels of delegated responsibility. Increased contracting delegation thresholds have been established with Governors being given the authority to approve contracts up to \$1 million without going to the High Contracts Committee and; large contracting ministries, such as Defense, Interior and Trade, Oil, and Electricity being given a threshold of \$20 million, with remaining ministries a threshold: \$10 million. In keeping with the hurdle approach, these thresholds are subject to change based on performance. For example, demonstrated good performance may lead to increased thresholds for ministries and governorates.

271. Procurement is subject to poor planning and imprecise specification. The previous section dealt with the importance of the formulation phase in increasing capital investment budget execution performance. This problem is being seen on the ground, with the general absence of feasibility studies to inform procurement planning, drafting of bidding documentation and contract specification.

272. Processes for advertising and awarding project contracts have been unclear and have not been well understood by implementers. While some have claimed that the length of time for advertising is too long, proper procurement planning and project

preparation should factor in these timeframes. The Government is endeavoring to improve understanding of procurement procedures through the introduction of procurement assistance centers both in Baghdad and sub-national levels.

273. Contract negotiation is proving to be very difficult and is causing delays. Following sound public service ethics, officials have been taking their role seriously during contract negotiation by endeavoring to ensure the Government receives good value for money. Poor specification in bidding documents and a lack of negotiating experience by the both negotiating parties are contributing to the problem.

274. Even after successful negotiation, contract specification is often found to be poor. This can have flow-on effects at other stages in the budget execution cycle, especially at verification and payment stages.

Box 3: What is the Hurdle Approach to Devolution and Budget Reform?

The Hurdle approach is a systematic way to either relinquish or claw back detailed centralized controls to/from line agencies. The level of control devolved to agencies is conditional on their continued achievement of hurdle standards. These standards can involve a number of management areas such as the following: budget planning, output costing, procurement management, budget and funds control, financial and performance reporting, asset management, and internal audit. These areas cover the core financial and performance management competencies that a line agency needs to substitute its resource management system for external, centralized controls. External controls can then be loosened or strengthened with less risk of wasted resources and greater chance of attaining better outcomes from government spending.

The hurdle approach differs from traditional approaches to budget reform in two main ways. First, the easing or reinforcement of central controls is formally linked to the strengthening of line agency management systems - as indicated by the achievement of the hurdle standards. Under more traditional budget reforms, the easing of central controls is less formally tied to improvements in line agency management. The traditional approach reflects implicit assumptions that line agencies are potentially well-managed and that relinquishing central controls will be enough to realize this potential. Second, central controls can be reduced on an agency-by-agency basis. Devolution is conditional on individual agencies achieving hurdle standards. In the more traditional, across the board approach to budget reform, central controls are eased for all agencies at the same time, regardless of their management systems and competencies.

Source: World Bank, PREM Note 73

Commitment Bottlenecks

275. Delays are occurring with the opening of bank accounts for projects. Prior to the initial release of funds for projects, specific project bank accounts need to be opened. Without these bank accounts, the MoF can not provide cash advances. As a consequence, ministries are unable or unwilling to commence commitment of government resources. While an obligation is essentially in place, Iraq's internal control system is founded on cash-based principles, where approvals are confirmed with the release of cash.

276. Delays with the provision of annual capital investment and procurement plans to the MoP have led to commitment delays. Provision of such plans to MoP is a key control point. It is noted that pressure to fast track budget execution may be having unintended consequences on internal control, leading to release of cash without the

ministries demonstrating that sound investment plans are in place. This control point is warranted when a system to hold ministries to account is not well established.

277. Delays continue to occur between the time the MoP approves in year project performance and the release of the next tranche of cash from MoF. This is a direct consequence of non-unified accounting and reporting procedures. While the MoP is concerned with oversight of project implementation, the MoF is responsible for the proper reporting and accounting of the use of Government resources. Multiple reporting requirements and drawn out procedures for clarification is the result. Commitment delays also occur as a result of delays in financial reporting from the governorates and ministries.

278. Ministries are experiencing long delays in the issuance of letters of credit by the Trade Bank of Iraq. There appear to be multiple reasons for these delays, which can be up to three months for issuance of a single letter of credit. For example, a lack of understanding of issuance procedures, unclear procedural guidance, workload and an absence of competition for the issuance of letters of credit are simultaneously effecting issuance turnaround time. Both the Trade Bank and the MoF have indicated that if all documentation is properly completed, letters of credit can be issued within a few days. There are, however, other issues to resolve to improve letters of credit cycle which are discussed elsewhere.

Verification Bottlenecks

279. A key control point in the process that is subject to delay is the verification that contracted goods and services have been provided and to the quality specified. Following up on implementation is a responsibility of multiple actors including the governorates, the line ministries, MoP and MoF. Governorate-based officials are the primary source of information that goods and services have been delivered. This requires timely reporting to the central ministries to avoid payment bottlenecks. MoP also undertakes risk based verification of project implementation. MoP representatives and IGs visit project sites to confirm that projects are being implemented as reported. MoF relies on timely and complete verification reports to support accounting reports. Discrepancies often require clarification, which contribute to delays.

280. Unsettled or amendments to contracts is also causing verification delays. Contractors and project managers are experiencing implementation delays due to disagreements on contract related issues. This can be partly due to poor specification, but it also can reflect real difficulties being experienced on the ground due to: i) the unstable security situation; ii) market imperfections; and iii) an environment that does not enable the private sector.

Payment Bottlenecks

281. Payment of contractors is often delayed. Unfortunately, there is no system in place to track arrears. Delays appear to occur primarily due to upstream problems in the

preparation, commitment and verification stages. MoF uses the payment stage as a critical component of its internal control procedures to mitigate fiduciary risk. If problems are evident with contracts, release of cash advances can be withheld until the issues are resolved. While delegation of actual payment is decentralized to the ministries and governorates, non-release of cash advances by the MoF result in payment delays. Consequently, uncertainty of project performance is affected by central agency approval.

282. There are reports of delays of up to 8 months for payments of invoices through the release of letters of credit. These delays have been said to have occurred for three primary reasons; i) disagreement on appropriate verification documentation between the ministries, contractor and the Trade Bank; ii) slowness of administrative follow up when issues are raised; and iii) poor specification of letter of credit payment conditions.

283. Moving cash around the country for payment is a tedious and risky business. This results in delays in the delivery of cash to where it is needed. The lack of an electronic banking and payments system is constraining timely payments. The Government, however, is establishing such a system, which is expected to provide significant benefits once fully operational.

284. Absence of policies and procedures to address losses from exchange rate fluctuations is another cause for payment delays. Most contracts are specified in US dollar terms. Due to the recent depreciation of the US dollar, uncertainty of project viability has increased in many instances. This is causing delays at the payment stage as time is needed to find a solution. The main problem faced by project managers is whether to restructure the project and contracts and/or secure additional financing to meet contracted requirements.

Oversight Bottlenecks

285. Oversight bottlenecks occur from upstream events of untimely and incomplete reporting from the Ministries and Governorates. Human resource constraints also exist. The MoF, MoP, BSA and IGs are responsible for providing oversight of projects to mitigate fiduciary risk - that is, to ensure Government funds are utilized for the purpose to which they were intended under appropriation. To undertake this function, compliance with reporting obligations by ministries and governorates is essential. In performing this function, oversight bodies are faced with competing objectives when balancing the need to minimize fiduciary risk with the need to realize benefits from Government spending. The outcome of the bottlenecks is delays in the timely identification of oversight issues and the required follow-up activities required to rectify problems.

286. There are unintended consequences of certain anti-corruption measures. A common approach to reducing levels of corruption is by identifying and then heavily sanctioning offenders and publicizing this. This approach is designed to entrench correct incentives to not engage in corrupt practices. Generally, the approach works in countries with a solid accountability framework. In countries with weaker accountability frameworks and those coming out of conflict, this approach often leads to unintended

outcomes. Without a solid accountability framework and due processes, a heavy sanction campaign can cause well-meaning officials to become overly reluctant to take decisions on use of Government resources. This appears to be occurring in Iraq.

287. Countries coming out of conflict often introduce competing policies that balance the need to reduce the risk of a reversion to increased conflict with the need to increase economic growth and the quality of life of all citizens, especially the poor. Since 2003, the short-time frames of transitional administrations have led to low social and financial discount rates of decision makers, the consequence of which is inappropriate projects and higher incidence of corruption. Use of deadline based amnesties agreed through wide stakeholder consultation provides a way forward.

288. The need for the Government to be viewed as just is a competing objective. Public support is not likely to be forthcoming if corrupt politicians, officials and contractors are seen to be allowed to go unpunished. That said, the use of corruption sanctions is often an appealing way for incumbents to remove opposition. Getting the right policy balance is extremely difficult.

289. Governance arrangements and execution performance are affected by the fragile political economy. There is an issue of the extent of influence of different political parties in different sectors and governorates. Procedures to hold ministers accountable for project implementation are not yet in place. However, the performance of the High Economic Committee and the Compact Implementation Framework are encouraging signs.

Capacity Constraints

290. Capacity constraints are a key issue. More work is needed to raise PFM capacity in the Governorates. In addition, officials' strengths may not be being properly recognized due to misalignment of job function and skills. Better specification of the roles and responsibilities of Directors General is desirable.

291. The lack of a national capacity development strategy supported by ministry or sector specific capacity development programs is seen as a limitation. The perceived failure of training efforts is thought to have been caused by the lack of a policy framework. The Government has recognized this and has identified the need to establish the policy foundations for a national capacity development strategy in the International Compact with Iraq. Discussions on the envisaged medium term PFM reform program have also highlighted the importance of improving PFM competencies in a prioritized and sequenced manner.

Market Imperfections

292. A range of market imperfections has contributed to slow CIB execution rates. These are in addition to the unstable security situation which has been a major cause of

the suspension of a number of government and donor projects due to kidnapping and killing of key personnel.

293. **The existence of real supply bottlenecks and excess demand is a factor.** Examples include the limited availability of critical equipment for infrastructure projects caused by a combination of a lack of supply and increased demand. In addition, intense competition for machinery and tools to meet existing infrastructure projects requirements is increasing costs as importation of critical equipment is constrained.

294. **Fuel shortages are something of a fluctuating problem.** During times of shortage, it is often the case that fuel is unavailable to operate machines, while the effects on the distribution and transport network further disrupts project implementation. In addition, high inflation in these periods causes further difficulties.

295. **Private sector constraints have caused the construction and importation markets to be less responsive to increased demand.** Constraints include the lack of an adequate enabling environment and the legacies of previous policies, such as the nationalization of private sector industry. The role of the public sector vis-à-vis the private sector continues to be debated.

296. **The reliance on foreign experts in certain areas may cause difficulties.** There is a feeling among GoI officials that not enough use is made of local experts and consultants in project preparation phases.

297. **Difficulties in resolving land disputes are an important cause of project implementation delays.** Lack of availability of private or public land is common, due to unclear property rights, lack of transparent procedures for registration, leasing, ownership and transfer.

Are recent budget execution facilitation measures realizing improvements?

298. **It appears that recent measures introduced to facilitate investment budget execution are realizing real improvements.** Recent data indicates that capital investment budget execution performance has been improving (the Government estimates a rate of 63% in 2007, though there are doubts as to the accuracy of this figure), with aggregate expenditure deviation and composition variance improving significantly. This is partly due to the improved allocation of resources. In aggregate, poor CIB execution performance in 2006 and 2005 was largely due to the massive allocation of resources to the MoO who were constrained in execution of such large projects. It is understood that sufficient lead time for project preparation was not provided at the time resource allocation decisions were made.

299. **Big investment spending ministries are improving while small spending ministries continue to perform below aspirations.** In 2007, the MoO has improved dramatically from previous performance. The Ministry of Electricity, which has the second largest budget of any Ministry, appears to be performing very well with a

complete turnaround of execution performance. The same can be said for the Ministry of Public Works. An interesting result is the reversal of the Ministry of Education's solid performance in 2006. Much of this is attributable to the tenfold increased allocation of Ministry's budget over and above the level that was requested by ministry officials (see Chapter 7 for detailed analysis of the education sector). Table 15 below provides a functional analysis of capital budget execution over the period 2005-2007.

300. **In 2007, the Government introduced a number of measures to improve execution** of the investment budget including the following:

- High level oversight of execution performance through regular meetings of the High Economic Committee;
- Identified administrative bottlenecks targeted with corrective measures;
- Contracting procedures were clarified and additional training provided through Procurement Assistance Centers in Baghdad and the governorates;
- Introduction of increased delegation thresholds to large contracting ministries, other ministries and governorates; and
- Issuance of new and consolidated procurement regulations (pending approval of new procurement legislation).

Table 15: Capital Investment Budget Execution Performance: 2005-2007

Functional Head	2007			2006			2005		
	Original Budget	Forecast - Oct 07	Deviation	Original Budget	Est Actual	Deviation	Original Budget	Est Actual	Deviation
Oil	2,875	1,754	39%	4,657	214	95%	4,500	165	96%
Regions' Development (excl KRG)	2,623	828	68%						
Kurdish Region	2,013	2,013	0%	750	790	5%	750	772	3%
Electricity	1,745	1,733	1%	1,741	401	77%	440	214	51%
Public Works	558	422	24%	552	122	78%	252	101	60%
Health	431	22	95%	50	26	49%	60	27	55%
Housing & Construction	383	191	50%	312	136	56%	365	101	72%
Education	366	21	94%	28	24	15%	100	2	98%
Water Resources	330	267	19%	300	137	54%	276	180	35%
Higher Education	259	51	80%	60	23	61%	50	11	78%
Communications	193	108	44%	248	1	100%	200	-	100%
Labour and Social Affairs	141	68	52%	20	8	60%	27	10	63%
Transportation	133	28	79%	154	6	96%	145	23	84%
Baghdad Municipality	120	55	54%						
Planning	100	41	59%	38	36	6%	45	1	98%
Agriculture	63	17	73%	36	3	91%	26	1	96%
Defence	60	7	88%	500	304	39%	-	-	0%
Interior	50	5	89%	100	10	90%	-	-	
Industry and Minerals	42	50	20%	16	10	36%	14	13	9%
Youth and Sports	38	25	34%	386	264	32%	176	110	37%
Remainder	188	53	72%	968	403	58%	449	225	50%
Total expenditure deviation	12,710	8,371	34%	9,963	2,522	75%	7,495	1,732	77%
Composition variance	12,710	8,371	44%	9,963	2,522	75%	7,495	1,732	78%

Source: MoF for 2005 and 2006 and MoP for 2007 – see note on previous page

301. **It is clear that continuity and increased experience of senior members of Government is having a positive impact.** This can also be said for Government officials and is likely to be supported by an increased level of confidence in their leadership. Indicators of this are increased frequency of meetings between leadership and officials, greater levels of delegated responsibility from leadership to officials, and the completion of follow-up instructions.

302. **Development partners have also introduced new measures to support Government.** It is apparent that development principles of real ownership and genuine partnership are increasingly being followed during preparation and implementation of assistance projects.

303. **It is not possible to identify which of the measures and factors are contributing most to improved performance.** It is likely that all are contributing to some degree. While achievements have been made, more work remains to be done to further improve budget execution performance in terms of quality as well as quantity. This will require a sustained effort over a number of years based on an appropriately sequenced set of PFM reform measures.

CHAPTER 3: IRAQ FINANCIAL MANAGEMENT INFORMATION SYSTEM (IFMIS)

304. **Modern public (financial) management is heavily dependent on the existence of financial and management information systems.** Managers require information that is timely, accurate and reliable to facilitate decision-making. User requirements are many and varied and require careful and precise specification in terms of content, format and frequency. Budget progress reports, expenditure commitments, cash balances, trial balances and interim financial statements are some examples of the kinds of financial information that are required by financial and non-financial managers on a regular basis. At year-end central ministries, especially the Ministry of Finance (MoF), need to be able to consolidate financial information submitted by line ministries operating throughout the country in order to submit government financial statements for audit in accordance with the timescale prescribed by law. Thus a high premium is placed on the systems used to collect and report the relevant financial information.

305. **Modern governments are complex in terms of the range of activities and the institutional arrangements that exist to deliver essential public services.** For this reason, it is difficult to conceive of a situation where reliance on manual financial information systems will be sufficient to meet government's needs. Yet international experience demonstrates all too clearly that developing and implementing financial information systems is fraught with a range of difficulties that has frustrated many governments, including those in OECD countries. The situation is all the more challenging in environments ravaged by conflict, as has been the situation in Iraq since 2003.

306. **These issues are currently extremely important in Iraq.** The periodic release of budgetary allocations during the financial year is contingent upon timely and accurate financial information being supplied to the MoF by ministries, regions and governorates of their actual expenditure in the previous spending period. Trial balances recording expenditure need to be submitted on a monthly basis by spending units before any further funds will be released. The quality and speed of the processes by which financial information is captured and reported is therefore of paramount importance. Without their budgeted allocations being made available in a timely manner, public sector organizations are unable to deliver high-quality essential public services, nor are senior officials at Ministry level in Baghdad able to effectively monitor the levels of spending and outputs achieved with public resources. Similarly, public accountability depends upon financial reports being produced that are accurate, complete, and timely. Presently, in Iraq, there are significant delays in the reporting process, causing a lack of accountability to parliament and the people of Iraq.

307. Recognizing the importance of a functioning electronic system, the GoI has been attempting, with the support of the US Government, to develop an Iraq Financial Management Information System (IFMIS). USAID-contracted consultants have been working with GoI counterparts to develop and implement a financial system using the

proprietary software Free Balance Financials package, the hardware for which is centralized within the MOF. The IFMIS is an automated accounting system intended initially to improve budget execution for the Government of Iraq. Other modules are being added as part of a gradual move towards a more complete financial management information system. Several reviews of the operation of the IFMIS have previously been completed, including those undertaken by the IMF/World Bank in 2005 and that of the US Government's Special Inspector General for Iraqi Reconstruction (SIGIR) in 2007. The purpose of this chapter of the PEIA is to report the results of a survey on FMIS implementation carried out by the World Bank as part of the PEIA workshops.

308. World Bank staff worked with GoI officials on the following four key elements: i) effecting change; ii) a review of two case studies on FMIS implementation in other countries; iii) success and failure factors identified in a study of FMIS implementation around the world; and iv) a review of working papers on the subject.³⁵ The background profile of the officials consulted provides a sound basis to assess views of Government officials on the implementation arrangement for the FMIS in Iraq, given that they comprised an appropriate cross-section of officials, in terms of experience, expertise and involvement, and interest in FMIS implementation. Officials were invited to give their views on the effectiveness, constraints, and positive elements on IFMIS developments since 2003 according to criteria drawn from the World Bank's Six Pillars to Support Successful FMIS Reform and the IMF's Five Pre-conditions for Development of an FMIS.

Quantitative and Qualitative Assessment

309. **Detailed summaries of *quantitative* results of survey responses are shown as Attachments 1-3 at the end of this chapter.** They cover the following areas: i) success and failure factor ratings; ii) assessments against the World Bank's six pillars; and iii) assessments against the IMF's five pre-conditions. Selected *qualitative* assessment information is summarized in Attachments 4 and 5.

Success and Failure Factor Ratings

310. **Interpreting GoI officials' assessment of success factors³⁶ suggests that, overall, they rated progress to date on the IFMIS positively** with an average score of 5, which is the mid point of the positive ranking scale. However, there was a relatively greater dispersion of views when compared to respondent assessments of failure factors (see Figure 2).

311. Failure factors³⁷ that respondents considered contributed significantly to stalled implementation of the FMIS were observed for at least 6 of the 8 failure factors. There

³⁵ See: World Bank (2006), "World Bank's Experiences with Financial Management Information System (FMIS) Projects (discussion draft)", and IMF (2005), *Introducing Financial Management Information Systems in Developing Countries*

³⁶ Success factor scores below 6 indicate opportunities exist to improve FMIS implementation.

³⁷ High failure factor scores of 6 indicate opportunities exist to improve FMIS implementation.

was also general agreement on scores amongst responders for those six failure factors. Median results demonstrate an even stronger view that all failure factors were contributing to stalled implementation. This can be seen in Figure 3, which demonstrates a greater alignment of views at score 6 for rating of failure factors when compared to ratings for success factors. Nevertheless, an assessment of the results indicates that officials seem generally supportive of the implementation arrangements in terms of: i) project management; ii) project coordination; iii) linkages with the project to the political environment; iv) the effect of uncontrollable positive influences; v) training arrangements; and vi) the quality of project supervision.

Figure 2: Respondent Ratings of Success Factors

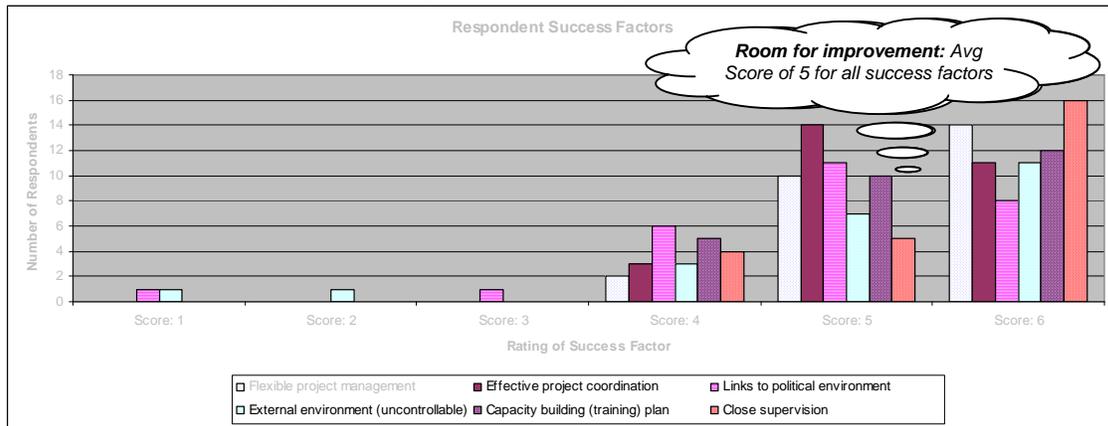
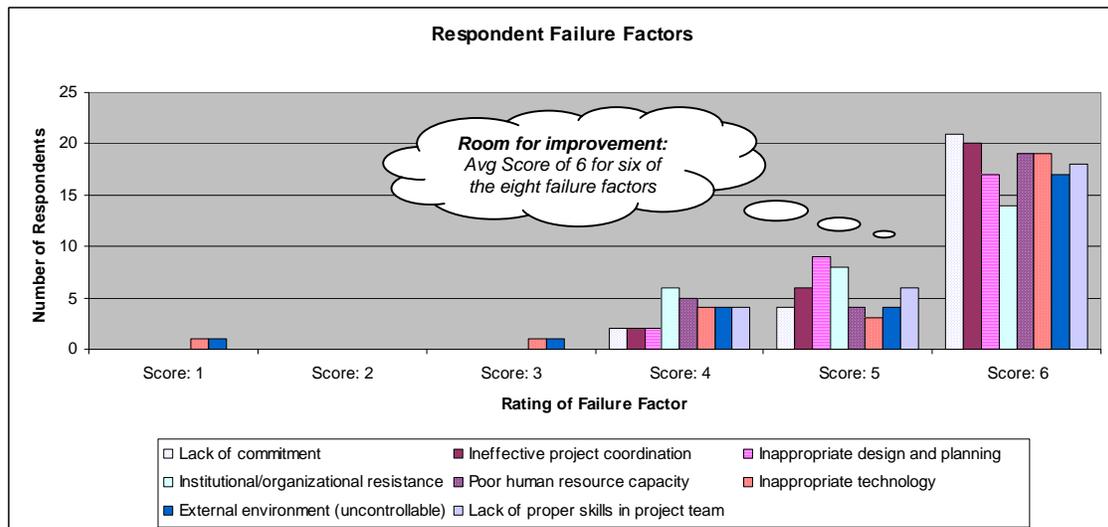


Figure 3: Respondent Ratings of Failure Factors



312. Interesting results worth noting include a qualified assessment of institutional resistance, type of technology used and the external environment. These three areas were considered less of a problem for stalled implementation than other factors such as lack of commitment and inappropriate design and planning. Moderate views of institutional resistance and type of technology suggest that officials believe that there is general support within Government for the IFMIS and the Free Balance software solution. The

view of officials of the impact of the external environment is noteworthy as the insecure environment is generally claimed to have had a significant impact on stalled implementation. The dispersion of views on the impact of the external environment (and links to the political environment), however, was relatively greater when compared to the other success factors with a higher standard deviation of 1.33 (political environment standard deviation. = 1.13). Presumably, the moderated view of the impact of the insecure environment reflects officials' experience in working in such an environment on a daily basis. There were numerous views expressed that coordination between donors and government could be improved. GoI officials appear to believe that, while coordination is a problem, a coordination mechanism is in place and is basically functional.

313. Implications for focus of any new FMIS implementation arrangements under this section include the development of strategies for: a) improving commitment and ownership; b) improving effectiveness of coordination amongst donors, between donors and government, and amongst ministries and departments; c) improving the design and planning functions; d) increasing relevant training including program, secretariat and change management and application usage; and e) developing an authoritative and skilled management team consisting of representatives of key and high ranking government officials (e.g. from MoF, MoP, line ministries, provinces, and BSA).

314. While supervision arrangements were not viewed as a significant problem by GoI officials, a review of supervision mechanisms in place over the last few years indicate that improved implementation could be achieved by restructuring supervisory roles and responsibilities. Currently, the GoI does not receive ongoing, active, and independent expert advice on recommendations received by Government from either the implementing agent or government officials on the steering committee. In addition, contract supervision is undertaken by staff inexperienced with supervision of FMIS projects set in conflicted affected environments. The impact of this arrangement is that the implementing agency may have inappropriate incentives in relation to identification of their principal client, which should be the Ministry of Finance and the Government of Iraq. This situation can lead to lags in decision making by the Government as it tries to assess advice, which it may view as potentially biased. Moreover, the lack of independent advice and inexperienced contract management may also result in lack of timely and appropriate information to make informed decisions on progress and direction of the project.

315. There are a number of measures available that could improve the supervisory function. For example, the appointment of an independent expert advisory panel could provide the necessary assurances needed by Government and contract management to facilitate implementation and management decision-making. Secondly, provision of training to contract supervisory staff on FMIS implementation in fragile state settings would provide improved skill sets to respond to emerging problems and assessment of project design recommendations. A third and more ambitious measure is the establishment of SWAp-like (Sector Wide Approach) arrangement for Public Financial Management reform, where the Government's development partners work together for

the provision of well coordinated set of assistance projects in line with the Government's medium-term PFM reform agenda, of which FMIS implementation is one key component. This approach facilitates discussion amongst a broader range of individuals and allows for key related reform activities to be programmed in a prioritized and well sequenced way. This last measure is subject to the development of medium-term reform program, which is envisaged as the next step following publication of the PEIA report. Medium term reform programming is discussed further in Chapter 9.

Assessment against the World Bank's Six Pillars

316. Officials' views were obtained on the compliance of the current IFMIS implementation strategy against the six pillars of the World Bank for successful FMIS reform. A general view became apparent that more could be done to meet all the implementation design recommendations that underpin the six pillars (see Figure 4). On average, respondents' views were that more work is needed to establish the preconditions necessary for successful implementation of a new FMIS. Attachment 4 highlights the lowest average scores by respondents for compliance with fourteen principles underpinning the six pillars.

317. Initial options to address the concerns raised by respondents in seven of the fourteen implementation principles assessed are as follows³⁸:

- 1) **Strategy:** FMIS aligned with imminent public interest through media³⁹;
 - Development and implementation of a communication strategy to raise the profile of the FMIS within Iraq. An ongoing media engagement and internal communication strategy are key elements.
- 2) **Strategy:** Right incentives instituted through laws and regulations;
 - Introduction of reform incentives or a piloting of a merit-based employment scheme that would introduce performance management systems, performance pay and meritocracy principles in recruitment, appointment and promotion.
 - Review legislation for required amendments and gaps in implementing regulations (also see item 7 below).
- 3) **Funding and stakeholder cooperation:** Effective coordination among donor communities;
 - Introduction of effective consultation and coordination arrangements. This could be achieved by incorporating the Government's implementation framework for the International Compact with Iraq (see 2007, Mid-Year Progress Report, GoI).
 - Develop an overarching PFM reform program and co-financing strategy.

³⁸ Scores of around 4 and under indicate that there are opportunities to improve FMIS implementation.

³⁹ There was some disagreement on the importance of media involvement.

- 4) **Funding and stakeholder cooperation:** Procurement: right balance between development effectiveness and fiduciary responsibility;
 - Develop and implement enhanced arrangements for contract management and project supervision arrangements.
- 5) **Human Resource:** Training program on all aspects (program and change management and application usage) developed and delivered;
 - Develop and implement enhanced training program targeting project and change management teams and users at all levels of Government.
- 6) **Institutional:** Business process change precedes computerization;
 - Undertake as a matter of priority a review of existing budget execution procedures for documentation with the view to identify areas for streamlining of processes, improving internal control and informing FMIS design.
- 7) **Institutional:** Laws/regulations amended.
 - Undertake as a matter of priority a review of previous and existing legislation in light of the review of existing budget execution procedures and other known required amendments to the Financial Management Law;
 - Develop drafting instructions for amendments to the Financial Management Law and necessary implementing regulations and instructions.

318. **Officials provided common and important comments on qualitative aspects** according to the six pillars; leadership, strategy, funding, human resources, institutional support and technology. These are summarized below, while the following summarizes key messages from respondents:

- **Leadership:** Improving coordination and communication amongst all stakeholders (leadership, project management teams, users, development partners, contractors, and media) is important.
- **Strategy:** A strategic plan and a clear implementation strategy should be discussed and agreed by all key stakeholders.
- **Funding:** Funding should be provided to provide incentives to those involved in reform. Arrangements need to be enhanced to improve contract management, disbursement, and supervision.
- **Human Resources:** Training is a top priority – induction programs for new staff or newly assigned staff is needed as are ongoing training programs for project and change management and application usage.
- **Institutional Support:** Improving the understanding of all key stakeholders on what is necessary to change existing processes, laws and regulations and their implications is critical to secure institutional support for such change.
- **Technology:** More computers with supporting upgrade and maintenance programs are needed.

Assessment against the IMF's Five Pre-conditions

319. **Views expressed by officials were also varied** on compliance of the current IFMIS implementation strategy with the IMF's five pre-conditions for the development of an IFMIS. Similar to the views expressed under the World Bank's six pillars, there was a general expression that while respondents are supportive of the IFMIS, more could be done to improve compliance with the implementation strategy design recommendations that underpin the five pre-conditions.

320. **On average, officials' views were that more work is needed to establish the preconditions necessary for reform.**⁴⁰ Reengineering work practices, provision of a working environment that encourages reform, training, and stakeholder (including users and steering committee members) engagement are seen as areas where a revised implementation strategy could focus. There was also a general perception that design is weak, with insufficient level of stakeholder engagement during the design phases. Respondents also noted that management arrangements could be improved and that there was probably undue delegation of authority to the contractor and contract managers. Median results suggest that further work on establishing *all* the pre-conditions may be necessary.

321. **Officials also provided revealing comments** through the qualitative section of the survey structured according to the five pre-conditions; 1) commitment and ownership; 2) reform preconditions 3) project design; 4) project management; and 5) resourcing.

322. **Priority areas identified by respondents included the following:**

Authorities' commitment and ownership

323. **Officials expressed the view (and consistently through the survey) that they believe their leadership at the highest levels is fully committed** to the IFMIS and reaffirmed its importance as part of the Government's public financial management reform program. However, commitment and ownership at official levels was seen as weaker, presumably due to the lack of: i) stakeholder consultation, ii) a change management plan; and iii) communication strategy. More engagement with other departments and Governorates was identified as a key need. A lack of delegated authority to government officials to implement and make decisions and a potential undue delegation of authority to the contracted firm was also noted by respondents.

Preconditions for reform

324. **Comments in this area focused on incentives, re-engineering of budget execution processes, training and coordination arrangements.** Pecuniary and non-pecuniary incentives for active engagement in the reform process are absent. Similarly, facilities for Government staff, that reflect the importance of the IFMIS to Government,

⁴⁰ Scores of around 4 and under indicate that there are opportunities to improve FMIS implementation.

are also absent. A process for the identification of current budget execution practices (e.g. at the budget release, commitment, verification, payment, audit stages), bottlenecks and control points has not yet been undertaken satisfactorily. Consequently, the implicit implementation strategy seems to have been to implement an automated accounting system that requires different budget execution work practices, thereby forcing a change in work practices. The opportunity for this fast-tracked method of implementation may have applied when the work began. However, given the current situation, a more systematic approach is now felt to be warranted.

325. More training to more government officials was identified as a critical need, as was the implementation of new arrangements for stakeholder consultation and coordination (e.g. with development partners, other ministries, the Board of Supreme Audit and the provinces).

Design

326. Officials clearly identified design issues as the weakest element of the initiative. Prior to the roll-out of hardware, benefit could have been derived from an informed position on current budget execution procedures (including the existing accounting framework and chart of accounts) being followed under the legacy system. Respondents expressed the view that stakeholder consultation during the design phase and review was insufficient. In addition, respondents noted the absence of a comprehensive timetable for all aspects of the initiative including: i) design and review, ii) accounting process review with streamlining option development, iii) stakeholder consultation and coordination, iv) Information and Communications Technology (ICT) roll-out, v) contract management and supervision, and vi) a comprehensive training program.

Project Management

327. Project management was seen by respondents as an area where relatively easy improvements can be achieved. For example, more involvement from financial managers and other key users was viewed as critical for success. Training for Government officials in project management and secretariat functions was also identified as an important need. Establishing the mechanism for broad consultation within Government (amongst central and line agencies and between the Baghdad and the Governorates and region) and between Government and its development partners and other stakeholders (such as the NGOs interested in transparency and accountability issues as well as the media). Improved arrangements for contract management and supervision were identified as a priority. In this regard, greater involvement in contract management by the project management team and leadership is seen as a critical first step to improving contract management.

Resourcing

328. Uncertainty of the source and level of funding for public financial management reform generally and the IFMIS specifically was identified as a major problem. Respondents noted that co-financing arrangements between bilateral, multilateral and the Government were unclear. During discussion, it was evident that a multi-year project budget specifying contributions and support areas had not been discussed or communicated with stakeholders. Moreover, funding and reform linkages with other PFM initiatives closely linked with the FMIS project was also unclear. While the government is starting to progress towards a medium-term approach to PFM reform programming through the International Compact with Iraq, the second National Development Strategy and this Public Expenditure and Institutional Assessment (PEIA), there remains no overarching PFM reform strategy paper to help guide leadership, decision makers, policy implementers and communication specialists.

Overall implications for the IFMIS

329. The FMIS implementation survey essentially used three different frameworks to ascertain views of Government officials on the effectiveness of the FMIS implementation strategy that has been followed over the last four years. The survey sought assessments against: i) known success and failure factors for FMIS project design and implementation; ii) the World Bank's Six Pillars to Support Successful FMIS Reform; and iii) the IMF's Five Pre-conditions for Development of an FMIS. Analyses of responses under the three methods were consistent and reinforced revealed positions. Consequently, results from the survey and issues raised in the discussion section above have a number of implications for the current FMIS project.

330. The IFMIS is clearly seen by respondents as an important project to progress reform of Iraq's Public Financial Management system. Moreover, respondents expressed a generally non-negative view of current arrangements. Nevertheless, it is apparent from analysis of quantitative results of the survey and inspection of comments provided by officials in the survey and at the workshop that there are opportunities to improve the IFMIS implementation strategy and effectiveness of the project.

Development of a Reinvigorated IFMIS Implementation Strategy

331. The following provides a summary of options to which a reinvigorated FMIS implementation strategy could be founded. Recommendations are grouped in to the following five themes:

- A. Improving supervision, contract management and co-financing;
- B. Improving project management;
- C. Strengthening ownership, commitment and partnership;
- D. Enhancing design; and
- E. Setting FMIS reform within the context of an overarching PFM reform agenda.

A. Improving Supervision, Contract Management and Co-financing

- **Establish an independent expert panel** comprising specialists from multilateral organizations and consultants.
- **Establish guidelines for supervision** of projects that are relevant to a fragile, oil-producing country like Iraq
- **Provide FMIS Project supervision training** set within the context of the above guidelines.
- **Undertake a review of contract management arrangements** concentrating on ways to improve ownership, partnership and long term visioning with a greater focus on results through contract specification and PFM reform programming. Areas to address could include: i) consultant approval processes; ii) contract deliverables and endorsement mechanisms; iii) PFM reform programming and co-financing planning; iv) dialogue with stakeholders on PFM reform partnership principles; and v) development of multi-tiered project performance indicators.

B. Improving Project Management

- **Enhance the effectiveness of the Project Management Team (PMT) and Secretariat** by increasing the number of well qualified and experienced Government Officials on the PMT.
 - Staff to be drawn from key departments within the MoF, MoP, BSA and Governorates.
 - Develop a system to provide financial incentives;
 - Establish professional development and training program for PMT and secretariat staff (e.g. training on program management, change management, international procurement, stakeholder consultation and contract management).
- **Establish a change management and communications section** with the PMT.
- **Develop a consultation strategy**, which could include setting regular steering committee meetings, wider stakeholder consultation arrangements, a media strategy for engagement with external stakeholders and production and distribution of an Arabic PFM/FMIS reform newsletter and website.
- **Provide high quality facilities for the PMT.**

C. Strengthening Ownership, Commitment and Partnership

- **Improve incentives** through piloting a merit based employment initiative.
- **Develop and agree an enhanced consultation process** for contract payments. Establish a Development Partners Committee comprising of interested Donors.⁴¹
- **Enhance the approval process** for appointment of consultants with greater consultation with Government.

⁴¹ Note that this committee should comprise of donor representatives that are staff and not consultants who are engaged to provide technical assistance and/or capacity development services.

- **Provide independent advice** through the establishment of an independent expert advisory panel and dialogue through a Development Partners Committee and the Public Resource Management Thematic Working Group.⁴²
- **Increase depth of understanding of FMIS functionality options** and implementation lessons by undertaking a study tour. Potential countries to visit include: UAE, Jordan, Beirut, Iran, Egypt, Russia, Pakistan, Australia, New Zealand and Thailand.
- **Include a comprehensive set of partnership principles** in a memorandum of understanding between the Ministry of Finance, the Ministry of Planning and Development Cooperation, the Board of Supreme Audit and Development Partners involved or interested in supporting FMIS implementation.
- **Establish Project Management Offices** in the Ministry of Finance and the Adnan Palace. It is important that these offices be in primary locations and are properly equipped and furnished.⁴³

D. Enhancing Design - developing a prioritized and sequenced medium-term FMIS implementation plan.⁴⁴

- **Review functionality options** and FMIS implementation strategies.
 - Undertake a study tour of countries where FMIS implementation has worked relatively well and relatively poorly (see above).
 - Document the lessons learned from the study tour and revise implementation strategy as required.
- **Review user requirements.**
 - Stakeholder consultation on user requirements (include discussions on options to support the integration of recurrent, investment and donor budgets);
 - Documentation of agreed functional specifications;
- **Document and review budget execution related work practices and policies.**
 - Documentation of existing accounting framework including investment budget execution arrangements⁴⁵;
 - Documentation of existing in-year budget variation framework;
 - Documentation of existing budget execution practices: budget approval, procurement procedures, commitment, verification, payment and internal audit – should include all control and approval points for each economic and administrative type of expenditure where they differ;

⁴² Refer to the Government's Compact Implementation Framework – see 2007 ICI Mid-Year Progress Report.

⁴³ A key indicator that demonstrates a government's commitment to reform or a project is the location and quality of the office of project management teams.

⁴⁴ It should be noted that the scope of an FMIS implementation plan can be narrow or wide. For example, a wide scope would include review and streamlining of budget execution procedures in preparation for roll-out of FMIS hardware, software development and application training.

⁴⁵ Documentation of the accounting framework commenced on 22 Sep 07 through the 7th PEIA workshop.

- Development of options for the streamlining budget execution procedures – those options need to be considered within the context of pre, concurrent and post FMIS implementation.
- Development of options for roll-out of GFS based and GFS compliant Chart of Accounts (CoA).
- Review of all legislation (both current and rescinded) for consolidation and amendment of current and new policy practices.
- **Review implementation strategies**
 - Development of processes for policy change, legislative drafting, and gradual roll-out of functionality requirements;
 - Development of an engagement strategy for greater involvement by stakeholders – in supervision, project steering, project management and audit.
 - Development of incentive mechanisms that encourages reform and recognizes the best and brightest (e.g. see above for merit based employment initiative incorporating pecuniary and non-pecuniary incentives and performance management systems with selection based on principles of meritocracy);
 - Development of a strategy to establish a core team of knowledge workers;
 - Development of a change management and internal and external communications strategy (see above);
 - Development of a comprehensive training strategy (program and change management, supervision and application usage);
 - Development of a new strategy for the parallel operation of legacy accounting system, application training, piloting, testing and roll-out of the FMIS. A training and stakeholder engagement strategy needs to be based on hands on usage of the existing system that has been rolled-out to the Governorates to-date.⁴⁶

E. Setting FMIS Reform within the Context of an Overarching PFM reform Agenda

- **Prepare an FMIS implementation strategy set within the context of medium-term public financial management reform** (a post-PEIA initiative).

Conclusions

332. Discussions during the PEIA workshop on FMIS implementation and results of the survey revealed a number of important perceptions that Government officials have of IFMIS implementation in Iraq. Firstly, it is clear that the IFMIS is seen as a high PFM reform priority and that the project teams have progressed implementation in a

⁴⁶ This is an important element as it will safeguard the investment in hardware and software that has been rolled out to-date, pending completion of other key components of a new FMIS implementation strategy. This element is subject to the Government's decision to either: i) start again and commence more fundamental PFM reform measures prior to downstream FMIS implementation; or ii) continue with the existing software and hardware solution under a new and reinvigorated FMIS implementation strategy.

very difficult context. The difficult context is not only due to the poor security environment of the last four years but also the nature of how the project was procured and designed from the outset. While it was clear that there may have been an opportunity to fast-track IFMIS implementation at commencement, this opportunity has now passed.

333. **The GoI has now signed a Memorandum of Understanding with the US Government to continue with the IFMIS project.** Consequently, the need now will be to develop a revitalized IFMIS project implementation strategy informed by the concurrent development of a medium-term PFM reform program.

334. **Given the views of Government officials attending the PEIA workshops and survey responses, it is apparent that a revitalized implementation strategy is achievable.** The main reason for this position is based on the revealed perceptions that Government ownership and commitment and project management arrangements are generally sufficient to drive reform and achieve objectives. Nevertheless, there appears to be obstacles in achieving real progress. These obstacles are summarized in to the following six areas:

- i) **Unsatisfactory project supervision** and contract management arrangements;
- ii) **Lack of support** for and recognition of Project Management Teams;
- iii) **Insufficient or inappropriate incentives** to promote the Government's PFM reform agenda;
- iv) **Inadequate consultative, coordination and co-financing arrangements** to support high levels of ownership, effective partnerships and high degrees of commitment from key stakeholders;
- v) **Poor IFMIS project design** and more specifically the planning process to set the IFMIS implementation strategy; and
- vi) **An absence of a medium-term PFM reform program** that informs the prioritization and sequencing of specific PFM reform measures including development and roll-out of an IFMIS.

Next Steps

335. **In terms of a revitalized IFMIS implementation strategy, several steps are recommended.** These include:

- a) **Undertake stakeholder consultation** – with discussion focusing on the positions and recommendations raised in this chapter;
- b) **Develop further** options to improve IFMIS implementation for Government's and Development Partners consideration focusing on the following areas:
 - Improving supervision, contract management and co-financing;
 - Improving project management;
 - Strengthening ownership, commitment and partnership;
 - Enhancing design; and
 - Setting IFMIS reform within the context of an overarching PFM reform agenda.

- c) **Progress the development of a medium-term PFM reform program;**
- d) **Draft a new IFMIS implementation strategy** based on above consultations;
- e) Undertake **further dialogue** with stakeholders (especially with senior leadership, end users and project management teams) on the draft IFMIS strategy as well as the prioritization and sequencing of PFM reform measures;
- f) Agree **and document a new IFMIS implementation strategy** based on an enhanced project design;
- g) Agree **and document mutual obligations and partnership principles** (e.g. through a MoU on co-financing, supervision, partnership and management of the project – items 6 and 7 can be consolidated in the form of a project document.
- h) **Operationalize key consultative and management arrangements;**
- i) **Publish the project document** and commence an external communication strategy; and
- j) **Commence** implementation in accordance with the project design, project implementation strategy and improved partnership arrangements.

Attachment 1: Respondent Rating of Success and Failure Factors –Result

Factors	Avg	Med	s.d.	Min	Max	N
Success Factors						
Flexible project management	5.46	6	0.65	4.00	6.00	26.00
Effective project coordination	5.29	5	0.66	4.00	6.00	28.00
Links to political environment	4.85	5	1.13	1.00	6.00	27.00
External environment (uncontrollable)	5.04	5	1.33	1.00	6.00	23.00
Capacity building (training) plan	5.26	5	0.76	4.00	6.00	27.00
Close supervision	5.48	6	0.77	4.00	6.00	25.00
Failure Factors						
Lack of commitment	5.70	6	0.61	4.00	6.00	27.00
Ineffective project coordination	5.64	6	0.62	4.00	6.00	28.00
Inappropriate design and planning	5.54	6	0.64	4.00	6.00	28.00
Institutional/organizational resistance	5.29	5.5	0.81	4.00	6.00	28.00
Poor human resource capacity	5.50	6	0.79	4.00	6.00	28.00
Inappropriate technology	5.32	6	1.22	1.00	6.00	28.00
External environment (uncontrollable)	5.26	6	1.23	1.00	6.00	27.00
Lack of proper skills in project team	5.50	6	0.75	4.00	6.00	28.00

Bolded items reflect possible areas of attention during implementation review

Attachment 2: Respondent Assessment: World Bank Six Pillars - Table of results

Six Pillars to Support Successful FMIS Reform	Avg	Med	s.d.	Min	Max	N
1) Leadership - Strong and consistent commitment from leadership	5.11	6	1.32	2.00	6.00	18.00
2) Strategy - Roles of stakeholders recognized and engaged in reform	4.58	5	1.22	3.00	6.00	19.00
• FMIS aligned with imminent public interest through media	3.62	3	1.42	1.00	6.00	26.00
• Right incentives instituted through laws and regulations	3.72	3	1.49	1.00	6.00	25.00
3) Funding -Enough support secured and stakeholders working together	4.37	5	1.38	1.00	6.00	19.00
• Effective coordination among donor communities	4.17	4	1.27	2.00	6.00	23.00
• Procurement: right balance between development effectiveness and fiduciary responsibility	4.14	4	1.08	2.00	6.00	22.00
4) Human Resource - <i>People determine reform success</i>						
• Training program on all aspects (program and change management and application usage) developed and delivered	4.04	3.5	1.37	2.00	6.00	24.00
• Core team of knowledge workers with right skill mix established	4.44	5	1.36	2.00	6.00	25.00
5) Institution/organization support - <i>A secret for sustainability</i>						
• Process change precedes computerization	4.22	5	1.51	2.00	6.00	23.00
• Laws/regulations amended	4.16	4	1.12	2.00	6.00	19.00
6) Technology						
• Affordable	4.24	4	1.30	2.00	6.00	25.00
• Understandable	4.44	4	1.26	2.00	6.00	25.00
• Scalable and connectable	4.28	4	1.28	2.00	6.00	25.00

Bolded items reflect possible areas of attention during implementation review

Attachment 3: Respondent Assessment: IMF Five Pre-conditions – Table

Five Pre-conditions for development of an FMIS	Avg	Med	s.d.	Min	Max	N
1) Authorities' commitment and ownership is clear	4.53	4	0.94	3.00	6.00	17.00
• Clear institutional designation	4.50	4	1.06	2.00	6.00	22.00
• Clear authority to implement	4.40	4	1.05	2.00	6.00	20.00
• Active involvement, with no undue delegation to suppliers	4.15	4	1.23	2.00	6.00	20.00
2) Preconditions are ready for reform	3.60	4	1.26	1.00	6.00	10.00
• Authorities prepared to reengineer work practices	3.67	4	0.59	3.00	5.00	18.00
• Environment encourages reform	3.52	3	1.12	1.00	6.00	21.00
• Sufficient skills and/or training available	4.25	4	0.85	3.00	6.00	20.00
• Users are "sold" on the system	4.29	4	0.78	3.00	6.00	21.00
• Steering group is active and representative	4.41	4	0.87	3.00	6.00	17.00
3) Project design is sound	3.71	3.5	1.07	2.00	6.00	14.00
• Adequate time taken on design phase	3.30	3	1.26	1.00	6.00	20.00
• Users fully involved in specification	3.75	3.5	1.25	2.00	6.00	20.00
• Not too ambitious in scope	4.07	4	0.88	3.00	6.00	15.00
• Timetable is realistic	3.53	3	1.07	2.00	6.00	19.00
4) Management of project is capable	4.00	4	1.13	3.00	6.00	12.00
• Adequate management skills	4.27	4	1.03	3.00	6.00	22.00
• Managers motivated to reform	4.50	4.5	1.22	2.00	6.00	22.00
• Full-time implementation team identified	4.50	5	1.06	3.00	6.00	22.00
• In-house or outsourced maintenance capacity identified, in place, and costed	4.57	5	1.24	1.00	6.00	23.00
5) Adequate resources are assured	4.33	4	1.12	3.00	6.00	9.00
• Sufficient funds since actual costs might exceed anticipated cost	4.59	4	0.87	3.00	6.00	17.00
• Resource demands caused by operating two parallel systems simultaneously	4.65	5	1.00	3.00	6.00	17.00
• Sufficient resources for long-term operation and maintenance of the system	4.61	4	0.92	3.00	6.00	18.00
If the above requirements are not in place in the order listed, a phased approach and/or interim solution	4.29	4	0.99	3.00	6.00	17.00

Bolded items reflect possible areas of attention during implementation review

Attachment 4: Lowest Average Scores against the World Bank’s Six Pillars

Pillar to Support Successful FMIS Reform	Avg
2) Strategy - Roles of stakeholders recognized and engaged in reform	
• FMIS aligned with imminent public interest through media	3.62
• Right incentives instituted through laws/regulations	3.72
3) Funding –Enough support secured and stakeholders working together	
• Effective coordination among donor communities: (project objectives and accounting/ reporting requirement not different)	4.17
• Procurement: right balance between development effectiveness and fiduciary responsibility	4.14
4) Human Resource - <i>People that determine the success of reform</i>	
• Training program on all aspects (program and change management and application usage) developed and delivered	4.04
5) Institution/organization support - <i>A secret for sustainability</i>	
• Process change precedes computerization	4.22
• Laws/regulations amended	4.16

Bolded items reflect possible areas of attention during implementation review

Attachment 5: Lowest Average Scores against the IMF's Five Pre-Conditions

Five Pre-conditions for development of an FMIS	Avg
1) Authorities' commitment and ownership is clear	
• Active involvement, with no undue delegation to suppliers	4.15
2) Preconditions are ready for reform	3.60
• Authorities prepared to reengineer work practices	3.67
• Environment encourages reform	3.52
• Sufficient skills and/or training available	4.25
• Users are "sold" on the system	4.29
• Steering group is active and representative	4.41
3) Project design is sound	3.71
• Adequate time taken on design phase	3.30
• Users fully involved in specification	3.75
• Not too ambitious in scope	4.07
• Timetable is realistic	3.53
4) Management of project is capable	4.00
• Adequate management skills	4.27
<i>A phased approach and/or interim solution</i>	4.29

Bolded item underscore lowest average scores

CHAPTER 4: ACCOUNTING AND ACCOUNTABILITY IN IRAQ

Summary

336. Public accountability demands an accounting framework that enables the reporting of clear and timely financial information to all those internal and external stakeholders who have an interest in, or responsibility for, the way the public money is being spent. It also requires well-defined institutional arrangements by which society and its elected representatives may hold the Executive accountable for its actions. The purpose of this chapter is to review the nature of public accounting and accountability in Iraq.

337. This chapter identifies the need for reform of Iraq's public accounting methods and standards, beginning with a comprehensive exercise to document the existing accounting framework. There is confusion over the status and applicability of various accounting laws and regulations, resulting in inconsistent application of accounting procedures and principles. A reform program will serve to improve the ability of the GoI to report fully and transparently on its financial transactions and situation to internal and external users of government financial reports and statements. The chapter sets out a framework for documenting current Iraqi public accounting practice.

338. The second part of this chapter considers the public accountability institutions (“also known as the anti-corruption pillars”) in Iraq and the key issues and challenges that they face. These include:

- A lack of capacity in the public sector including the public accountability institutions themselves
- Lack of clarity in the financial management regulatory framework
- Poor coordination between the public accountability institutions coupled with an unclear allocation of roles and responsibilities
- Difficulties caused by the security situation
- The misuse of laws

339. The GoI has recognized the need for greater clarity and consistency in public accounting. The fact that it has set as a priority the documentation of Iraq's public sector accounting framework is reflected in the ICI⁴⁷ and the Government's agreement with the IMF under a Stand-By Arrangement (SBA)⁴⁸. Documentation of the framework has been a standing recommendation of the IMF since June 8 2006, primarily through reviews of

⁴⁷ ICI Action item 4.1.2 B.3: By end 2008, accounting framework to be documented and implemented.

⁴⁸ SBA Structural Performance Criterion II.3: Adoption of fully detailed budget classification and chart of accounts in line with the IMF's Government Financial Statistics Manual (GFSM) 2001, within a cash accounting framework (originally due: 30 June 2006)

the GoI's Chart of Accounts (CoA)⁴⁹ and the Financial Management Information System (FMIS) project. Follow up action on the IMF's recommendation has been slow, which may reflect a misunderstanding of the recommendation.

340. The PEIA analysis established that, for internal bookkeeping purposes, the GoI uses what has traditionally been known as a modified cash based system of accounting. Elements of an accrual basis of accounting are followed for recording certain transactions. For example, for transactions that form the Government's consolidated cash flow statement⁵⁰ the MoF generally follows a cash basis of accounting, where transactions are recognised when cash is received or paid. For certain balance sheet and memorandum items, however, the MoF follows an accrual system of accounting, where transactions are recognised when they occur (i.e. not at the point in time when cash is received or paid). Treatment of certain financial assets, such as receivables, prepayments, advances, and certain financial liabilities, such as payables, borrowings and accrued expenses, are recognized on an accrual basis. Non-financial assets are recorded on a cash basis and on a historical cost basis. In addition, memorandum accounts are used to record some contingent assets and liabilities, such as letters of credit oil revenue from contract sales and donor asset transfers.

341. Public accountability demands confidence on the part of users of financial reports that the financial information they contain is reliable. In Iraq, since the government's accounting policies are not consolidated or codified there is limited confidence in financial reports. Moreover, there are anecdotal indications of some inconsistency in reporting and accounting among ministries, which also undermines the reliability of financial statements. Consequently, there is a pressing need to document and apply a coherent set of accounting policies through a structured process of consolidation of existing legislation, instructions and standards and review.

Accounting Concepts and Standards

342. The BSA and the Accounting Department of the MoF are the bodies involved in establishing the concepts and standards for public sector financial accounting and reporting in Iraq. Under BSA Law 1990, Article 2.2.4 as amended by CPA Order 77/2004, Section 3, the BSA is responsible for promulgating accounting regulations based on accepted international standards, and cooperates with the Commission for Public Integrity (CPI) (now renamed the Commission on Integrity) to improve on a continuous basis the rules, practices and standards applicable to accounting for public funds in Iraq. Under the draft BSA Law of 2005, Article 3, the BSA would be mandated to expand the accounting systems based on the *local and* international standards and improve rules and standards applicable to the management and accounting. Under Section 6.4.b the Financial Management Law (FML) of 2004, the Minister for Finance (MfF) is responsible for determining the economic and functional classification system

⁴⁹ "A chart of accounts (COA) is a logical coding framework that forms the basis of recording accounting transactions and balances (flows and stocks) in the general ledger, the principal accounting record of an entity." (See A Khan and S Mayes, *Transition to Accrual Accounting*, IMF)

⁵⁰ Or statement of operations

for the budget estimates in accordance with international standards. Under Section 11.3, the FML also requires the MfF to prescribe “*internal control arrangements, accounting procedures and standards, submission of reports on the usage of budget funds, and the manner of recording receipts, payments, and commitments*”.

343. The rules defining the accounting framework of the Government of Iraq date back to the laws of Accounting Principles (Law 28) from the 1940’s. These were amended every decade up to the 1985. With the fall of the previous regime, the Coalition Provisional Authority (CPA) introduced the FML, which establishes the public financial management framework for Iraq. Copies of Iraq’s accounting rules and regulations are available, although they are not in one place and may not be complete. A list of known available legislation and documents is provided at Attachment 6. It is understood that not all accounting related documentation is available due to the loss of documents from events that occurred immediately after the 2003 war.

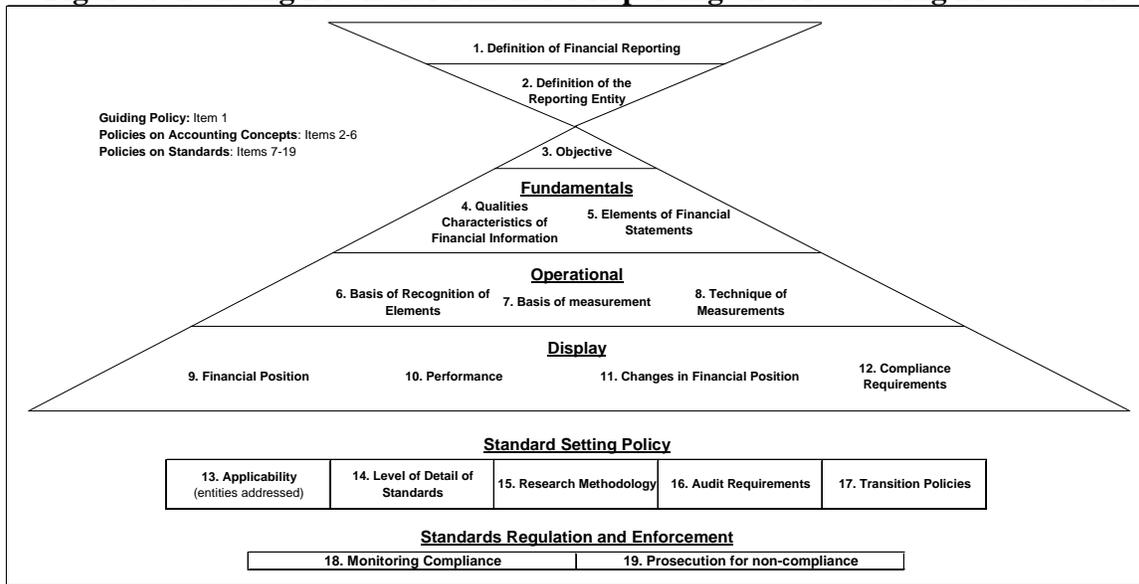
344. The accounting framework and public sector accounting practices as currently being practiced have not yet been comprehensively documented. Because of this and a lack of dissemination, it is assumed that Iraq’s accounting concepts and standards are not well known by all the Iraqi officials that need to know this information. Consequently, the PEIA workshop raised the importance of using a common approach to documenting Iraq’s Accounting Framework. In order to document the framework, it may be useful to refer to the building blocks for documenting accounting and financial reporting frameworks (see Figure 4).

345. Documenting the accounting framework and internal control practices will also prepare the way for further Public Financial Management (PFM) reform measures. Documenting Iraq’s accounting framework is essential to provide consistent and accurate accounting and financial reporting. It also helps establish the pre-conditions required for successful implementation of a modern FMIS.

Building Blocks for Documentation of the Accounting Framework and Financial Reporting

346. Accurate financial reporting, for both internal and external users of financial information, is the primary objective of accounting. Consequently, the accounting framework needs be seen in terms of where it fits within a financial reporting framework. This will help ensure that documenting the accounting framework is done well and sets the conditions for further reform down the track.

Figure 4: Building Blocks for Financial Reporting and Accounting Framework



Source: drawn from AASB, PS 5

347. **Figure 4 provides an overview of key elements that need to be considered when documenting an accounting framework.** The logical first step is to establish the guiding policy by defining the scope of Government financial reporting (item 1). Basically, this informs the establishment of the accounting components. Items 2-6 in the figure establish the policies on accounting concepts to be applied. These policies define the:

- Criteria for determining reporting entities (item 2);
- Objectives of financial reporting (item 3);
- Qualitative characteristics of financial information (item 4);
- Elements of financial statements, e.g. receipts, expenditures, assets, liabilities and equity (item 5); and
- Basis of recognition of each element (item 6).

348. **Items 1-6 are foundation concepts for accounting and therefore, they could be the structure followed when documenting an accounting framework.** Items 7-8 deal with operational aspects of accounting policies and provide the bases and techniques for the measurement of the elements of financial statements. Items 9-12 deal with the nature of information that should be displayed in financial reports. Items 13-17 deal with the policies that a standards setting entity would adopt in relation to the development, structure and application of accounting standards. Items 18-19 establish procedures for monitoring compliance with established accounting standards.

349. **The public sector financial reporting environment practiced around the world is characterized by a spectrum of practices** between cash accounting and accrual accounting (see attachment 2 for an outline of the accounting basis used by thirty different countries). Different governments adopt a variety of reporting practices along this spectrum.

350. A key objective of documenting the accounting framework is also to establish a documented set of public sector accounting standards and an instruction manual that describes in detail each item of the Government's CoA. The purpose of the framework document establishes the foundation policy that guides the drafting of detailed instructions on each item on the CoA. The purpose of the instruction manual is to provide transparent guidance to the public sector accountants and financial controllers responsible for recording transactions and provides the basis for auditing of standards compliance. Ideally, the framework and instructions manual should be based on international and local standards. The instruction manual breaks down the five elements and/or sub elements (item 5) to the lowest transaction coding level. In other words, the accounting framework document provides a description and the recognition criteria of each element and sub-element if necessary, while the manual provides the detail for every transaction code.

351. The International Public Sector Accounting Standards (IPSAS) structure could be used to guide the documentation of the accounting framework. There is an urgent need to get greater clarity on certain accounting policies, such as the accounting treatment of transactions associated with letters of credit,⁵¹ advances to ministries,⁵² foreign currencies,⁵³ joint ventures and conditional and unconditional grants to sub-national governments as well as administered or agent related cash flows.⁵⁴ Consequently, it is recommended that when documenting the accounting framework, a review of accounting practices be conducted using the IPSAS structure as a guide. This will help identify the formal policy gaps of current practices and also lay the groundwork for straightforward comparison of current practices with international standards. The Government will then be in strong position to prioritise and sequence reform options as they deem necessary while at the same time have a solid platform to improve quality of reporting using existing practices.

A Way Forward

352. Representatives from the BSA and the GoI with support from the international community could form a technical working group to compile and

⁵¹ MoF have elaborated that letters of credits (L/C) are treated as advances at the time of issuance. These are then adjusted and treated as expense as and when certain documents required by an LC, such as a bill of lading and/or inspection certificate, are received.

⁵² MoF maintains current accounts with line ministries (centralized and decentralized spending units and provinces). When funds are released they are charged against such current accounts (likely as an advance). These are then adjusted (expensed) as and when line ministries (centralized and decentralized spending units) submit their trial balance. By 15 of each month, line ministries (centralized and decentralized spending units) are required to submit their trial balances.

⁵³ MoF advised that they book foreign currency revenues (receipts) from sale of petroleum products on the basis of information received from CBI. The CBI receives timely information on cash balances of the Development Fund for Iraq (DFI), where all oil receipts are deposited under authority of UNSC resolutions. It is understood that contracted oil sales information is not yet provided to the CBI or MoF in a timely or complete manner. The GoI has identified this as an ICI priority.

⁵⁴ It is not yet clear how revenues collected by SOEs are being collected and deposited in the national treasury. Consequently, the accounting treatment is also not yet clear.

discuss all of Iraq’s financial and accounting laws, regulations, instructions and actual accounting practices. The group would have the responsibility of drafting, and agreeing at the official level, a single document that lays out the accounting framework currently in practice. A proposed name of the technical working group is the “Iraq Accounting Reform Group (IARG)”.

353. Oversight of the IARG would be by the Public Resource Management Working Group (PRM WG), which is responsible for monitoring and driving the GoI’s PFM reform priorities as laid down in the ICI. This is appropriate as the documentation of the accounting framework is an ICI priority action.

354. Leadership of the IARG would be through assigning joint chairmanship to the BSA and MoF, reflecting their respective roles and responsibilities. Members of the group would need to include director general and assistant director general level officials from the BSA, MoF (Accounting and Finance Departments and Governorate Treasuries), MoP, Inspector Generals, line ministries (e.g. MoE, MoT and MoH), and a significant State-Owned Enterprise (SOE). In-country technical assistance to the IARG could be provided by the World Bank, DFID and the Office of the US Treasury Attaché. Further Technical Assistance could be provided by the IMF and other international and/or regional institutions.

355. In order to produce an approved Accounting Framework document for Iraq, it is recommended a three-phased approach be adopted as follows:

Phase 1: Preparation

This phase includes development of: i) a project document and detailed work plan; ii) collection and translation (where unavailable) of all available current and rescinded financial and accounting laws; iii) other related documentation; and iv) preparing workshop materials and logistics.

Phase 2: Workshops

- The workshops would bring the technical working group together to discuss, identify, and describe if possible any undocumented key accounting policy gaps and agree in-principle the first draft of Iraq’s Accounting Framework as it is understood to be currently followed.
- The workshop would also be a forum to discuss the importance of accounting reform within the context of PFM reform generally and PFM reform measures specifically, such as the implementation strategy of an FMIS.

Phase 3: Consultation and Publication of the Final Report.

- This phase will involve reviewing the draft through wider stakeholder consultation and consideration by the relevant authorities, being the President of the Board of Supreme Audit, the Minister for Finance and the Council of Ministers. The IMF and other international bodies should also be consulted.

356. **Commencing work to document the GoI's internal control processes could occur** during or after the third phase. This work would involve reviewing each budget execution control point from commitment through verification and payment. This step is unlikely to be able to be done in parallel with the accounting framework work as the same people would need to be involved. Expanding the scope of the workshop is an alternative. However, this is likely to get too unmanageable with the current security environment and existing workload of officials that need to be involved. Audit controls should be addressed separately but could be conducted in parallel.

357. **After the accounting and internal control frameworks are documented, development and discussion on detailed reform options could commence.** It is noted that it may be possible to introduce certain elements of reform during the documentation phase, however, at this stage it should not be a key objective of the workshops.

358. **On approval of the phased approach, a concept note financial and technical assistance could be sought from Iraq's Development Partners.** It is understood that the World Bank, IMF, DFID and the Office of the US Treasury Attaché and USAID stand ready to provide assistance. A workshop assistance program would then be developed further and costed. A preliminary costing exercise has estimated that the workshop component would require around \$250,000, which is based on conducting two week-long workshops outside Iraq. This cost estimate does not include operation costs, staff time, security costs of any workshop and assistance provided in Baghdad.

Public Accountability

359. Weak public accountability constitutes one of the most significant governance challenges facing Iraq. **This section of the chapter will describe and analyze the overall framework of the oversight and accountability institutions and seek to identify the key issues and systemic challenges in Iraq. It comprises both an overview of the public accountability framework and detailed consideration of the individual organizations.**

360. **The public accountability architecture in Iraq comprises three primary organizations that have become known as the three public accountability, or anti-corruption "pillars".** Effectively, this framework was established by the Coalition Provisional Authority (CPA). The three "pillars" are the BSA, the Office of IGs and the Commission of Integrity (COI). A diagrammatic representation of the roles and responsibilities of these organizations and their interrelationships is shown at Attachment 3

External Audit – The Board of Supreme Audit

361. **The Board of Supreme Audit (BSA) is Iraq's Supreme Audit Institution (SAI).** As such, it performs the government external audit function. It has been in existence since 1927. Over the years, it has been the subject of a number of amending laws, culminating in its re-establishment as an independent public institution with juridical

personality by CPA Order 77/2004 to: “enhance the economy, efficiency, effectiveness of the credibility of the Iraqi government”. This CPA Order 77/2004 amended the previous law of 1990.

362. The BSA is the most established of the public accountability organizations and is generally considered to have greater capacity than the newer organizations like the IGs and COI. Article 103 of the Iraqi Constitution establishes the financial and administrative independence of the BSA, and provides for it to be “attached” to the Council of Representatives (COR) -that is the legislature. Its budget come through the COR, thus enhancing the BSA’s independence. The Board President has ministerial rank and enjoys all the rights and privileges of a minister. The BSA has six regional offices that service the 15 governorates of Iraq. Most ministries have BSA units “embedded” within them. The BSA is trying to strengthen linkages with the two Boards in the Kurdistan Region, which operate independently of the Board at the center.

363. The BSA has the power to audit not just the federal budget and any supplement to it but also the financial statements of any organization that receives public money. During the course of the audit of ministries, the Minister and relevant IG are given the opportunity to respond to any issues of concern identified by the BSA before these are included in the formal audit report. BSA audit reports are provided to both the IGS and the CPI. Criminal matters are referred to the latter. The BSA reports annually to parliament.

364. The BSA plays a role in the anticorruption setting primarily in terms of examining administrative corruption cases. However, the BSA has played an important role in identifying instances of grand corruption through its audit work.

The Inspector General System

365. The Inspector General (IG) system was set up in 2003 by the CPA in an attempt to ensure accountability throughout the GoI. Currently, there are approximately 37 IGs in total, with 31 IGs in ministries and six in non-ministerial organizations such as the Central Bank of Iraq. The IGs have no real presence in the governorates, with their work being focused primarily in Baghdad.

366. The IG is meant to provide regular assessments on the adequacy and effectiveness of the Ministries decision-making process, risk minimization and internal control issues – thus a focus on administrative corruption with some role in grand corruption cases. The IG is also the main point of contact for the BSA, and the IG Office is to provide information on the status of execution of the annual audit plan, and to work with the BSA on ensuring follow-up on recommendations arising from BSA audits. The IG is responsible for conducting internal investigations within their organization when necessary. Where the IG finds cases of fraud, theft, embezzlement, corruption, within the organization, the IG refers the case, along with any relevant evidence to the COI. The IGs office also acts as the conduit to the COI for any organizational documents, and for any such assistance required by the COI.

367. **Since its inception, there has been limited Iraqi buy-in of the Iraqi IG system.** It was established with little consultation with Iraqis and it mirrored the American IG system, and then bolted onto the Iraqi system. The Iraqis had little support for the IGs because of their role as the “eyes and ears” of the ministry – a role that was played by loyalists and supporters of the previous regime. The IG system further fueled a culture of distrust within the community as a whole, which was amplified in public institutions which were generally tools of the regime. Furthermore, there was little support from Coalition partners as the system was unique to the U.S. government. The IGs have also suffered from a lack of capacity, resources and funding.

The Commission of Integrity (COI)

368. **The COI is established by Article 102 of the Constitution with the status of an “independent commission subject to monitoring by the Council of Representatives” with its functions regulated by law.** Its scope, role and responsibilities are set out in Law 55/2004 introduced by the CPA. The COI is the enforcement arm of the anti-corruption pillars. It has the legal authority to investigate allegations of corruption, and take jurisdiction of cases in lower courts and refer them to the Central Criminal Court of Iraq (CCCI). It has a staff of about 120 investigators covering 31 ministries and a number of non-ministerial agencies. They also have jurisdiction over sub-national government.

369. **The COI has developed a code of conduct for civil servants.** In cases of violation of the code, the COI refers matters to the head of the organization or the Minister, as well as to the relevant IG. The COI is required to refer all criminal matters to the Investigative Judges (IJs) of the Central Criminal Court of Iraq (CCCI). Once the case is referred, the COI investigators may assist the IJs. The COI is still subject to the Iraqi Criminal Procedure Code which means that the investigative court has primacy and prosecutorial discretion is at this level. It does not have arrest or detention powers.

370. **In accordance with Law 55/2004, the COI has a hotline to receive calls about allegations of waste and corruption; develop a public awareness program; and enforce collect and enforce a government-wide financial disclosure requirement.** It is obliged to investigate fully any criminal referral or complaint. However, it cannot demand or order the production of documents, require a person to provide testimony or make arrests. The COI has had a rather controversial first few years, culminating in the recent departure of its first Head.

Joint Anti-Corruption Council (JACC)

371. **The JACC, launched in May 2007, is meant to advise the Prime Minister on effective ways to establish the rule of law and transparent, accountable governance in Iraq.** Its focus is intended to be the creation of independent, non-partisan and effective oversight institutions, and to facilitate effective programs to promote those purposes. The objectives set out in the JACC Charter are: i) to demonstrate high level buy-in and political will to address corruption in a coordinated fashion throughout the GoI and ii) to

facilitate coordination between the three anti-corruption “pillars” (BSA, IGs and COI) – this has been a major weakness to date.. The JACC membership comprises the Secretary General of the Council of Ministers (Chair); the Chief Justice of the High Court of Iraq; the President of the BSA; the Commissioner of the COI; and the Chair of the Association of IGs. The Chair may invite other individuals or organizations to JACC meetings.

Key Issues and Challenges

372. The Iraqi accountability agencies are unable effectively to enforce the body of anti-corruption laws as a result of a range of issues and challenges.

Impact of the Security Situation

373. The overall security situation, sectarian violence and the consequent restricted access to the ministries are critical hurdles. The difficult security situation in many parts of Iraq has had serious consequences for overall transparency and the neutrality and impartiality of those involved in oversight and monitoring. Violence and the political capture of many public institutions have caused individuals to be afraid of reporting incidents of impropriety; this includes auditors, other officials, civil society and the media. There have been allegations that parts of the COI and some IGs are themselves affiliated with sectarian and political interests. Auditors and investigators are often unable to travel safely to and from their clients’ premises. Staffs of accountability agencies are often subject to intimidation and violence (the former President of the BSA was assassinated in 2004). As a result of inadequate accountability and transparency as well as political capture, there have been cases where the legal system may be used to protect violators (under Article 136b of the Criminal Procedure Code) or to target innocent people. Due to the security situation and the high level of personal risk, there has been a high staff turnover, with predictably adverse consequences for organizational capacity.

Lack of clarity in the financial management regulatory framework

374. In keeping with the provisions of the Constitution for highly decentralized governance arrangements, there has been considerable decentralization of budgets and spending authority (much of it ad hoc) to sub-national governments lacking in capacity in critical skill areas. This has caused problems for both those receiving funds and the oversight and accountability institutions. Given the frequent political and governance changes since 2003, there are now four administrations and an array of institutional arrangements, laws, and regulations ranging from pre-2003, the period of the Coalition Provisional Authority (CPA), as well as recent times. In many instances, this has led to wide divergence between formal and informal systems and practices, with officials preferring to fall back on old practice when unfamiliar with new requirements. There is also considerable uncertainty over the relative powers of the line ministries in the governorates and the sub-national authorities, as well as different interpretations of the relative powers of the Governor’s Office and the Governorate Council. Clarification of these issues in law is urgently required.

The misuse of laws – its impact on accountability and transparency

375. The application of Revolutionary Council Command (RCC) 38 has had serious implications for budget execution. The application of RCC 38 in cases of certain types of corruption has resulted in many innocent people being arrested while investigation into allegations of corrupt activity is completed. An allegation of fraud or corruption, supported by two pieces of evidence, is all that is required to oblige the COI to investigate the allegation and the integrity of the evidence. On completion of its investigation, the COI refers the matter to the courts where the investigative judge determines, on the basis of the evidence, whether the case should go to trial. This usually means that the individual is arrested until the court's finding is made. This procedure has had a serious impact on budget execution and service delivery. Uncertain about the application of contract and procurement laws and regulations, officials have been reluctant to sign off contracts as they are fearful of politically motivated allegations and the application of RCC38 against them.

376. Article 136B of the Criminal Procedure Code grants ministers the right to shield their subordinated from prosecution. Cases against ministry employees can proceed only with the permission of the minister. A number of investigations have been stopped because the relevant Minister has invoked Paragraph 136B.

377. There is an urgent need to revisit both RCC38 and Article 136B. The International Compact for Iraq contains a benchmark requiring Parliament to be notified of instances where Article 136B has been invoked. However, a recent parliamentary amendment provides further protection to the Minister and the accused as the Minister does not have to provide any justification for two years from the time that Article 136B is invoked. In addition, the Prime Minister issued an order early in 2007 that no further investigations be carried out by the CPI against any minister without the Prime Minister's explicit permission in writing. Given the impact that these developments have had on budget execution and accountability, the review of these laws and orders must be accorded the highest priority. In principle, the JACC is ideally placed and mandated by its Charter to make recommendations to the Prime Minister and to Parliament to minimize abuse of these legal provisions.

Possible new regional institutions

378. The Constitution permits the establishment of new accountability and enforcement agencies at the regional level. If this were to happen, it would add another layer of institutional challenges. Already there are two separate BSAs in Kurdistan, although these are in the process of merging. Capacity problems in these two organizations are significant, and this issue would similarly affect any new accountability institutions. Additional confusion concerning the roles and responsibilities of new bodies vis-à-vis existing ones would also be a matter for concern.

Low capacity at the sub-national level of government

379. Growing fiscal decentralization has led to concerns on the part of the BSA about the management of public resources. Capacity at the sub-national level is seen as too weak to support efficient and effective public management, thereby providing ample scope for fraudulent and corrupt activity. This problem, while far from unique in developing countries, is particularly acute in Iraq, given its highly centralized history outside the Kurdistan region. Issues of concern identified by the BSA include a) the paucity of accounting units or control systems; b) the lack of a unified accounting system at the sub-national level; c) the insufficiency of auditors to cover the full extent of the work at the governorate level, coupled with the fact that it is difficult for auditors to work with some Governorate Councils as they are placed under pressure to manipulate reports and d) the lack of experienced and qualified auditors in the Kurdistan Region.

Attachment 6: List of Known Documents related to Accounting in Iraq

1. Financial Management Law (CPA Order #95) of 2004
2. Board of Supreme Audit Law of 1990
3. Amended BSA Law CPA 77 of 2004
4. Draft BSA Law 2005
5. Board of Supreme Audit Accounting Standards - Instruction numbers: 1-10 and 12-14
6. The Amended General Accounting Assets law No.28 of 1940, with attached accounting instructions. (Accountings General Directorate, Al-Hurria Printing – Baghdad – 1976)
7. Budget law No. 107 of 1985 and instructions on the decentralized accounting system
8. Guide books:
 - First: Plan for organizing the treasury.
 - Second: Implementation procedures
 - Third: The new accounting instructions
9. The seventh annual book of instructions, issued by the Accountings General Directorate in 1979.
10. A project of the unified State Accounts system
11. Governmental Accounting
12. Chart of accounts – Part II
13. Classification Manual accounts for the financial centre. Ministry of Finance – Accounting Office
14. Explanatory memorandum on the suggested Accounting Manual for the advance accounts.
15. Explanatory memorandum on accounting Manual for the current budget
16. Chart of Accounts for the state accounts.
17. Auditing Section and the relationship with public financial management for the State /Accounting Office
18. Research offered for the fourth conferences of the accounting office which held on 3-4.Dec.1988
19. Documentation related to Ministry of Finance initiated changes to the current budget structure from 1977

Attachment 7: Accounting Basis for Financial Statements

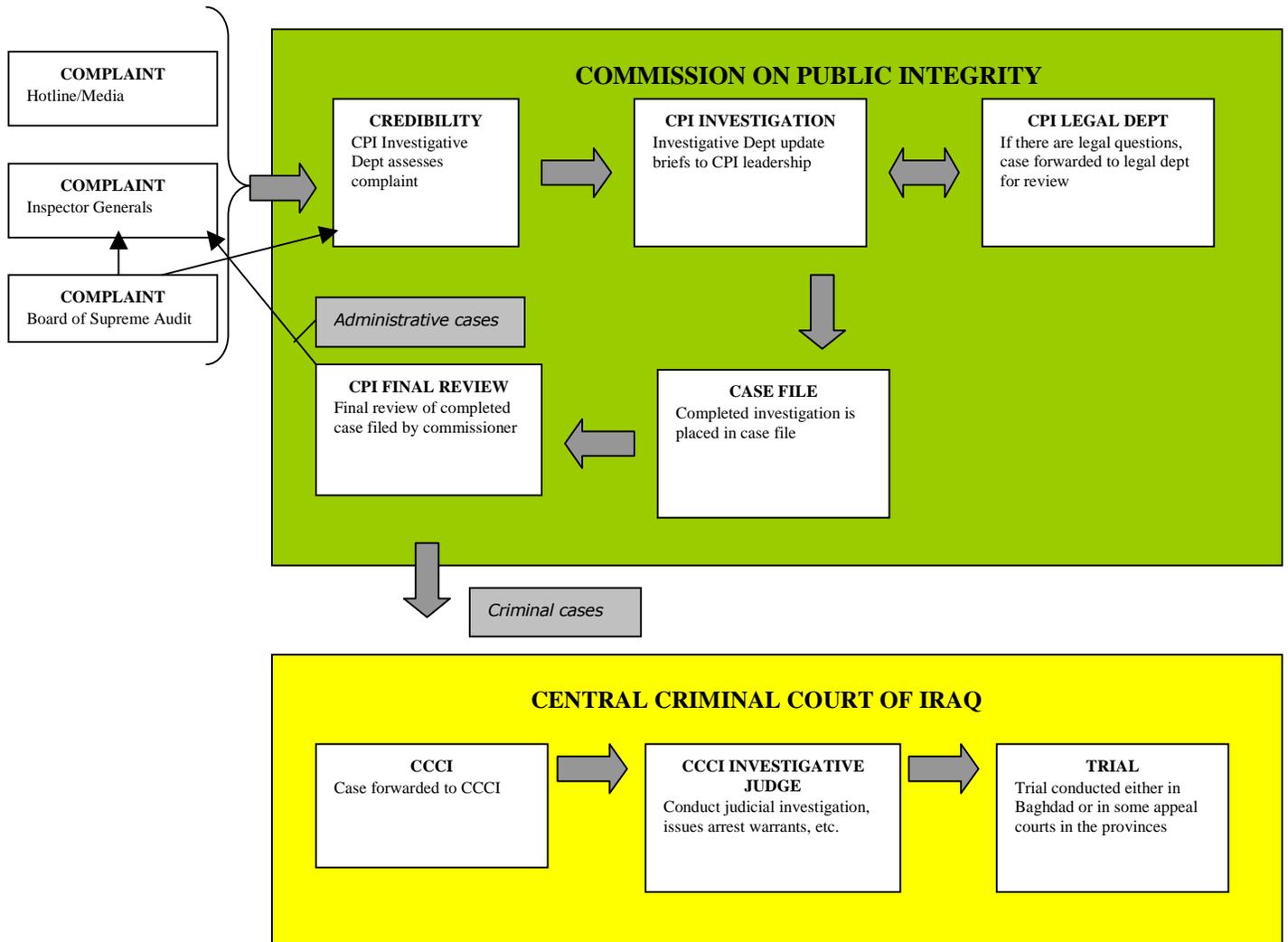
Box I. Accounting Basis for Annual Financial Statements			
	Full Cash Basis	Combination of Cash and Accrual basis	Full Accrual Basis 1/
Australia			X
Austria	X		
Belgium	X		
Cambodia		X	
Canada			X
Colombia			X
Czech Republic	X		
Finland		X	
France			X
Germany	X		
Greece	X		
Hungary	X		
Iceland		X	
Indonesia		X	
Ireland		X	
Israel		X	
Jordan		X	
Kenya	X		
Mexico		X	
Morocco	X		
Netherlands	X		
New Zealand			X
Norway	X		
Slovak Republic	X		
Slovenia	X		
Suriname	X		
Sweden		X	
Turkey	X		
United Kingdom			X
United States			X

Source: Data selected from OECD/World Bank *Budget Practices and Procedures Database*, updated by current information where available.

1/ "Full accrual basis" means financial statements are prepared on the basis of accrual based national or international accounting standards, also sometimes referred to as generally accepted accounting principles (GAAP).

Source: A Khan and S Mayes, Transition to Accrual Accounting, IMF

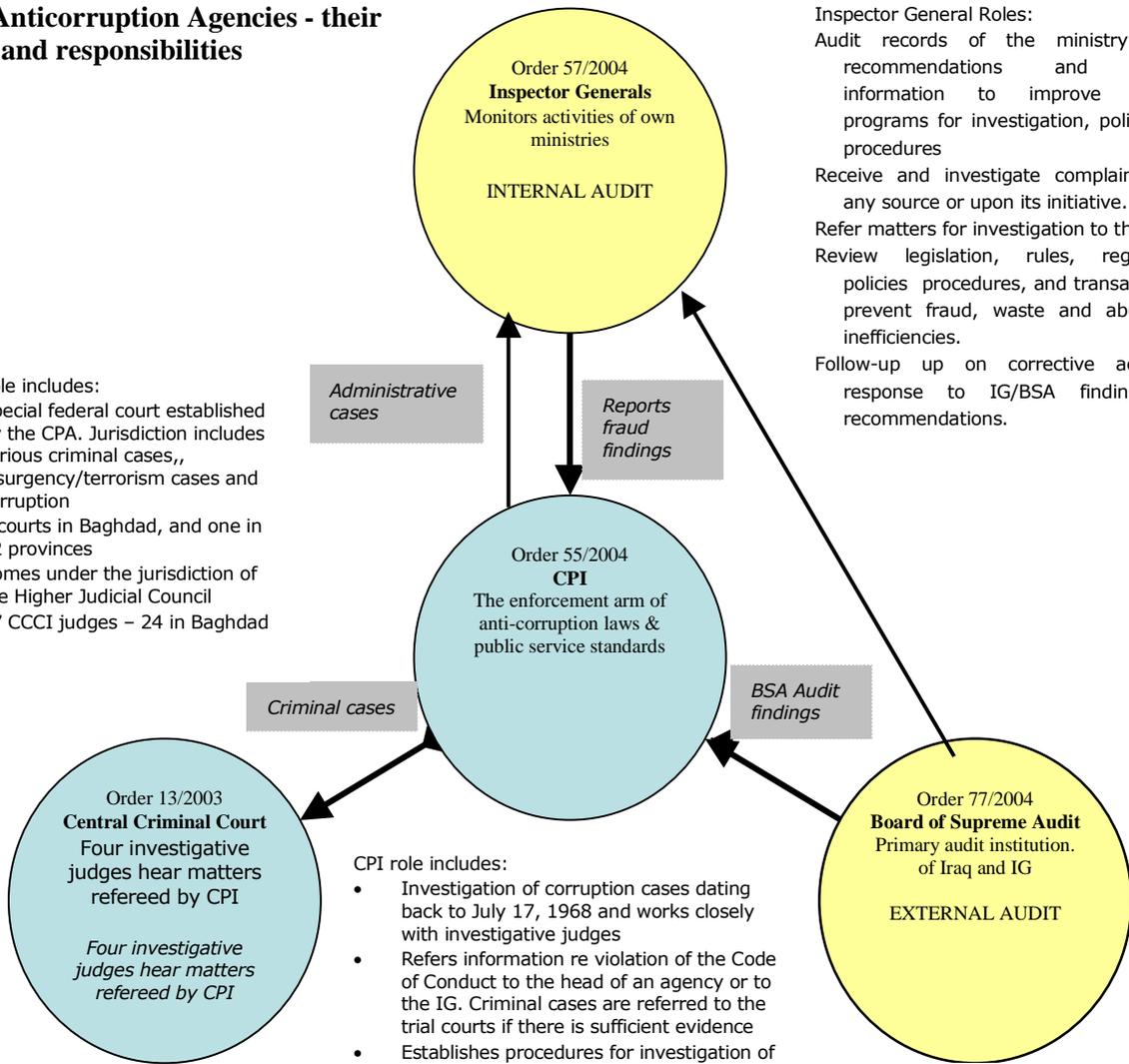
Attachment 8: Public Accountability Institutions



The Anticorruption Agencies - their roles and responsibilities

CCCI role includes:

- Special federal court established by the CPA. Jurisdiction includes serious criminal cases,, insurgency/terrorism cases and corruption
- 3 courts in Baghdad, and one in 12 provinces
- Comes under the jurisdiction of the Higher Judicial Council
- 57 CCCI judges – 24 in Baghdad



CPI role includes:

- Investigation of corruption cases dating back to July 17, 1968 and works closely with investigative judges
- Refers information re violation of the Code of Conduct to the head of an agency or to the IG. Criminal cases are referred to the trial courts if there is sufficient evidence
- Establishes procedures for investigation of allegations

- CPI also promulgates mandatory financial disclosure regulations
- Promulgates Code of Conduct for civil servants
- Can propose additional anticorruption legislation to the Council of Representatives

Inspector General Roles:

Audit records of the ministry; make recommendations and provide information to improve ministry programs for investigation, policies and procedures

Receive and investigate complaints from any source or upon its initiative.

Refer matters for investigation to the CPI.

Review legislation, rules, regulations, policies procedures, and transactions to prevent fraud, waste and abuse and inefficiencies.

Follow-up up on corrective action in response to IG/BSA findings and recommendations.

BSA: role includes

- Promulgates auditing regulations and works with CPI to improve auditing rules
- Conducts annual financial and performance audits of the Iraqi government and state property, and internal and external obligations
- Reports findings to the IG of the relevant Ministry and the CPI
- Has no standing with the courts on criminal matters

spreading out expenditures to benefit future as well as current generations and smoothing out government expenditures caused by fluctuations in the oil price. These objectives have in many cases been met by the use of oil, or sovereign wealth funds dedicated to these purposes. The usefulness of these funds lies in the fact that they help to sterilize some of the inflow of foreign exchange, thus leading to less pressure on the domestic economy.⁵⁵ However, oil funds are not a panacea to the resource curse, but work only so far as the fiscal rules underlying the Funds are followed. By itself, an oil fund neither constrains expenditure nor reduces the nonoil deficit. The performance of many oil exporters is inferior to that of resource-poor countries. For example, the world's largest oil producer, Saudi Arabia, experienced negative GDP growth over 1978-2003. This so-called "resource curse" is attributed to the harmful effects of oil wealth on public sector governance and of oil price volatility on the domestic economy, deteriorating competitiveness of traded non-oil sectors, and limited linkages from oil exports to the rest of the economy. However, economic stagnation or decline is not inevitable. Several resource-rich countries — such as Botswana, Chile, Indonesia, Malaysia, and Norway — have used oil resource revenues to achieve steady economic growth, as demonstrated by the growth of Indonesia's GDP per capita

Box 4: Resource Curse

The appreciation of the real exchange rate. The so called "Dutch disease" effects created by an appreciation of the currency caused by the net inflows from the export receipts of the natural resource have been widely discussed (Gelb and associates 1988). The export and production of the non-oil sector falls, which may lead to sectoral unemployment (oil employs relatively few workers), while the price of non-traded goods increases. This leads to a loss of economic diversity and the loss of whole sectors of the economy that may find it difficult to reestablish them once the natural resource boom has ceased.

Lack of domestic absorption capacity. Substantially increased spending on domestically produced items, made possible by the extra revenues from the taxation or ownership of the natural resource, may encounter rising supply curves. The effect of the increased spending is then largely to force up the prices of such goods.

Weak governance of public spending. Where a substantial amount of the new resource revenue enters the government budget in the form of increased expenditure, the ability of the civil service to manage large increases can be limited. Poor choice of projects, lax contracting procedures, and weak project oversight can lead to poor performance in terms of the social output obtained from the expenditures undertaken. The notion that there is sudden "easy money" may lead the government to a choice of projects with very low payoffs, but which appeal to popular sentiment.

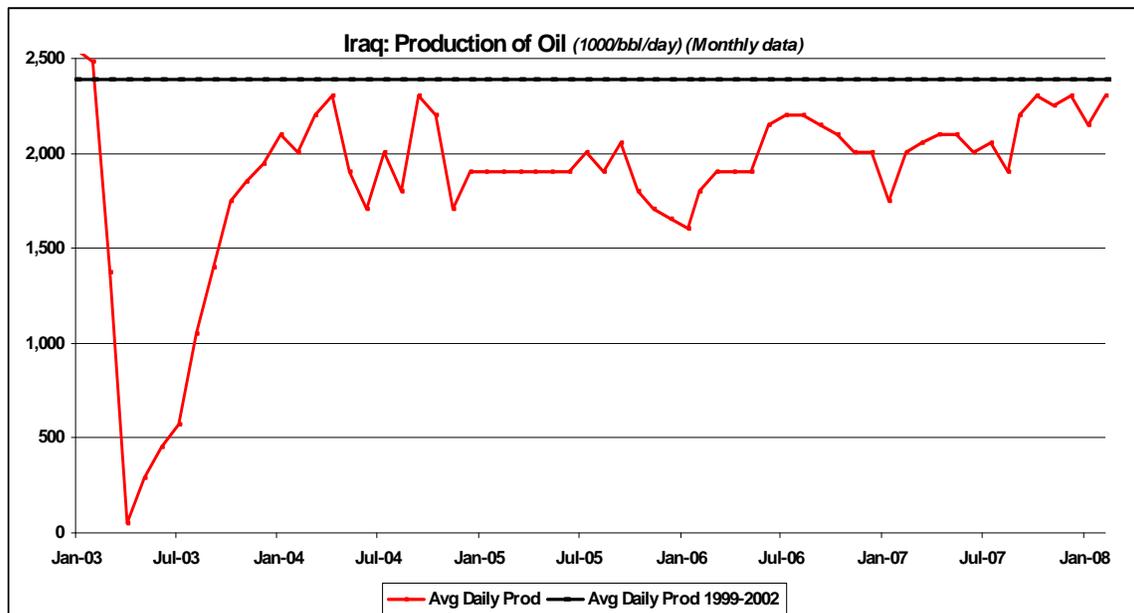
Increased corruption. The large increases in public spending accompanying the development of a natural resource sector, which correspond in large part to a rent on the resource and are therefore not the direct result of the efforts of any individuals in the society, can lead to various corrupt practices. These can occur in the contracting for projects or even in the siphoning off of resource payments due to the treasury. As corruption becomes more widespread and more egregious, there can be a tendency for it to become endemic and affect other sectors of the economy. This weakens the investment climate and can result in steady erosion of the country's economic performance.

382. The volume and price of Iraq's oil exports are volatile: monthly oil export revenues have ranged from \$0.6 billion to \$3.02 billion during 2004-2006. This was in due to volatility in both production and prices. In the short term, production and exports

⁵⁵ See "Experiences with Oil Funds: Institutional and Financial Aspects", World Bank, June 2006, Robert Bacon and Silvana Tordo for a full discussion of Oil Funds.

were constrained by sabotage and inadequate maintenance of pipelines, pumping stations and other facilities. On average, crude oil production for 2007 has gone up to 2.05 mbpd from 1.5 mbpd on average in 2003, (see chart below) well below the high levels of over 3.5 mbpd reached in 1979. At the same time oil prices have also been highly volatile. In the five years between January 2003 and May 2008, for example, the price of one marker crude, Brent, varied by a factor of 4.9, ranging from US\$24 a barrel in May 2003 to US\$119.0 in May 2008. Over the medium term, revenues can rise dramatically, if oil production capacity improves and oil prices remain high. Even if oil prices decline, Iraq may be able to maintain high revenues by increasing the volume of exports. However, revenues can also decrease, if oil production stagnates at current levels and prices decline. Substantial investment is needed to rehabilitate and expand the petroleum sector.

Chart 2



383. **Iraq's oil industry includes 15 state owned companies (SOEs) under the purview of the Ministry of Oil (MoO)** (see box below for a list of companies and their main activities). These were previously managed by Iraq National Oil Company established in 1964 until it was dissolved in 1987. Iraq's MoO has 970 employees and close to 65, 000 employees in the 15 SOEs. The fields are large and highly productive; thus costs are extremely low. Although Iraq is a member of OPEC, it is not currently subject to quota and unlikely to be so in the near future. Substantial investment is needed to rehabilitate and expand the petroleum sector. However, the petroleum sector needs significant capital expenditure and operating expenditure to create capacity. Given that only 15 of Iraq's 74 discovered fields have been developed, adequate capital expenditure could boost production provide management of the industry improves. At this point, given Iraq's revenue flows, both capital expenditure and operating expenditure come through the budget, although the SOEs have some own revenues.

Box 5: Iraq Oil Companies

UPSTREAM

1. NORTH OIL COMPANY

MAIN ACTIVITIES: Production of oil and gas from the northern fields (including Kirkuk, Nineveh, Erbil, Baghdad, Diyala and part of Hilla and Kut). Delivery of crude oil of different types to Iraqi refineries and associated gas to North Gas Company units and to electric generation stations as well as for export through a network of pipeline system toward north and west of the country for export from terminals in Turkey and Syria.

2. SOUTH OIL COMPANY (SOC)

MAIN ACTIVITIES : Production of oil and gas from the southern fields, delivery of treated crude oil to the export terminals & the local refineries, operation of the oil export terminals and compression & delivery of gas to southern gas plants.

3. OIL EXPLORATION COMPANY (OEC)

MAIN ACTIVITIES: Exploration for oil and gas reserves and their updates.

4. IRAQ DRILLING COMPANY (IDC estbd 1990)

MAIN ACTIVITIES: Drilling, completion and work-over of oil and gas wells in addition to repair and maintenance of drilling rigs and their related equipment.

5. IRAQ OIL TANKERS COMPANY

MAIN ACTIVITIES: Management and operation of oil tankers fleet.

DOWNSTREAM

1. NORTH (Baji) REFINERIES COMPANY (NRC)

MAIN ACTIVITIES: Industrial management and operation of oil refineries in the northern region. The company produces a wide range of refinery products including LPG, Lube Oils and asphalt.

2. MIDLAND (Daura) REFINERIES CO. (MRC)

MAIN ACTIVITIES: Industrial management and operation of oil refineries in the midland region. The company produces a wide range of refinery products including LPG, lube oils, greases, wax and asphalt.

3. SOUTH (Basra) REFINERIES COMPANY (SRC)

MAIN ACTIVITIES: Industrial management and operation of oil refineries in the southern region. The company produces a wide range of refinery products including LPG, lube oils and asphalt.

4. NORTH GAS COMPANY (NGC)

MAIN ACTIVITIES: Processing of associated gas from the northern fields to produce dry gas, liquid gas, natural gasoline and sulphur.

5. SOUTH GAS COMPANY (SGC)

MAIN ACTIVITIES: Processing of associated gas from the southern fields to produce dry gas, liquid gas and natural gasoline, in addition to the industrial management of liquefied gas storage tanks and export terminals.

OTHERS

1. OIL MARKETING COMPANY (SOMO)

MAIN ACTIVITIES: Marketing of crude oil and products in the international markets.

2. OIL PROJECTS COMPANY (SCOP)

MAIN ACTIVITIES: Design and execution of oil projects e.g. Refineries, oil depots, pipelines, storage tanks and exporting crude oil terminals

3. OIL PRODUCTS DISTRIBUTION COMPANY (SADOP)

MAIN ACTIVITIES: Sales of oil products, transportation of oil products by road tankers, management & supervision of oil products filling stations.

4. PIPELINES COMPANY

MAIN ACTIVITIES: Management and operation of oil products depots, pumping stations and oil product and gas pipelines to distribution depots and industrial consumers.

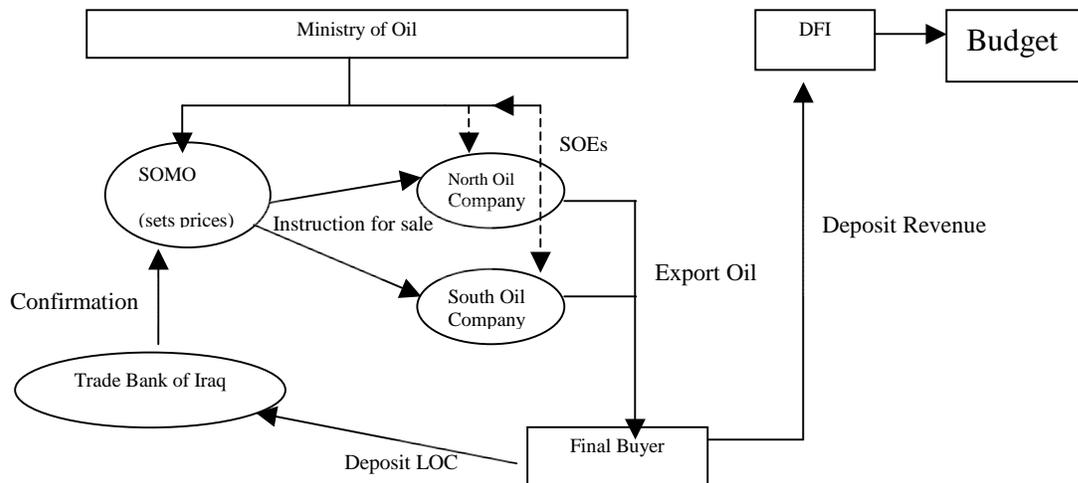
5. GAS FILLING COMPANY

MAIN ACTIVITIES: Industrial management and operation of gas filling complexes.

384. All revenues from oil flow into the DFI. Oil is marketed by SOMO which sets the price of oil – based on the Saudi price. Once the Letter of Credit from the buyers who negotiate a sale reaches the Trade Bank of Iraq, SOMO instructs the oil producing companies, NOC and SOC, to proceed with the sale, that is, ship or load the oil into pipelines to be exported. NOC's oil is mainly sent through the pipeline in the north,

whereas SOC mostly ships oil through the Basra terminal. All revenues from exports are deposited in the DFI. (see figure 5).

Figure 5: Oil Revenue Flows



385. Oil revenue management is an important issue for Iraq. At this juncture the Development Fund for Iraq (DFI) plays de facto the role of an oil fund. All proceeds of export sales of petroleum, petroleum products and natural gas from Iraq are deposited into the DFI. Oil revenues above the estimated price set in the budget accrue to the DFI. However, the decision-making process regarding the use of all the money that accrues to the DFI over that which goes into the budget is not clear. Iraq has applied a simple fiscal rule in preparing its budgets for 2004–07, using very conservative export price forecasts. The Iraqi Financial Management Law contains provisions on accountability and audit oversight, including publication of financial reports of oil revenues.

386. Discussions about creating an oil or sovereign wealth fund are underway in Iraq but are tied to the larger discussion of how revenues will be shared. According to the Constitution, strategic policy-making is a shared power between the federal level and oil-producing governorates and regions.⁵⁶ In this, Iraq is somewhat unusual. Many federations with significant natural resource revenues such as Canada, US, Australia and Russia, provide states with extensive ownership rights, with the federal government playing a leading and central role in all other salient aspects in relation to natural resources. The GoI has yet to decide whether these revenues will be used to minimize the transmission of oil price volatility to fiscal policy i.e. establish a stabilization fund, or whether it will act as a savings fund and address intergenerational concerns.⁵⁷ Nor is it

⁵⁶ Several aspects of this are left unclear i.e. does regional legislation override federal law? and, which level of government would police the implementation of Article 112?

⁵⁷ If the intention were to establish a Savings Fund instead, on average only the “permanent income” from the wealth would be spent keeping the wealth of the Fund constant. However, a Stabilization Fund can be considered the same as a savings fund to an extent, although it may not be able to maintain a permanent

clear whether the funds in the DFI are being invested such that benefits are maximized. At present, the Committee of Financial Experts audits the DFI. But the audit objectives are fiduciary in nature with no focus on ensuring that the resources are effectively managed. Moreover, several past audits of the DFI have pointed out concerns regarding inadequate controls over Iraq's oil and other aspects of the DFI's operations.

Box 6: The Development Fund for Iraq

The Development Fund for Iraq (DFI), established under United Nations Security Council Resolution 1483 and housed within the Central Bank of Iraq, holds the proceeds of Iraq's petroleum and natural gas export sales, as well as assets and funds of the former Iraqi Government. Its accounting records are maintained by the Central Bank of Iraq on behalf of the Iraqi Ministry of Finance. Funds are held in the U.S. Federal Reserve Bank in New York (FRBNY).

From 2003 to end-June 2006 the DFI received US\$68.8 billion from the proceeds of Iraqi oil export sales and balances from the UN oil-for-food program and frozen Iraqi funds. Of this, US\$59.6 billion was disbursed to the Ministry of Finance or used for letters of credit for Iraqi ministries and contracts administered by U.S. agencies.

Until the end of 2007, the International Advisory and Monitoring Board (IAMB) serves as the audit oversight body for the DFI. Thereafter the Government of Iraq's Committee of Financial Experts (COFE) will act as the audit oversight body for the DFI. Established in 2003 under Resolution 1483, the mandate of the IAMB was to ensure that the DFI was used in a transparent manner for the benefit of the people of Iraq and that export sales of petroleum, petroleum products, and natural gas were consistent with prevailing international market practices. The IAMB's first summary report in December 2004 covered operations from May 2003 until the dissolution of the Coalition Provisional Authority (CPA) in June 2004. The second interim report with the IAMB's comments and conclusions was released in December 2006. The IAMB was succeeded by an Iraqi Oversight Board composed of financial experts and chaired by the president of the Board of Supreme Audit. The decision to replace the IAMB with the new body (Committee of Financial Experts) was made by the Council of Ministers in October 2006.

DFI's accounts are audited by an independent international audit firm every six months. The auditor's task is to audit the financial statement, transfers from U.S. agencies to the Government of Iraq, and funds disbursed by all spending ministries. Until its dissolution, the IAMB monitors the reports produced by the contract auditors and determines whether the audits were conducted in a comprehensive and satisfactory manner. Iraq's Board of Supreme Audit follows up on the recommendations of the audit reports, and reports to the IAMB on the steps taken. External audits have revealed unresolved differences between the DFI's asset balances and related liability balances in the records of the Central Bank of Iraq.

387. In Iraq proceeds from oil either accumulate in the DFI or finance public spending through the budget. Thus the quality of public spending and the internal control mechanism of the PFM system, in addition to transparent reporting, are key to the use of these revenues. These issues are discussed in detail elsewhere in this report. As with all publicly managed sectors, clear legislation and clear delineation of roles and responsibilities should be a key priority. Legislation should clearly specify responsibilities and ownership structure of different government entities including the national oil company (or companies), government involvement in the oil sector through equity participation, fiscal authority over oil revenue and borrowing, and the role of the private sector (domestic and foreign). Experience elsewhere suggests that clear assignment of roles and responsibilities, and in particular separating commercial activities from regulatory functions, is important for the development of an efficient hydrocarbon sector. Moreover, transparency is key to better public spending; in this

income. Similarly the Savings Fund can display an element of stabilization depending on how well it is integrated into the budget process.

respect it is encouraging that the GoI has expressed its intent to participate in the Extractive Industries Transparency Initiative (EITI)

Box 7: Transparency in Oil Revenue Management

Legal framework

- Responsibilities and the ownership structure of the national oil company (or companies), Government involvement in the oil sector through equity participation, and fiscal authority over oil revenue and borrowing and the role of the private sector (domestic and foreign) should be clearly specified in the law.
- A budget should be set aside to cover audits, reconciliation of inconsistent figures, publication of reports on revenue flows, dissemination, and public awareness campaigns.
- Once roles and responsibilities are properly defined, establishing strong administrative and/or corporate structures should be given priority.

Audits

- External audits by an independent auditor of revenue flows should be regularly conducted and reported.
- Initially, the Government may wish to consider physical audits. In such a case, proper metering is needed.
- In the early stages of establishing revenue transparency, the Government may consider a quarterly certification process.

Reconciliation of payments and revenues

- Differences in the accounting periods, currencies, and units, as well as cash versus accrual basis for accounting can lead to legitimate discrepancies.
- The Government may consider setting up specific verification and reconciliation mechanisms and institutions to ensure consistency.

Regular public disclosure

- A credible, timely, and comprehensive publication of revenues and payments, and their audits, is important to ensuring correct accounting and winning the trust of the public.
- All material benefit streams should be reported. They include revenues from direct sale of crude by Government entities; production entitlement by the Government, the national oil company, or any other Government entity; income, production, and profit taxes; royalties; sign-up, discovery, and production bonuses; dividends; and license and other fees. Taxes, royalties, bonuses, dividends, and fees should be reported for all companies, including the national oil company. Both cash and in-kind payments received by the national as well as sub-national Governments should be reported.
- If and when private investors enter the oil sector, accounting for benefit streams becomes much more complex than today.
- All financial assets held by the Government domestically and abroad from oil-related savings should be disclosed.
- Selecting an independent third-party to aggregate and analyze the reports submitted by the Government, the national oil company, and private companies operating in the oil sector will enhance the credibility of the final report.
- Disclosure reports should be accessible and understandable.

388. Oil revenues shape public spending and growth. Much of the recent higher oil revenue has been used to fund increased current and, to some extent, capital spending. Oil contributes to growth directly and indirectly via public spending. Due to the dominance of the public sector in the Iraqi economy, public spending is the main driver of the economy. While some amount of additional spending can easily be accommodated without giving rise to concerns about fiscal sustainability, several risks are present in the current domestic fiscal environment. First, an excessively rapid increase in spending could come up against supply or capacity constraints and result in higher inflation. Secondly, lack of attention to the time profile of costs associated with a

boosted capital spending program could generate significant inefficiencies in program performance in the future. Third, the quality of spending could deteriorate. There is always a risk that policymakers will choose expenditures which provide short term payoffs while neglecting more productive expenditures that provide long term benefits. Fourth, contingent liabilities could increase, thus worsening the government's balance sheet. Managing these risks requires strengthening budget formulation and execution.

389. Increased capital investment, in turn, will generate increased private sector activity in the future. This will have several benefits:

- i. Generate increased employment immediately, during the construction of these infrastructure projects.
- ii. Reduce the cost of transporting people and goods due to improved infrastructure. This will undoubtedly generate increased economic activity in the non-oil sector and generate increased employment once the projects are completed.
- iii. Increase tax revenues to the Government of Iraq due to increased non-oil sector economic activity after the projects are completed.
- iv. Allow Iraq to develop non-oil industries to diversify its economy and become less vulnerable to fluctuations in the price of oil.
- v. Lower the pollution levels in the cities as mass-transit become readily available.

CHAPTER 6: PUBLIC SECTOR PAY

Summary

390. **The purpose of this chapter of the PEIA is to analyze the issue of public sector pay in the framework of public expenditure management in Iraq.** It considers the following aspects of the topic:

- The size of public sector pay in relation to government expenditure and the economy of Iraq
- The payroll control framework
- The institutional arrangements governing the management of the public payroll

391. **The chapter highlights the substantial growth in the public sector wage bill in the last few years.** While this has been more than matched by the growth of GDP resulting from high world oil prices, a number of weaknesses exist in the control framework for public sector employment are. These include the use of different payroll applications; the widespread practice of paying public servants in cash; unclear legislation leading to varying interpretations; cumbersome reporting processes; and inefficient employee transfer procedures

Public Sector Pay and Government Finances

392. **The Government’s wage bill has been increasing rapidly over the past few years. (See Table 16).** While this issue has not caused great problems in the recent past due to rising oil revenues and under-spent capital budgets, in the longer-term it is essential that effective control is exercised over public sector pay if much-needed capital investment and operational expenditure is not to be crowded out.

**Table 16: Iraq: Fiscal Accounts Expenditure on Salaries and Wages
(in billion Iraqi Dinars)**

Year	2005 (SBA)	2005 Est	2006 (SBA)	2006 (Est)	2007 (SBA)	2007 Proj.	2008 Budget	2009 Proj.	2010 Proj
S&WEx p	8,591	9,282	12,899	10,959	15.172	14,098	16,324	17,944	19,131
As % GDP	17.7	20.1	20.6	15.1	19.4	18.0	16.6	15.5	14.4

Source: IMF-Iraq Request for Stand-By Arrangement December 2007

393. **Given that the recurrent budget work-plans do include a focus on staffing, the GoI has the basis for an effective civil service personnel control mechanism, with ministry staffing profiles assessed and agreed during the annual budget process and reflected in published annual establishment lists.** Unfortunately, budgeting performance of civil service employee remuneration and pension payments has been unpredictable.

Execution of the salary, wages and pension payment budgets has been volatile with actual payments deviating from budget allocations by 9% in 2004, 32% in 2005 and 6% in 2006 and 24% forecast for 2007 (see IMF, 2007, 3rd and 4th SBA Reviews). In the draft 2008 Budget, the Government has made strong reform statements to reverse the increase in the wage bill. As Table 18 shows, the 2008 budget and 2009/10 projections all show expenditure on salaries and wages being projected to decline as a percentage of GDP

The Control Framework for Public Sector Employment

394. **In order to deliver these reductions, the GoI will need to exercise effective payroll controls; these are essential since payroll is particularly susceptible to weak control and corruption.** Weak control can lead to serious consequences, including: i) *poor fiscal discipline* (i.e. mismanagement and corruption); ii) *misallocation of resources* (i.e. more resources being allocated to salaries that is needed for any given desired outcome or not enough resources devoted to public services like education and health); iii) *inefficient use of resources* (i.e. more resources being used for the amount of staff actually needed to produce required output); and iv) *leakage of resources* due to fraudulent and corrupt activity.

395. **A human resource database is the key link between the establishment list and the payroll system.** The establishment list is used for budgetary control of the number and cost of workers. The payroll system is used for control of payments. Human resource databases also maintain all the records of entitlements for each employee (e.g. salary levels, service, hire dates, termination dates, leave and allowances). The system for reconciliation and amendments is critical. Consequently, changes to entitlements need to be processed accurately and in a timely manner in time for the next pay run. Reconciliation between the personnel system and the payroll system needs to happen monthly. Payroll audits should be undertaken regularly to identify ghost workers, fill data gaps, and identify control weaknesses.

396. **The Constitution of Iraq requires the establishment of a Federal Public Service Council** to regulate the affairs of the federal public service, including appointments and promotions. The GoI is in the process of establishing the Council and drafting policy position for a law that is to regulate the Council's structure and competencies.

397. **In addition to the FML, the legal framework for human resource management and payroll is supported by numerous subordinate legislation⁵⁸** and instructions. The following have been identified:

- *Establishment list controls* for hiring are specified in Budget instructions and Article 8 of the Staff Law, No. 25 of 1960.

⁵⁸ Subordinate legislation is a collective term used for statutory rules, regulations, ordinances, by-laws and rules that are indirectly approved by the legislature through delegation of some of its law-making powers (e.g. a government department). Subordinate legislation will contain the many details necessary to ensure a law operates successfully.

- *Advertising requirements* for vacant establishment positions are specified in Order No. 30 of 2003 and Memorandum No. 4036706 of 2006.
- *Secondment controls* are reflected in MoF (Budget Department) Memorandum No. 403/2610, of 2006.
- *Promotion rules* are enshrined in Civil Service Law No. 24 of 1960, in MoF (Legal Department and Budget Department) Memorandum No's. 13716 of 1985 and 403/31216 of 2006, and Presidents' Council (dissolved), Memorandum No. Kha/8/4645 of 1980.
- *Expert consultancy provisions* are outlined in MoF Memorandum No's 403/26649 31216 of 2006.
- *Retiree contracting arrangements* are covered under Article 11 of the Retirement Law, No. 27 of 2006 and in Memorandum No. 403/10820 of 2006.
- *Salary and conditions of employment* reform was initiated with CPA Order No. 30 of 2003.
- *Financial and performance audits* related to payroll and personnel are included in BSA Law of 1990 and BSA Audit Directive 18.

398. **Reconciliation between establishment lists and MDAs' payroll records occurs infrequently and integrity of payroll and personnel data is undermined** by the lack of complete personnel records and a comprehensive personnel database in the MDAs. Pre and post-transaction payroll control is weak. It has been reported that disbursement reconciliation in respect of deductions, transfers and ledger postings seems to be broadly acceptable in terms of process design. However, in practice, it has proven difficult to determine how processes are actually implemented.

399. **Several international institutions have undertaken investigative work on payroll reform in Iraq**, including the World Bank, IMF, International Advisory and Monitoring Board (IAMB) and others. These efforts have raised concerns about the reliability of present arrangements. Current payroll processes and procedures are not able to guarantee allocation of funds or that payments are not being made to "ghost"⁵⁹ employees or to so-called "double dippers". Existing systems have also made it difficult to assess current and future liabilities of pension policies, since meaningful estimates require critical data on certain items, such as establishment numbers, ages, grades, length of service, and dependents and beneficiaries.

400. **MDAs predominantly use a manual payroll system**, however some computerized systems do exist, though they are unique stand alone and do not connect to other applications. The manual system in MDAs are either book based systems or book-based supported by spreadsheet or outdated database applications. The MoF uses an internally developed Fox Pro system, while the Ministry of Industry and Minerals use an internally developed Access application. The Ministry of Oil uses a COBOL mainframe application developed in the 1960s.

⁵⁹ A ghost employee may be a fictitious employee on the payroll, such as one who is no longer employed (e.g. for death, retirement, resignation or termination)

401. **As part of the Government's Stand-By Agreement with the IMF, the MoF is conducting a comprehensive Civil Service Census.** The objectives of the Civil Service Census include establishing an information baseline that will facilitate enhancements to: i) budgeting and control of personnel; ii) payroll auditing; iii) information needed for estimating financial implications of pension policies; iv) civil service restructuring policy options; v) and other cost savings measures; and vi) civil service information management strategies. Linkages to establishment control and payroll reform options continue to be explored.

402. **Delays in processing changes to payroll and nominal roll are often significantly longer than three months** and require widespread retroactive adjustments.

403. **Integrity of the human resource systems and databases is critical** for good levels of control and fiscal discipline. Any additional employees or changes to existing civil servant's salary levels, service, hire dates, termination dates, leave and allowances and other employment conditions, need to be processed in a timely manner. Systems also need to produce a consistent and comprehensive audit trail to ensure control and transparency.

404. **The foundation for an effective establishment control system is in place** within the context of the annual budget process. However, the lack of computerized systems and standard coding structures compromises the integrity of both the manual and any computerized personnel database that is in place. This makes it difficult for the authorities to control changes and monitor and report on establishment compliance.

405. **Specific problems in payroll management include the following:**

- MDAs use separate payroll applications, with only limited classification and reporting standards;
- Almost all civil servants are paid in cash and consequently pay dates vary from ministry to ministry to ease pressure on banking systems;
- Signature sheets are often not countersigned at the point of payment, nor are unclaimed funds routinely identified and returned to ministerial treasury departments;
- Instances of managers collecting salaries on behalf of employees have been reported;
- Related legislation is not clear with different interpretations being reflected by MDAs;
- The process for validation of payments is weak. Cash disbursement of salary though a three-person payment committee is the standard method. There is no standard process for returning unclaimed funds to the MoF;
- There is no common civil service employment number. Consequently, employee transfers require termination and rehiring and meaningful employee history is unavailable; and
- There is no standard coding structure, which causes data aggregation problems causing reporting to be a resource task.

406. **Payroll audits should be undertaken regularly** to identify ghost workers,⁹ fill data gaps, and identify control weaknesses. There are three key components of payroll auditing. Auditing the control of records determines how well records are kept and maintained. Auditing of payroll procedures looks primarily at the rules, and checks compliance against principles of separation of duties. Auditing reconciliation and review of payroll involves: i) reconciliation of the payroll journal with the general ledger accounts; ii) review of payroll transmittal (time cards, absenteeism); iii) verification of calculations (e.g. hours worked and leave); IV) verification of employee information (e.g. wage rate and allowances); and VI) review of payroll reconciliations since the previous audit.

407. **Some partial payroll audits have been undertaken by the BSA and Inspectors General**, who have identified the significant problems mentioned above. MDA audit procedures generally review monthly variances rather than undertake any form of systematic, random or compliance checks. The BSA has procedures for performance audits which involve more detailed analysis of payroll control (BSA Audit Directive 18). Some payroll surveys and analysis have also been commissioned by the World Bank and others on request of the Government. The civil service census should help to provide the basis for improved controls and data and better payroll auditing.

CHAPTER 7: SECTOR LEVEL PFM ISSUES: A CASE STUDY IN EDUCATION

Summary

408. **The objective of this chapter of the PEIA is to identify the key messages emerging from an initial analysis of education expenditure and public financial management in education** to provide a basis for strategies that will improve the effectiveness of service delivery and to feed into wider strategy development.

409. **The chapter begins by providing an overview of Iraq education sector's changes in the past few decades with focus on its expenditure patterns and system efficiency.** It highlights key education sector issues, drawing on anecdotal and empirical evidence obtained through workshops and previous World Bank projects. It reviews the existing system and practice of i) budget formulation and planning; ii) budget execution; iii) monitoring and reporting; and ix) procurement. The chapter goes on to summarize the latest issues in education sector finance with details both on operational and investment expenditures. It provides an in-depth analysis of overall financial management in education sector by applying the PEFA framework. The PEFA indicators cover the area of i) credibility of education budget; ii) comprehensiveness and transparency; iii) budget cycle; and iv) donor practice. Finally, the chapter explores critical issues in institutional capacity and provides recommendations for the improvement of education sector strategies in enhancing the effectiveness of financial management and promoting capacity development both at sector and macro level.

410. **The micro-level approach adopted in this chapter confirms many of the issues and challenges identified at the macro-, or aggregate level.** Capital investment budget execution rates are low; there is little use of a financial planning time horizon beyond the annual budgeting process; there is limited knowledge and application of new laws and regulations; financial management capacity is weak; co-ordination of recurrent and investment expenditure is problematic; internal financial controls and audit arrangements are weak; and education expenditure is skewed towards personal emoluments.

Background and Current Situation

411. **The Iraq education system that was among the best in the Middle East in the 1980s went through a major financial crisis in the 1990s. Its recovery in the past four years since April 2003 has been hampered by limited capacity and deteriorating security (expenditure on security has increased dramatically).** Early expectations of rapid reconstruction of the education system after 2003 have not been met as the education system has had to deal with the effects of ongoing civil strife, population displacement and erosion of institutional capacity. The system has suffered massive degradation and deterioration of the physical infrastructure and accumulated backlogs in policy, system and human resource development, and school construction and

maintenance. This is reflected in (1) a sharp decline in education expenditure and also in (2) a substantial decline in teacher salaries. Moreover, as a consequence, currently the education system suffers from (3) significant deterioration in system efficiency and effectiveness.

A sharp decline in education expenditure

412. Education expenditure declined dramatically during the nineties as a result of the wars and the economic embargo. Expenditure per student declined from \$623 in 1989 to \$35 in 2003. From mid-2003, the authorities increased the allocations and more resources were earmarked to the sector so that by 2006 expenditure per student reached \$253. However, this is still about one third of the expenditure level in absolute terms that Iraq used to enjoy in the late eighties. In real terms, it is significantly less.

A substantial decline in teacher salaries

413. During the UN embargo in the nineties, the Oil for Food Program (OFFP) did not include cash payments and as a result, OFFP funds were not used for meeting recurring expenditure of any kind. This, in turn, added to the financial crisis in the sector and led to a substantial decline in staff salaries. The average teacher salary fell from around \$500 per month in 1989 to \$ 5-30⁶⁰ per month in 2003. A new salary structure was established in 2004 and the average salary was increased to \$120 per month and it was raised again to about \$250 in 2006.

A significant deterioration in system efficiency and effectiveness

414. The extremely low allocations to the sector led to a rapid deterioration in all aspects of the education system. New students were admitted to existing schools because there were no funds to build new schools. One third of schools are still operating in double or even triple shifts to accommodate student growth. These difficult conditions contributed to an increase in dropout and repetition. The crowded classrooms, shortage of teaching and learning materials, and the loss of qualified teachers became much worse after the last war in 2003 due to the damage to the education establishments and looting of their equipment and physical infrastructure. Many schools have still not recovered from the effects of these events.

415. Despite the legacy of degradation and neglect, the education system in Iraq has continued to operate and expand access since 2003. However, the massive backlogs in capital development and maintenance and human resource development that accumulated over the previous decades continue to present a major challenge to the reconstruction of the education system. Moreover, in many areas security conditions, household poverty and population migration have impacted negatively on school and university attendance

⁶⁰ This range is a result of different bases for calculation of the teacher salary, the higher figure representing the amount that includes numerous allowances. Not all teachers were entitled to these allowances, so a simple average would be misleading.

and enrolment. The higher education system also suffered seriously from neglect in the past two decades and from extensive looting and arson in 2003.

416. Currently, despite substantial efforts by the authorities, most institutions lack adequate facilities, learning materials, access to the international community, and have suffered from massive loss of highly trained staff. The sectarian violence has affected both general and higher education operations, and seriously hampered the recovery of the system needed to provide a basis for system reconstruction.

417. Against the background, the government has been making considerable efforts to improve the system and practice in financial management. The next section provides an analysis of the education sector's budget and expenditure.

Education Sector Budget and Expenditure

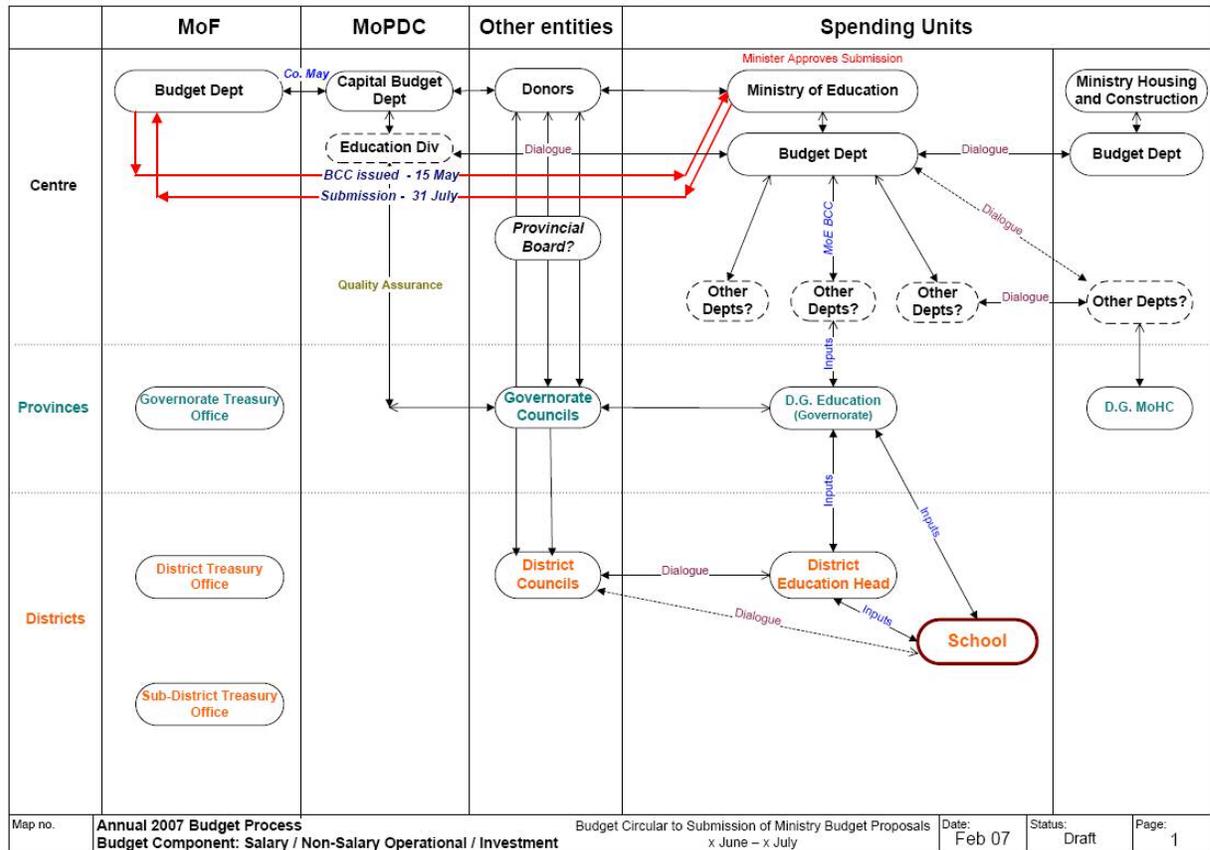
418. This section analyzes education sector policy and practice in financial management. It first describes the overall structure of budget process and execution system in the education sector, then identifies the major issues which needs solutions in improving system efficiency and effectiveness.

Overall budget formation and execution system in education sector

419. The Ministry of Education is subject to, and follows the same budget development and execution processes that apply to all line ministries, as discussed in more detail elsewhere in the PEIA. This section draws on the discussions with senior officials in MoE, MoF and MoP most closely connected with the budget preparation and execution, and seeks to identify strengths of the system in MOE on which to build, and the weaknesses that need to be addressed. The section will focus on those strengths and areas for improvement that apply specifically to the MoE experience.

420. As illustrated in Figure 6, a clear budget preparation mechanism exists, and according to the Iraqi education officials, the system works, and is based almost entirely on the regulations and procedures from the previous system. There appears to be very little awareness amongst education officials of the implications of changes to the legislation since 2003. They were aware that there have been delays in the implementation of the budget process, and that, in the years 2003 and 2004, the budget process was not at all clear to any stakeholders. Changes to the education system, with increasing allocation of investment funds to governorates, for instance, are not adequately reflected in regulations and procedures on which officials depend, and they are aware that there is a need to update existing procedures and regulations to accommodate the changes.

Figure 6: Map of Budget Preparation Process



Insufficient Capacity at MOE: Lack of multi-year perspective or clear strategies in budget planning

421. **There is no multi-year perspective in planning and budgeting.** Each budget cycle since 2003 has been a separate and independent exercise, with little continuity. In addition, there have been four different political authorities responsible for the budget since 2003, and this has added to the discontinuity.

422. **The budget planning cycle starts before guideline amounts are indicated by the MoF, and runs on the system in place for the past decade.** The MoE assembles data from the governorates on both enrolment and teacher numbers for the recurrent budget, and on requests for additional classrooms or schools for the investment budget. This data is submitted to the respective ministries – MoF for recurrent expenditure, and MoP for investment expenditure. The MoP also collects information from the governorates and determines nominal needs using a formula based on a number of key indicators, including population density, present pupil -classroom ratios and some socioeconomic indicators to determine relative deprivation and poverty. In recent years

this process has often been delayed leading to unpredictable allocations, which fluctuate each year.

423. At the workshops, Iraqi government officials clearly identified the problem that there is not sufficient planning capacity both at the central and the governorate levels in the MoE to assemble and interpret the data, and there is a great need to strengthen this capacity to ensure that more reliable and timely data is available. The MOE is hampered by an almost complete dislocation between the planning and implementation of the recurrent and investment budgets, which are negotiated with different ministries.

Needs-based budgeting and disparities in allocations

424. Allocation is needs-based. Each governorate outside Baghdad submits its request for recurrent and investment budget. The recurrent budget needs, based almost entirely on student, teacher and population numbers, are submitted through the MoE to the MoF, and an allocation is determined by MoF using a formula-based approach. While the system is structured technically to allocate equitable recurrent resources across the governorates, in reality, there are significant disparities in per student and per capita allocations across governorates. Since there is no transparent monitoring system these disparities are not readily identified.

Budget execution: Lack of strategic approach in staffing and low levels of coordination in school constructions

Recurrent

425. Currently, 94% of recurrent budget goes to salaries. Teachers are being paid regularly for the most part, but staffing priorities are not determined by any strategic approach, and numbers of teachers employed are often determined by factors outside the sector – i.e. the re-employment of tens of thousands of former teachers from the previous regime in 2004 and 2005, and the addition of over 20,000 teachers in 2006 to increase employment opportunities. Given the high proportion of recurrent expenditure that goes to salaries, the amount available for investment in other inputs, such as textbooks, materials, in-service training of teachers, equipment is very limited, with adverse consequences for quality.

Investment

426. MOE suffers a significant budget and planning challenge in terms of coordination. Coordination of donor financed school construction has been extremely difficult because most financing is off-budget, and the extent of control that the MoE has over various donor financed schools' construction and rehabilitation initiatives is limited. This problem has been somewhat reduced by efforts on the part of donors to prepare a matrix of donor programs, and by MoE in improving its planning capacity. However, the increasing autonomy of sub-national (governorate) authorities in capital investment in

education present additional challenges to the MoE in preparing its submissions, as not all school construction financed by other ministries (Housing and Construction; Provincial Reconstruction Committees, etc) and other donors and the US military, is reported. In addition, MoP has its own data base of school construction activities on which it bases its assessment of needs for each governorate in each sector.

427. MoE has relatively limited experience in school construction; hence the achievement of the much-increased 2007 sectoral investment budget was highly improbable. Prior to 2003, school construction was controlled by Ministry of Housing and Construction (MoHC), with MoE responsible for maintenance and repairs. Since there was very little new school construction in the 15 years prior to 2003, this did not present significant problems. Since 2003, MoE has had direct responsibility for school construction, and established a Directorate General with responsibility for coordinating this function. However, the move towards budget decentralization since 2005 has resulted in a significant shift away from this model. In 2007, while MoE was responsible for school construction in Baghdad, responsibility for school construction in the governorates was dispersed among the governorate authorities, the donors active in each governorate, and the MoHC and reconstruction which was allocated a significant (68bn Iraqi Dinars) for school construction in the governorates.

428. Previously, the investment budget was not managed by the governorates but, since a 2006 decision, funds for school construction are transferred directly to governorates to be implemented on a temporary basis with the support of the MoHC. This has led to a fragmentation in the budgeting process and little clarity on how it can be consolidated.

Constraints in enhancing the effectiveness of reporting, monitoring, and auditing

429. Officially there are institutional arrangements for internal and external auditing of all MoE expenditure, both capital and recurrent. Institutional and other constraints, however, have limited the effectiveness of these arrangements. The dispersal of capital expenditure across many different spending units creates serious challenges for both internal and external audit. Sometimes, auditing staff (internal auditors) are also involved in fund management, with an unclear distinction between auditing and fund management and inevitable consequences for their independence.

430. There is a reporting and monitoring system in place but institutional, contextual and other factors mean that it does not function systematically. Quarterly reports are often not available.

431. The Bank project Emergency Textbook Provision Project and the Emergency School Reconstruction and Development Project have both yielded high quality quarterly financial reports despite all the difficulties. This demonstrates that the human resources are available, and that investment in developing them and building the institutional capacity can result in positive outcomes in project implementation and

reporting of the fund management. Six months of external auditing rated the financial management generally satisfactory.

Procurement

432. **In the education sector, internationally acceptable standards and processes have been introduced and Iraqi officials are utilizing them in Bank financed projects.** This again indicates that the human resources exist in Iraq, and that with training and institutional capacity building, acceptable procurement standards can be achieved. While bidding documents and procedures currently in use for government procurement of civil works that are not financed by the Bank are not fully compatible with World Bank guidelines, there has been significant progress in this direction, with the adoption and adaptation of bidding documents and procedures developed in the bank financed Projects.

433. **The adoption of the new procurement law in Iraq will help to better align government procurement procedures with those that are acceptable to the Bank, according to its guidelines.**

Current Issues in Education Sector

434. **This section further examines critical issues in the education sector that prevent effective financial management.**

Basic Information on education sector budget (MoE & Ministry of Higher Education (MoHE))

435. **Despite the recent increase in the sector budget its ratio to the public budget is still one third of the comparable ratio of all countries in the region.** The sector budget has seen a continuous increase since 2003. The combined budget of MoE and MoHE (excluding KRG)⁶¹ increased from ID 1.6 trillion in 2005 to 2.2 trillion in 2006 and to 3.2 trillion in 2007 while its share of the government budget increased from 4% in 2005 and 2006 to 6% in 2007 (see Table 17).

⁶¹ The KRG has been receiving budgetary block grants from the central government and there is no available information on how much is spent on education. MoE and MHESR budgets cover the central and southern part of the country.

Table 17: Government and Sector budgets, 2005-2007 (ID mil)

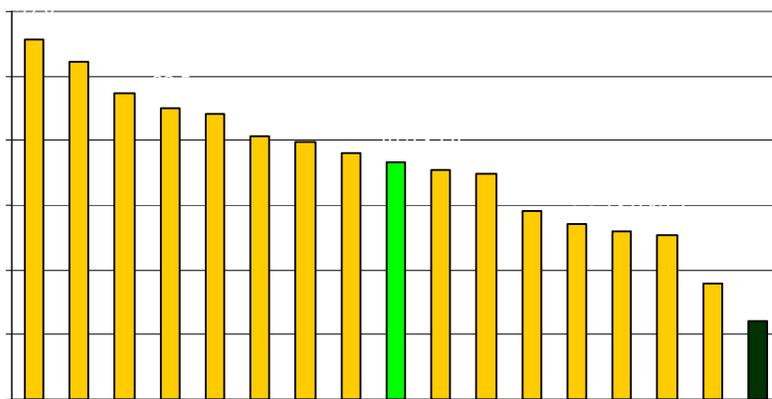
	2005	2006	2007
Government budget	35,981,168	50,963,161	53,390,159
Operational	28,431,000	41,691,161	42,283,159
Projects& Const	7,550,168	9,272,000	11,107,000
MoE & MoHE budgets	1,598,785	2,181,228	3,208,351
Operational	1,535,302	2,092,828	2,759,380
Projects& Const	63,483	88,400	448,971
% Ed bdg/Gov bdg			
Total	4.44	4.28	6.01
Operational	5.40	5.02	6.53
Projects& Const	0.84	0.95	4.04

Source: Gov budget from MOF, and Sector budget from May 2007 workshop

Analysis by investment and operational budget

436. **The huge increase in the MOE investment allocations in the 2007 budget (about thirteen fold) has inflated the education sector budget.** If the MoE investment is allocated on the basis of the implementation capacity of the previous years, the ratio of the sector budget to the total government budget would be 5% in 2007. Despite the increase in the sector budget in the past few years, the level of sector expenditure is still quite low compared to other countries in the region as the ratio of sector budget to the public budget in Iraq is way below the comparable ratios found in other Middle Eastern and North African countries where the average ratio of these countries is 18%. (Figure 7)

Figure 7



437. **These statistics should be interpreted in the light of two important considerations:** (i) Iraq is a country that is still involved in ongoing civil conflict and therefore has a budget more comparable with countries at war; (ii) the legacy of subsidies and war reparations has a distorting effect on public expenditure which constitutes an inordinately high percentage of the GDP.

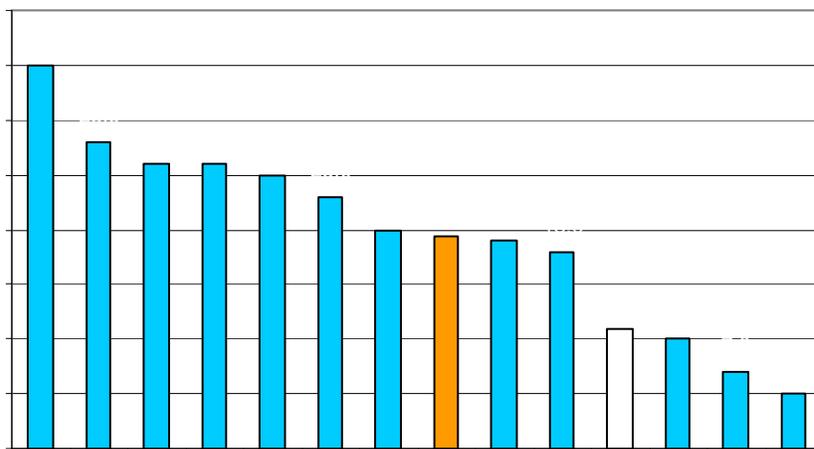
438. **The high proportion of operational expenditure (96% in 2006) in the sector budget reflects the government's high priority to keep the system functioning.** As a result, allocations to investment expenditure became quite low (4% in 2006) in comparison to other Middle East countries where the average ratio of investment to operational budget in these countries is three times that of Iraq. Since 2003, the government has relied on donors and international agencies to finance capital projects in education. In recent years, implementation of both government and donor agency investment projects has been very slow and difficult due to the limited implementation capacity, corruption, complicated procurement procedures, and deteriorating security situation. As a result, a significant proportion of the investment budget remains unspent at the end of the year.

Recurrent Expenditure

Imbalance between expenditure in wages and non-salary items due to massive education staff recruitment

439. **The MoE has been facing substantial difficulties that are characteristic of countries affected by conflict.** From an expenditure perspective, the main issues facing MoE are; (i) the challenge of balancing between employment generation and the cost of hiring teachers, (ii) the very limited funding for non-salary expenditure, (iii) the unpredictable budget preparation process, (iv) the fragile governance and prevalence of corruption, and (v) the limited participation and weak accountability. These problems have impacted the pattern and efficiency of expenditure as well as budget allocations and implementation. For the past few years, the MoE budget consisted mainly of operational expenditures where salaries make up more than 95%. The continuous hiring and re-hiring of teachers enlarged the salaries expenditure and left very little to non-salary expenditure. The small share of non-salary expenditure in both MoE and MoHE is about half of the average share of non-salary expenditure in other Middle Eastern Countries (Figure 8).

Figure 8



442. **In the past few years, the MoE has been focusing on building its managerial and administrative staff to fill in the vacancies in the ministry's structure.** Large numbers of officials have been recruited and previously dismissed staff has been re-hired. Within MoE, the number of non-teaching staff almost doubled between 2005 and 2006, increasing from 53,000 in 2005 to about 110,000 in 2006. This is reflected in the budget as the expenditure of the central ministry and administration categories, that makes 13% of the budget, increased by almost three times. Meanwhile, expenditure on primary and secondary education, which accounts for over 80% of the total MOE budget, has increased by only 4% between the same two years.

Huge increase in salary expenditure in 2006 and 2007

443. **In recent years, MoE salaries have been increasing in addition to the massive recruitment of teaching and non-teaching staff.** Salary expenditure increased moderately from ID 1.1 trillion in 2004 to ID 1.2 trillion in 2005 (6%), and then jumped to ID 1.4 trillion in 2006 (17%). The 2007 budget shows an even higher growth where allocations to salaries were ID 1.9 trillion -- a 27% increase over 2006. The substantial jump in salary expenditure between 2004 and 2005 is also shown on the ratio of salaries to operational expenditure where it increased from 91% in 2004 to 95% in 2005 and it remained at comparable level in 2006 and 2007 (Table 18).

Table 18: MOE budget, 2004-2007 (ID mil)

	2004	2005	2006	2007	2004 %	2005 %	2006 %	2007 %
Operational Budget	1,170,461	1,240,488	1,478,385	1,928,112	97.7	98.9	98.1	84.0
Salaries	1,112,168	1,176,360	1,375,639	1,745,987	90.6	94.8	93.1	90.6
Non-salary	58,293	64,128	102,746	182,125 366,000	5.0	5.2	6.9	9.4
Investment	27,995	13,483	28,400	*	2.3	1.1	1.9	16.0
Total	1,198,456	1,253,971	1,506,785	2,294,112	100.0	100.0	100.0	100.0

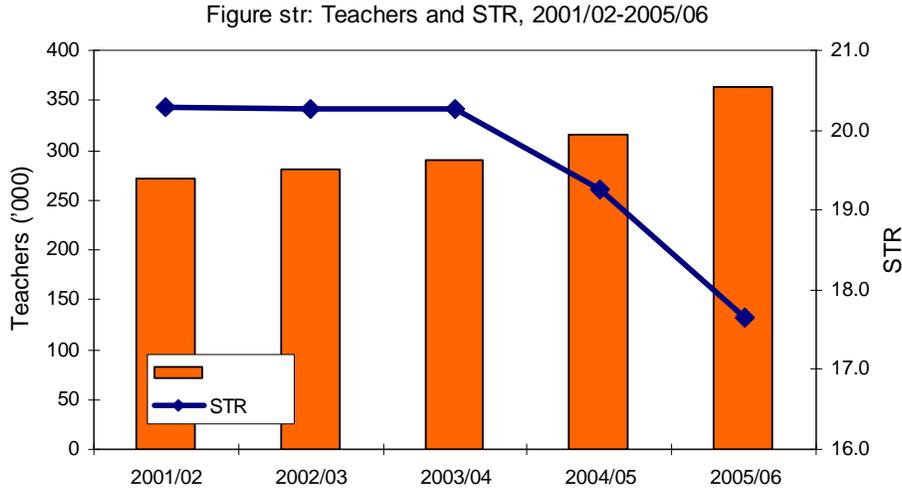
** investment allocations in 2007 are exceptionally high compared to previous years. If implementation followed past years, the ratio of operational expenditure would be 97% in 2007 and salaries would be 93%.*

Source: obtained by World Bank Mission (April 2007)

Impact of education staff recruitment on student: teacher ratio (STR)

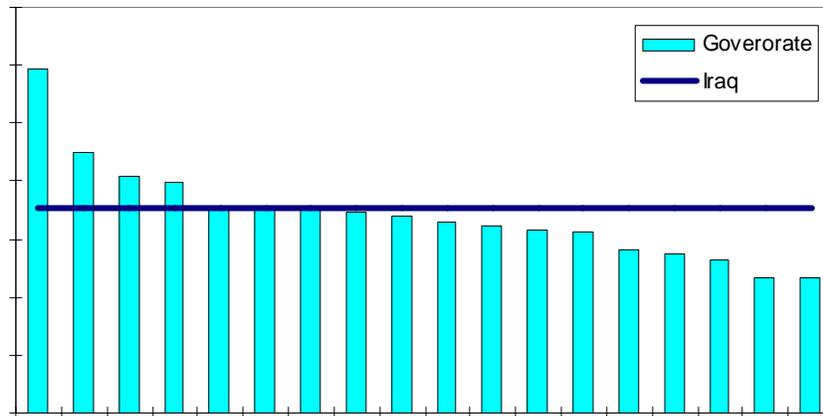
444. **The already low STR has declined further, the surplus of teachers increased, and teacher mal-distribution is accentuated.** As the number of teachers increased in the past few years, the already low STR in general education declined. Figure 9 below shows that during 2001/02- 2003/04 the STR was level at a fairly low ratio of 20:1 then it started to decrease rapidly and reached 17.6:1 by 2005/06 as a result of the massive increase in teacher numbers during the past two years. If the government continues this pace of recruitment, the STR will further decline, the salary bill will continue to soar, and the system will suffer further inefficiencies.

Figure 9



445. **The low STR level hides substantial variations among the STRs in the governorates and within the STRs of the six districts of Baghdad governorate.** In 2005/06, Ninevah Governorate had a ratio (30:1) that was almost three times the ratios found in Wassit and Missan governorates (12:1) (Figure 10). Within Baghdad governorate, the highest ratio is found in the two districts of Rasafa 1 and 2 where the STR is 25:1 and the lowest is found in Karkh 1 with a ratio of 16:1. There is no available information on teacher allocation to different schools and regions and the distribution of the recent newly recruited teachers among the governorates and districts is not clear.

Figure 10



446. **The latest comprehensive survey carried out by UNICEF in 2004 showed that there is a large number of schools with teacher shortage and others with teacher surplus.** Anecdotal evidence suggests that recent sectarian violence and family

displacement and re-location among neighborhoods within Baghdad governorate and some governorates have negatively impacted teacher distribution and utilization.

Low efficiency of recurrent expenditure

447. **One of the critical problems in education sector expenditure is that non salary expenditure is very low, under-spent, and most of it goes to security related equipment and services.** The result is that a very small amount is spent for improving the quality of learning such as teaching material, equipment, and in-service teacher training. This has a serious negative impact on the already low quality of education (see Table 19).As mentioned earlier, the escalating salary expenditure of MoE has crowded out other expenditure and even with the recent increase in the share of non-salary expenditure over the past three years, (from 2% in 2004 to 6 in 2006) its level is still small compared to other Middle East countries where the average ratio of non-salary expenditure to the operational budget in these countries is double. Furthermore, what is actually spent of the non-salary category is below the budgeted amount. For example, in 2006, about 14% of the approved budget for non-salary expenditure was not spent. On the other hand, a large part of the non-salary budget that was spent in 2006 (88%) was used for purchases of expensive security services and goods and equipment (guards, armored cars, equipment, weapons, etc.) needed to protect the ministry’s buildings from the escalating violence mainly in the Baghdad metropolitan area.

Table 19: MOE budget and the ratio of actual to approved (ID mil)

	2004	2005	2006	2004	2005	2006
	actual	actual	actual	act/ act/approved	act/ approved	act/ approved
<i>Total Operational Budget</i>	916,038	1,251,345	1,493,586	0.78	1.01	1.01
Salaries	894,416	1,210,231	1,405,522	0.80	1.03	1.02
Non-salary	21,622	41,114	88,064	0.37	0.64	0.86
Services	4,991	11,664	16,868	0.24	0.46	0.73
Goods & material	12,135	19,742	61,070	0.37	0.76	0.98
Maintenance	968	5,307	5,973	0.81	0.86	0.85
Capital goods	3,473	4,331	4,128	0.96	0.66	0.42
Transfers	55	70	25	0.28	0.35	0.10
<i>Investment</i>	19,783	1,934	22,806	0.71	0.14	0.80
Total Oper & Investment	935,821	1,253,279	1,516,392	0.78	1.00	1.01

Potential improvement in resource utilization for recurrent expenditure

448. **As a potential strategy for improving expenditure efficiency, streamlining the education staff and reversing the decreasing trend of the STR would bring substantial savings and free-up resources that could be re-invested in the needed areas of quality enhancement.** The current inefficiencies in resource utilization in the

education system comes from: (i) the surplus of the teaching force and the imbalance of its distribution and utilization, (ii) the extremely small share of expenditure for quality improvement inputs, and (iii) the rapidly increasing numbers of drop-outs and repeaters and the reported declining student attendance.

449. The continuing inefficiencies in recurrent expenditure suggest a need for the development of a comprehensive teacher supply, utilization, and development strategy that will provide for more cost-effective use of human resources. Rationalizing the numbers of education staff and reversing the decreasing trend of the STR would bring substantial savings and free-up resources that could be re-invested in the mostly needed areas of quality enhancement. A study conducted in 2005 showed that a gradual increase of five points in the STR in five years would bring considerable savings that would amount to about one third of the budget (TEEP Project Papers, September, 2005).

450. Other potential savings could be generated from improving the internal efficiency of the education system. The security situation and the prevalence of violence have worsened the system's efficiency as rates of dropout and repetition increased, and student attendance decreased dramatically in some parts of the country. Information on the impact of the continuing violence on school dropouts, repeaters, and attendance is not available. The UNICEF survey in 2004 showed high levels of dropout and repetition rates in primary and secondary education. Approximately 19% of primary students and 22% of secondary students fail to complete their respective cycles. A simulation of reducing repetition rates by half their current level would bring savings of more than one percent of the MoE operational budget (TEEP Project Papers, September, 2005). Resources saved would be allocated for meeting the enormous needs for reconstruction and upgrading of the education system.

Investment expenditure

Low level of MoE's investment expenditure

451. Government's budgetary provision for building and rehabilitation of school infrastructure falls far short of what is required to address the massive backlog and yet is under-spent. If the government is to successfully address this fundamental problem, an urgent review of the school construction strategy is required.

452. Allocation to investment projects is extremely low and not spent fully. Only 2% of the MoE budget was allocated to investment in 2006 and about 20% of this allocation was not spent by the end of the year. In absolute terms, the investment budget of MoE decreased sharply from ID 28 billion in 2004 to 14 billion in 2005 and increased again to 28 billion in 2006. The MoE utilizes the investment funds primarily to build and renovate primary and secondary schools. These categories made about 90% of the actual investment expenditure in 2006 (Table 20).

Table 20: MOE Actual investment expenditure, 2004-2006 (ID mil)

	2004	2005	2006
Storage for Books & Equipment	2,193		30
Rehabilitate the Printing Building	842		555
Rehabilitate & Dev. Directorates Building	354		
Build Wings and Sanitary Utilities	1,227		136
Habilitate the Educational Departments	361		107
Construct Central Warehouses for Vocational Training	200		
Modernize & Develop Agriculture Schools	64		
Expand Existing School Buildings	587		28
Prepare Studies & Designs	10	5	13
building primary and secondary schools	13,945	1,929	20,469
Habilitate, Renovate, Enhance Sch. Buildings			1,417
Develop, Modernize & Build Annexes & Scouts / Camps			52
Total	19,783	1,934	22,806

453. **The investment budget for 2007 was exceptionally high.** That allocation was ID366 billion for Baghdad governorate and an additional allocation of ID75 billion was for the other governorates. Specialists from the ministries of Education, Planning and Finance recognized they are unlikely to be able to spend such an allocation in 2007. In the event actual spending was only ID 27 billion; nevertheless the unspent balance has been carried forward into 2008 along with a new provision of ID 150 billion. The credibility of such a level of spending in 2008 must be open to serious doubt.

454. **The share of investment expenditure to the total MoE budget declined from 2% in 2004 to 1% in 2005, and increased to 2% in 2006 and then jumped to 16% in 2007.** The large dip in the investment budget in 2005 was mainly due to the fact that the increase in the total MoE budget between 2004 and 2005 went primarily to operational expenses to pay for the salary increase in 2005 as well as the additional education staff that were recruited in the same year.

High reliance on donors' investment programs

455. **From 2003 to 2006, as recurrent expenditure was given top priority, the government relied heavily on international organizations and donors to finance investment expenditure on school infrastructure.** The government's priority from 2003 was to get the education system going and the increase in resources was mainly channelled to operational expenditure to pay for the mounting salary bill. Rehabilitation and rebuilding school infrastructure was primarily financed by the international donors' communities including the WB. A range of international agencies has been involved in supporting education in Iraq since May 2003. Because of the lack of coordination and speed of implementation in the early days after the war in 2003, the data on donors' support to education is fragmented and scattered and not reflected in the government budget. The Ministry of Planning is responsible for coordinating these activities and there are plans to assess these programs and incorporate them in the investment budget of the coming years.

456. **The UN and the World Bank have been providing assistance largely through the two trust funds under the International Reconstruction Fund Facility for Iraq (IRFFI).** The US has been the major bilateral donor and its support has been provided through three main channels; through contracts granted to USAID financed from US Supplemental Budget for Iraq, through direct reconstruction and rehabilitation activities undertaken by the US military, and through allocations from the Development Fund for Iraq financed from national resources in Iraq administered by the Coalition Provisional Authority in 2003 and 2004. Recently USAID has shifted its focus in education exclusively to capacity-building in the ministries of Education and Higher Education.

457. **The UN financed programs (\$80 million) covered a wide range of activities including school rehabilitation, supplies, equipment, and capacity building.** The World Bank implemented two emergency projects, with a value of \$100 million, which financed textbook printing for 2004/5, and school rehabilitation and construction, and capacity building. The WB prepared a third emergency project for another \$100 million primarily for building new schools and rehabilitation of existing ones in all the governorates of Iraq and capacity building. The WB and the Islamic Development Bank now provide the largest external financing for school construction, and are the only agencies using recipient execution, implementing projects through the ministries.

458. **All these programs represent a good start but are still very small when compared to the sector needs (\$4.8 billion) assessed by the UN/WB Needs Assessment Study (October 2003).** The execution of these capital projects was very limited in the past few years especially in the governorates outside Baghdad mainly due to the limited government capacity, the poor security situation, and the complicated procurement arrangements.

The low efficiency of investment expenditure

459. **The significant unspent amount of investment expenditure suggest that the problem is not shortage of funds but the capacity of implementation staff at the central, governorate, and district levels.** Despite the fact that investment budget represented in 2004 - 2006 a relatively small percentage of total MOE budget, the MOE and the education authorities in the governorates did not manage to spend all the allocations of that budget. For the past few years the proportion of the unspent amount to the total investment budget was 29% in 2004 and declined to 20% in 2006 (Table 21). The unspent ratio in 2005 investment budget was 86%, indicating that in that year the program was hardly implemented. The massive increase in the investment allocation in the 2007 budget from almost IQD23 billion in 2006 to IQD366 billion for Baghdad alone suggests a high likelihood that investment funds in 2007 were significantly under-spent as well.

Table 21: MOE Investment Budget (ID mil)

	2004	2005	2006	2004%	2005%	2006%
Spent	19,783	1,934	22,806	70.7	14.3	80.3
Unspent	8,212	11,549	5,594	29.3	85.7	19.7
Total investment	27,995	13,483	28,400	100.0	100.0	100.0
% investment to total budget	2.3	1.1	1.9			

460. **Donors' programs as well as WB financed projects also suffered** from the slow and difficult implementation primarily because of capacity limitations.

461. **With the enormous increase in the 2007 investment budget there does not seem to be much point in mobilizing significant additional investment funds which will simply add to the burden of unspent budget each year.** The urgent need is to build the capacity of the Ministries of Education and Planning to plan and implement a **major multi-year capital development program** that will provide for incremental increase in the investment allocation.

The challenge of implementing the massive increase in investment allocation for 2007

462. **On the basis of past years' experience, government specialists agree that there was very little possibility that this amount of increase could be implemented during 2007.** The investment budget for school construction in Baghdad governorate for 2007, announced in February, showed a 13 fold increase (from ID28 billion in 2006 to ID366 billion in 2007), while a further ID75 billion was allocated to the governorates in 2007 budget.

463. **The current backlog of more than 4,500 schools as calculated in 2003 would constitute an almost 40% increase in the number of schools currently in the system.** If the government's aspirations to restore universal primary access and expand secondary access to levels comparable with other countries in the region are taken into account, plus anticipated population growth, the additional number of schools will be considerably higher. Such a massive program requires a major national effort and a comprehensive capital development strategy.

464. **Specific measures that need to be taken to accelerate implementation of education capital projects are:** (i) establishing an inter-ministerial team of specialists to develop a comprehensive school construction and maintenance plan that would provide the basis for a multi-year investment program to address the school construction backlog (ii) improving communication and coordination among MoE, MoP, and MoF, also coordination between MoE and governorates on investment budget execution, (iii)

accelerating technical staff training and capacity building to execute the projects, (iv) accelerating development of a prototype design for schools, and site identification, (v) obtaining approvals for assigning the properties, and starting implementation as soon the investment budget is released, (vi) developing an alternative plan in case of delay in execution of the original plan, (vii) preparing bills of quantity in current prices, (viii) preparing design and technical studies for investment projects with incomplete studies (ix) investigating the possibility of involving other government and private sector partners to supplement the capacity of the MOE during the implementation of this program.

Education Sector Performance under PEFA Framework

465. **In this section, the Public Expenditure and Financial Accountability (PEFA) framework is employed to assess the public financial management systems for the education sector.** While the PEFA framework is primarily designed to assess Government-wide public financial management systems, certain performance indicators were applied that were deemed applicable for the education sector. The following analysis is based on the 21 PEFA indicators, which cover the area of i) credibility of education budget; ii) comprehensiveness and transparency; iii) budget cycle; and iv) donor practice

Credibility of the Budget: Aggregate expenditure out-turn and composition of expenditure out-turn compared to original approved budget

466. **The education sector's budget appears to be increasingly credible; however, deeper inspection reveals there are areas where budget credibility is compromised.** A key element of a credible education budget is how accurate the original annual budget is as a predictor of actual expenditure at the end of the year. Applying the PEFA framework methodology, reveals that the education sector actually performs very well, scoring a B (see Tables 22 and 23). A score of B using this methodology implies that "*in no more than one out of the last three years has the actual expenditure deviated from (original) budgeted expenditure by an amount equivalent to more than 10 % of budgeted expenditure*". At the ministry level, performance is also satisfactory, with the MoE scoring a B and the Ministry of Higher Education scoring a C (*in no more than one of the last three years has the actual expenditure deviated from budgeted expenditure by more than an amount equivalent to 15% of budgeted expenditure*).

467. **The framework methodology implies that in aggregate at the sector and ministry levels, the original budget is a relatively good predictor of actual expenditure.** That said, with deeper inspection of budget outcomes at the operational and investment budget levels, performance starts to deteriorate. At the operational budget level, the education sector scores a C, while at the investment budget level, the score is the lowest possible with a D (*in two or all of the last three years did the actual expenditure deviate from budgeted expenditure by an amount equivalent to more than 15% of budgeted expenditure*). Both education ministries score a D at the operational and

investment budget level. It should be noted, however, that investment budget performance by both education ministries have been improving each year.

468. Variation in the education budget expenditure is not due to reallocations between the education ministries. Given there are only two ministries in the education sector, it is not surprising that the Education sector scores an A (*variance in expenditure composition exceeded overall deviation in education expenditure by no more than 5 percentage points in any of the last three years*) for composition of education expenditure (PI-2). What this score implies is that reallocations between education ministries have contributed little to variance in education expenditure composition beyond the variance from changes in aggregate education expenditure.

469. The results raise important issues such as the quality of budget integration and in-year budget management. It appears that the non-integration of the Budget (separate operational, investment and donor budgets) are not contributing to better budgeting outcomes and that management of the budget execution and/or cash release is at the aggregate level in practice. In addition, the results indicate that the process for in-year amendments for transfers between recurrent and investment appropriations that do not require prior approval from the legislature needs review.

470. It is understood that there are frequent adjustments to the budget during the year and a final revised budget is submitted to the CoR with the next Annual Budget Law. Nevertheless, the education budget at the aggregate level performs relatively well and investment budget credibility has been steadily improving since 2004.

Table 22: Performance indicator scores under PEFA framework

Scores	Recurrent Investment Aggregate			
	No of yrs	No of yrs	No of yrs	
PI 1 - Aggregate education expenditure out-turn compared to original approved budget	0 1 1 1	0 0 0 3	0 1 2 0	Less than 5% deviation Between 5% and 10% deviation Between 10% and 15% deviation Greater than 15%
PI 1 Score Education Function By Ministry	C	D	B	
PI 1 - Education	D	D	B	
PI 1 - Higher Education	D	D	C	
PI 2 - Composition of education expenditure out-turn compared to original approved budget	3 0 0	3 0 0	3 0 0	less than 5% deviation greater than 5% deviation greater than 10% deviation
PI 2 Score Education function	A	A	A	

Table 23: Education expenditures compared to original approved budget (ID b)

Year/ Functional Head	Recurrent		Investment		Aggregate	
	Original budget	Est.actual	Original budget	Est.actual	Original budget	Est.actual
2004						
Education	1419	1201	10	20	1429	1221
Higher Education	277	294	12	12	289	306
Total	1696	1495	22	32	1718	1527
2005						
Education	1168	1405	100	2	1268	1407
Higher Education	295	379	50	11	345	390
Total	1463	1784	150	13	1613	1797
2006						
Education	1559	1505	28	24	1588	1529
Higher Education	614	507	60	23	674	531
Total	2174	2012	88	47	2262	2059
	Dif	Abs %	Dif	Abs %	Dif	Abs %
2004						
Education	-218	15%	10	98%	-208	15%
Higher Education	17	6%	0	0%	17	6%
Total	-201	12%	10	44%	-191	11%
Variance in excess of total deviation		2%		0%		2%
2005						
Education	237	20%	-98	98%	139	11%
Higher Education	84	29%	-39	78%	45	13%
Total	321	22%	-137	91%	184	11%
Variance in excess of total deviation		0%		0%		0%
2006						
Education	-55	4%	-4	15%	-59	4%
Higher Education	-107	17%	-37	61%	-144	21%
Total	-162	7%	-41	47%	-203	9%
Variance in excess of total deviation		0%		0%		0%

Source data: MoF, MoP and MoE

Credibility of expenditure: payment arrears

471. **There are no reliable data on education expenditure arrears.** A requirement for a credible education budget is a low level of expenditure arrears as high arrears imply non-transparent debt-like financing. In Iraq's decentralized system of public financial management, ministries have the responsibility to manage and account for appropriated cash provided by the Ministry of Finance. Guidance on how ministries account for cash and control budget execution is enshrined in rescinded subordinate legislation.

472. **The primary mechanism utilized to minimize expenditure arrears is through an informal commitment control system where prior approvals for large value contracts are checked against unreleased appropriations and cash held in the ministry.** In addition, ministries are required to provide contract budgeting information for projects to the MoP, and the MoF has the power to withhold further cash allotments if monthly or quarterly expenditure are not accounted for. As part of the end of year process to close the accounts, central ministries undertake a process to estimate the value of contracts that have or will be signed where payments will fall due in the following fiscal year. This process helps to minimize the incidence of high value and unaccounted for expenditure arrears. Nevertheless, the Education and central ministries do not have a formal mechanism to monitor and control commitments nor do they have a mechanism to monitor the age profile of expenditure arrears.

Transparency and comprehensiveness of the education budget

Education budget classification

473. **While the education budget is adequately classified, there is room for improvement in the classification and reporting of the education budget.** Under the PEFA framework, the education sector scores a B for budget classification (see Table 24). Education budget formulation and execution is based on administrative and economic classifications using a standard that can produce consistent documentation according using GFS, COFOG and ISECD-97⁶² standards. The 2007 Budget was prepared on the basis of a GFS based system for economic classification.

474. **Currently, education accounting is utilizing the classifications of the legacy system which is then mapped centrally to the new GFS based classification system.** That system does not map expenditure to education functions. However, given the programmatic nature that is established in the MoE and the fact that MoHESR budget is primarily for tertiary education purposes, an adequate system of mapping to GFS/COFOG function is easily performed (see Table 25). This mapping has been undertaken for budget related reporting, although not on a regular basis.

⁶² GFS= Government Finance Statistics, COFOG= Classifications of Functions of Government, ISECD-97=International Standard Classification of Education.

Table 24: Education Classification of the Education Budgets - Internal Systems and Reports

	Budget Formulation	Budget Execution
GFS/COFOG standards		
Administrative	Yes	Yes
Economic	Yes	Yes
Sub-functional	No	No
Sub-programs mapable to sub-functional	Yes	Yes
Functional	No	No
Overall Score	Score	Score
B	B	B

Table 25: Mapping of Education Programs to Function

Education Programs	GFS/COFOG Education
MoE	
Ministry Central	To be allocated to by % weights to: Education and other programs
Vocational Education Training	Tertiary education
Technical Institutes	Education not definable by level
Secondary	Secondary education
Primary	Pre-primary and primary education
Kindergarten	Pre-primary and primary education
MoHESR	
Higher Education	Tertiary education
Scientific Research	Split between: R&D Education and Tertiary Education as appropriate.

Comprehensiveness of information included in published education budget documentation

475. **There is no separate official documentation publicly available that provides more detailed information on the education budget than is contained in the Annual Budget Papers.** Ideally, the education sector should release a portfolio budget statement at the time of transmittal of the Annual Budget Law or shortly after the approval of the budget by the legislature. The minimum requirements could include the following:

- Prior year's budget outturn, presented in the same format as the budget
- Current year's budget presented in the same format as the budget proposal
- Summarized budget data for both revenue (if any for education) and expenditure according to administrative, economic and functional classification, including data for the current and previous year
- Explanation of budget implications of new policy initiatives, with estimates of the budgetary impact of all major revenue policy changes and/or some major changes to expenditure programs

- Financial Assets, including details at least for the beginning of the current year
- Medium term expenditure framework for the Education sector, including medium term estimates by program and function and high level economic classification for project and program assistance provided by development partners (also split by function)
- Details of any block grants provided to the Governorates for education purposes

Is the education budget policy-based?

476. **For the education budget to be founded well in education policy**, the participation of the education ministries needs to be orderly and set within the context of a multi-year perspective.

Orderliness and participation in the annual budget process

477. Opportunities exist to improve the orderliness and participation of education ministries in the annual budget process. **The Financial Management Law (CPA Order # 95) establishes the key components of the annual Budget formulation calendar and incorporates an integrated top-down and bottom-up budgeting process. The MoF and MoP drive the process. During the 2007 annual budget process, MoE budget proposals were submitted and revised many times due to disagreements at official levels at MoP, MoF and the MoE, misunderstanding of and changes to what was required and revised sectoral ceilings. This suggests that clarity of the budget timetable in the budget call circular and timetable compliance could be improved.**

Multi-year perspective education expenditure planning, expenditure policy and budgeting

478. **The education ministries have not yet resumed multi-year planning;** however, the pre-conditions are in place for the introduction of a pilot program for a Medium Term Expenditure Framework (MTEF) for the education sector. The MoE is developing an Education⁶³ sector strategy, which will be a sound basis for an MTEF. Proper costing of the education sector strategy will be critical element in any move towards an MTEF as will be the identification and inclusion of recurrent cost implications of investment projects.

Predictability and Control in Budget Execution

Predictability of the availability of funds for education budget expenditures

479. **Education ministries receive reliable information on the availability of funds for the commitment expenditures for operational and investment inputs.** However, due to the non-integration of the budget and Iraq's system of cash control, either the MoF or MoP can impose controls on the ability of education ministries to commit

⁶³ Excluding tertiary education.

expenditures. Iraq is not currently cash constrained in terms of in-year budget execution, as significant reserves have been accumulated to due ongoing under-spending of the investment budget at the aggregate level and weak investment budget forecasting during the annual budget process. Controls available by the central ministries that can affect the predictability of availability of funds are associated with deemed non-compliance with monthly or quarterly expenditure reporting obligations. MoP can exert control at project reporting points of the investment budget reporting cycle. MoF can exert control at expenditure accounting points for the recurrent and investment budgets. It is uncertain if control is appropriate or not as systems are not in place to determine cause of problems and duration of resulting delays at reporting and key control points.

480. Project planning for infrastructure needs occurs regularly and monitoring and evaluation of projects progresses in cooperation of the MoP. The education budgets are already prepared on a programmatic basis which can be mapped to GFS/COFOG education functions. Systems are also in place in the MoP for the collection and monitoring of level of donor assistance to the education sector. In-house expertise for the costing of budgets is also of a sufficient standard as the MoE have established agreed unit costs on items such as administration and teachers salaries and school building costs.

481. Cost driver information, such as enrolments, the number and size of schools, and number of teachers, is also available and monitored. There may be some knowledge gaps, however, for completion of a zero-based costing exercise. Nevertheless, sufficient capacity exists to undertake medium term forecasting of expenditure requirements of current policies underpinning the recurrent and investment budgets. Some technical assistance will still be needed to support the ministries' efforts to progress an MTEF pilot.

Effectiveness and transparency of cash flow planning and budget adjustments

482. Cash flow planning is rudimentary. Currently, the MoF releases cash to ministries every month on the basis of 1/12th of the annual appropriation. Cash flow forecasting at the central agency does not yet implement a simple top-down approach based on the previous year's performance of the ministry adjusted for known changes to a ministry's budget. The collection of cash flow forecast information from education ministries (bottom-up) does not yet occur systematically.

483. Significant amounts of in-year adjustments are made to education budgets and are non-transparent. An amended budget for the previous fiscal year is submitted to the legislature with the Annual Budget Bill. This is a non-transparent practice and can impact on predictability of funds if an adequate system to monitor all in-year adjustment is not in place at central and line agencies. Clear overarching rules are established in the Financial Management Law (CPA #95); however, the recent Annual Budget Laws introduced rules that are in conflict with the FML. The processes for implementation of FML requirements for in-year adjustments are unclear, and officials revert to rescinded legislation. A clear process is needed to ensure agencies have advanced notice of the adjustment mechanism that relates budget adjustments to budget priorities in a systematic

and transparent manner. The MoF is currently exploring options for the review and amendments of existing legislation and drafting of new implementing legislation.

Recording and management of cash balances, debt and guarantees

484. **The process for the consolidation of cash balances of the Education Ministry bank accounts is unclear.** Due to the absence of a true Single Treasury Account (STA), a timely consolidation of cash balances held centrally and in line ministries does not occur. While not a pre-condition, the absence of a functioning electronic banking and payments system hampers the effective development of an STA. The trial balance system utilized by the MoF and the education ministries provides the essential elements of a linked, book-based STA. However, it is unknown if bank account reconciliation occurs at the ministry level on a systematic basis as part of the monthly trial balance reporting process.

Effectiveness of payroll controls

485. **While payroll controls are likely to be insufficient in the education ministry, a definitive assessment is not possible as the civil service census has yet to be completed.** The system of payroll controls in the ministry appears adequate in terms of structure but is not supported by efficient systems. The wage bill is by far the biggest item of expenditure for the education ministries. The budgets for salaries when compared to total operational budgets are over 90% for MoE and over 80% for MoHESR. Inclusion of pension payments into consideration increases these ratios even further. Consequently, it is essential that adequate controls are in place in these ministries to minimize leakage through mismanagement and corruption. The payroll control system in the education ministries is based on two systems: i) an establishment list that is approved by the CoM each year through the annual budget process; and ii) the personnel and payroll system, which is currently book-based. The personnel recording system is the key link between the approved establishment list and the payroll system.

486. **The personal departments at the governorate and central levels in the education ministries are responsible for ensuring that no new officials are hired unless a vacant position is identified in the establishment list.** These personnel departments are also responsible for transmitting payroll information to the education ministries' finance departments in the governorates and centrally for the payment of salaries each month. This system is appropriate in terms of the basic structure as it has all the key elements for effective payroll control.

487. **The system falls short, however, in practice due to the lack of computerization that is needed to pay report and monitor the salaries of hundreds and thousands of government teachers and administrators.** The system is further complicated as coordination and administration of personnel records at the governorate and central levels is a complex task.

Competition, value for money and controls in education procurement

488. **There is currently insufficient data needed to assess the method used to award public contracts. However, there are anecdotal reports that open competition is limited and private sector involvement is crowded out by the public sector in practice through protection offered by rescinded procurement legislation, which may still be followed.** The degree to which this applies in the education sector is uncertain, although there have been positive outcomes reported by the MoE during procurement of large value contracts for items such as text books, where value of money has been clearly demonstrated after following international procurement standards. The pressure to fast track procurement is apparent elsewhere in Government, as the justification for the use of less competitive procurement practices is commonplace given the current situation. While the MoE has an internal complaints mechanism, the complaints generally occur during negotiations. Moreover, the complaints handling process is more than likely to be poorly understood by the private sector. The new procurement law and its implementing regulations will provide a sound basis to move forward with the Government's effort to improve value for money and control in procurement.

Effectiveness of internal control for non-salary expenditure

489. **Commitment controls systems are generally lacking, while verification and payment control systems are in place and are well understood by officials.** The cash allotment and trial balance reporting system is the primary form of commitment control and is also well understood by officials and is effective in establishing compliance incentives. The lack of true commitment controls and current incentive structures, however, may be having unintended consequences for budget execution performance. Internal control systems try to balance facilitation of budget execution needs with compliance with control requirements to mitigate fiduciary risk. Currently, the MoP has been experimenting with systems for the obligation (reservation of funds) and commitment of expenditure through new accounting policies associated with the investment budget.

490. **Internal controls differ for certain items such as salary payments and telephone bills as commitment is recognized when payment falls due.** Generally however, commitments occur when an obligation to pay has been incurred, which is usually when a contract for goods or services has been signed. Verification and payment control systems in Iraq are historically very strong and are founded on pre-auditing of transactions, where multiple authorizations are required before payment is made. However, given the need to improve budget execution, some of these controls may be relaxing. A more systematic approach is needed and should be based on a review of existing budget execution processes including signatory requirements at each key control stage from commitment through verification and payment for each administrative and economic type of classification, where they differ.

Effectiveness of internal audit

491. **It is doubtful if internal audit arrangements in the education ministries support effective oversight.** Management in the education ministries receives regular feedback from the Inspector General for Education. However, there is little evidence of follow-up on internal audit findings. The internal audit function provided by the Inspector Generals is new to Iraq and was introduced in 2004. There are promising signs of increasing internal audit capacity, however, it is understood that internal audit procedures followed by the IGs are not yet compliant with International Standards for Professional Practice in Internal Audit (ISPPPIA), issued by the Institute of Internal Auditors. Response by management to internal audit reports delivered by the Inspector General for Education is unknown as formal written responses to reports are unavailable at the time of writing.

492. **The state internal auditing of financial and performance of schools and governorates remains unclear.** The lack of financial management expertise in the governorates and schools is likely to produce adverse internal audit findings at the governorate level, which could be easily missed during internal auditing at the central level. The GoI is currently working to improve financial management capacity and the accountability framework at the sub-national government level and a separate report on decentralized public financial management addresses this issue in more detail.

Effectiveness of accounting, recording and reporting

493. **A strategy to improve the timeliness and scope of accounting information in the education ministries will need to be developed to support moves towards an education MTEF.** Two options include: i) the development of an education specific FMIS that incorporates reporting standards that comply with standards set by the central ministries; or ii) expansion of the MoF's FMIS implementation strategy to incorporate piloting of the same system adapted to the needs of the education ministry. It is stressed that, prior to any roll-out of software and hardware, work should be prioritized to establish the necessary conditions within the education ministry to progress implementation of any FMIS system

Table 26: Preparation of multi -year education expenditure forecasts and functional allocations

Economic classification	Forecasts of fiscal aggregates			Links between multi-year estimates and budget ceilings
	Functional/sector classification	No of Forward Years		
No	Yes	None	No	
Score	D			

Timeliness and regularity of education accounts reconciliation

494. **Account reconciliations by the education ministries are not as comprehensive or as timely as they could be.** Reconciliation of accounting data and bank accounts

administered by relevant education departments in Baghdad and the governorates varies considerably. Reconciliations at the centre are generally regular and are timely as the trial balance reporting process requires this. The regularity of reconciliation and clearance of suspense accounts and advances issued by the education ministries is uncertain as the central ministries trial balance process does not adequately identify ministry-based advances. The quality of such reconciliations is uncertain as education audit reports are not yet available for review nor has a census of bank accounts held by education ministries been undertaken.

Availability and reliability of information on resource received by schools

495. Reliable information is collected on certain resources received by schools; however, an expenditure tracking survey in education would be necessary to determine the proportion of resources from the Government and development partner's budgets that actually reach the field. The non-integration of the recurrent, investment and donor budgets is a constraint for the systematic reporting of all resources received by schools.

The quality and timeliness of in-year budget execution reports

496. The budget execution reports and annual financial statements produced by education ministries are currently constrained. This constraint is due to a number of systemic issues as follows: i) the current approach being followed for the roll-out of the new GFS based classification system; ii) the lack of a consolidated set of treasury instructions on the accounting and in-year budget adjustments; iii) the lack of a computerized financial management system that is required to consolidate Iraq's new decentralized system of budgeting and accounting; and iv) lower levels of accounting capacity at the governorate level.

Donor Practices

497. The practices of development partners do little to support improvements in education budget preparation and reporting. Financial information provided by development partners as a whole for budgeting and reporting on education related projects and program aid is untimely and incomplete and the breakdown is inconsistent with the Government classification system. Latest information available from the MoP's Development partner Assistance Database (DAD) indicates that around \$890m for the education has been agreed by the Government and development partners since 2003, of which around \$525m has been spent (see Tables 27 and 28). This represents the majority of investment expenditure in the education sector (see Table 29). It should be noted that DAD data is over a year old and major data quality concerns remain. The Government is currently developing new procedures to promote donor compliance with reporting requirements and to improve consolidation and integration of the Government's budget and donor assistance budgets. Improvements in the provision of aid flow information in the education sector will be important to allow the education ministries and the Council

of Ministers to make better decisions on resource allocation during the budget process and to ensure sustainability of projects.

Table 27: Development Partner Funded Education Projects: by year

Category	Year							Total
	Unknown	2003	2004	2005	2006	2007	2008	
# of Projects	19.0	1,749.0	1,450.0	1,243.0	66.0	8.0	2.0	4,537.0
Project Cost (US\$ m)	213.3	134.6	165.2	249.1	90.3	36.4	0.8	889.8
Committed (US\$ m)	-	141.8	150.6	341.4	89.6	5.5	0.1	729.0
Disbursed (US\$ m)	-	113.3	108.0	224.1	67.2	12.6	0.1	525.3

Table 28: Development Partner Funded Education Projects by Source

Financing Source	# of Projects	Project Cost (US\$ m)	Committed (US\$ m)	Disbursed (US\$ m)
Unspecified	1			
Canada	4	43.5	14.3	13.4
Japan	19	29.4	21.5	21.1
Korea	9	32.8	30.8	19.0
Norway	1	0.2	0.2	0.2
Spain	4	12.6	6.6	3.8
Sweden	3	0.1	0.1	0.1
UNDG.ITF	18	144.0	144.1	115.4
UNDP.TTF	1	11.0	2.7	2.7
(funded by EU)				
United Kingdom	1	14.6	7.3	7.3
United States of America	4,419	395.5	395.5	293.0
WB	1	100.0	0.0	0.0
WB.ITF	3	106.0	106.0	49.4
		0.0	0.0	0.0
Total	4,484	889.8	729.0	525.3

Table 29: Education Sector Investment Budgets – Government and Development Partners

Category	Year				Total
	2004	2005	2006	2007	
<i>Donor Projects - Education (%)</i>	83.6	96.3	68.1	3.5	48.8
Donor Projects - Education (US\$ m)	108.0	224.1	67.2	18.1	530.8
MoE and MoHSR Investment Budget (US\$ m)	21.2	8.5	31.5	496.0	557.2
Education Sector Budget Investment Program (US\$ m)	129.2	232.6	98.7	514.1	1,088.0

Source: DAD, MoF and MoP data

498. **The proportion of education aid managed by national systems is well under the 50% threshold for the lowest possible score under the PEFA framework.** There is no budget support or a functioning education Sector Wide Approach (SWAP). The World Bank's projects are the only aid projects in the education sector where Iraqi officials manage project funds, procure, sign and manage contracts and are responsible for project design and implementation. The Bank supported projects, however, require

adherence to non-national systems to World Bank rules for procurement and financial management covenants and other grant conditions. These soft conditions are designed to minimize fiduciary risk. It is envisaged that with the passage of the new procurement law and implementing regulations that are consistent with international best practice, World Bank projects will, in the future, allow procurement following the Government's new procurement system.

Institutional Capacity

499. Various internal and external constraints and challenges are identified throughout the previous sections of this chapter, which all profoundly affect institutional capacity at education sector. Despite all the difficulties, the government has been eager to adapt to new changes and making steady progress. Nevertheless, it is essential to further strengthen the strategic planning and budgeting, and capacity-building within MoE for budget execution and management.

500. One of the primary reasons for the very slow implementation of investment projects is the weak capacity of MoE in the center and in the governorates. Large amounts of the investment budget have usually remained unspent at the end of each year in the past four years. Over 20% of the approved investment budget was unspent in 2006. This is not unique to the MoE as the capacity of the government as a whole, to execute its own investment budget is extremely limited, and almost every ministry had large amounts of unspent investment funds in 2006.

501. In workshops (November 2006, March 2007) held with MoE, MoP and MoF officials and World Bank specialists, a number of factors responsible for implementation delays were identified. Principal among these was the limited institutional capacity that exists in the MoE to handle a substantial capital works program. School construction in the 1970s and 1980s had been the responsibility of the MoHC and not the MoE. During the 1990s and early 2000s school building came to a virtual standstill due to financial and other constraints. The transfer of responsibility for school construction to the MoE was implemented in the restructuring of the government in 2004, and consolidated in 2005 in the Directorate General of School Construction. The MoE had to recruit new engineers, architects, and other technical staff to the new unit and its capacity in 2007 was very limited. In 2005, the MoE reported to the Bank that it had some engineers on its establishment who were posted in each governorate school construction directorate. However, once school construction by the MoE began in earnest in 2005, it was discovered that many of these engineers were relatively inexperienced, and virtually none had adequate experience in school construction or in supervising large civil works contracts. Their major function in previous years had been to manage the very limited funds allocated for school maintenance.

502. In addition, the procedures and regulations for procurement of consulting services and contractors were very complex and required substantial review by committees which proved difficult to convene since the Ministry in Baghdad was no longer located in a single building, and security and communication challenges

made meetings difficult. The outdated and complex procurement procedures were further complicated by additional requirements emanating from the offices of the Inspector General, the BSA and the MoF. In the case of World Bank financed contracts, a further complication was that the GOI procurement procedures were not aligned with the World Bank guidelines. Therefore, procurement processing had to meet requirements of two separate systems, adding significantly to processing time and to the potential for errors.

503. Implementation of many construction projects was also affected by the capacity limitations in the private sector, particularly with regard to contractors. While Iraq had a considerable body of well established contractors and consultants in 2004, most of the more experienced ones were not attracted by the relatively small contracts for school construction or were already fully engaged in the large contracts that were being managed by other ministries or by various implementing agencies for the US supplementary budget for Iraq. Thus the contractors selected for school construction often proved to lack the skills and experience required. In the case of the World Bank-financed contracts, school design and site supervision was contracted to local consultants, and again the consultants selected proved largely to lack experience in school design and some have had difficulty in meeting their commitments on site supervision.

504. The difficult security situation has also been responsible for many implementation challenges, not only through increased security costs, but because of difficulty in accessing sites, and several reported cases of contractors or their crew being threatened or even killed. The security situation also led to the departure from Iraq of many experienced consultants and contractors, so that there was a smaller pool to draw on.

505. A further problem experienced by the World Bank financed projects was the limited institutional capacity of the Iraqi banking system, so that inter-bank transfers of payments to contractors and consultants were often delayed by problems in the banking system, in some cases leading to contractors suspending operations due to delayed payments.

506. One of the main issues of implementation is shortfall of human and institutional capacity. Experience of WB education projects showed that capacity building through project implementation is having marginal impact because the implementation is often not being mainstreamed within MoE but is, instead, being limited to Project Management Teams. Also, in such an environment, the fiduciary risks are made worse, and the pace of implementation is slowed by the imposition of extra controls by both MoE and the WB.

507. However, despite all these constraints, MoE has been adapting well to many changes in government and administration system, with different sets of rules and regulations. This shows their flexibility and capabilities in effectively responding to rapid changes.

508. **In order to improve the institutional capacity of MoE, it is important to strengthen the strategic planning and budgeting, and capacity-building within that ministry for budget execution and management.** It is also necessary to increase MoE capabilities to have a proper financial management mechanisms and adequate data reporting frameworks and a fully functional statistical system. On the policy side, it is important to support MoE in developing the human and institutional resources that will be required to conceptualize, negotiate and implement financial system reform and policy options. In addition to managing the interim policy and strategy, adjustments that will be required to improve the efficiency of the system and to lay the groundwork for more substantial system development that will promote better efficiency of expenditure and provide policy alternatives.

509. **As for improving the financial capabilities of MoE, it is important to develop the ability to allocate resources effectively and track overall spending and outcomes** i.e. improve budget distribution to the governorates, expenditure authorization, and monitoring procedure during the year. Recent changes that allocate investment budgets directly to governorates and do not reflect them in the budget of the MoE, may further undermine the capacity of the MoE to monitor the implementation of the capital development program for the country. This does not necessarily imply recentralization, but certainly requires that effective and reliable information about needs and construction programs is available to the MoE, along with information on projects financed and implemented by agencies outside of the government.

The education sector strategy

510. **In summarizing the analysis and assessment in previous sections, this section aims to provide policy recommendations for the development of education sector strategy with focus on financial management and capacity building.**

511. **MoE has prepared, revised, and posted an education strategic framework, which still needs to be developed to reflect the national development vision, clear priority areas, and links to the budget to ensure programs' financing and sustainability.** After 2003, the MoE produced the first concise paper that describes the strategy for general education "Education in Iraq: Current Situation and New Perspectives" (December 2003). The paper that was prepared by the Interim Iraqi Government had a vision statement and addressed the urgent recovery needs of the education system. It was well received by the donors and international community. The strategy identified the urgent priorities of; (i) capacity building for the development of a strategic framework for the sector, (ii) emergency rehabilitation and provision of supplies (including textbooks), (iii) initiation of a curriculum reform process, (iv) addressing of immediate needs in teacher training, and (v) initiating policy dialogue on technical/vocational education and training.

512. **To start functioning in the new era after 2003, the MoE started its rationalization of its organizational structure and filled the vacant senior posts.** This was updated and modified in 2004. The ministry recently circulated its revised strategy

and targets for reconstruction and development of education in Iraq, building on the earlier strategy developed during the Interim Iraqi Government. The recent strategy identifies the need for new school buildings as the first priority. After school construction, the most critical needs are in the areas of institutional capacity building, teacher management, training and deployment, and capacity building for curriculum and sector reform.

513. The WB conducted several workshops during 2006 and 2007 with the technical staff of MoE, MoP, and MoF to discuss the education strategy and the experience of other countries in the region in reforming their systems. The critical security situation and the atmosphere of crisis that prevails in the education system made it difficult for MoE specialists to move from the list of the immediate needs of the system to focus building an overall strategy with vision, strategies, programs, and activities. In 2006, MoE revised its strategic framework to include goals and programs under the themes of increasing access, enhance quality, improve relevance, and upgrade system management. The revised framework covered the period of 2007–2015 and was divided into short, medium, and long term periods. To ensure implementation and sustainability, the MoE technical staff calculated the initial cost of the programs and activities in today's prices. The preliminary cost of the programs in the MoE strategy (for 2007-2015) was about \$36.4 billion with school construction as the major component under increasing access. The average annual cost of the programs in the framework would be over three billion dollars and that is double the MoE budget in 2007.

514. During the workshop in March 2007, the specialists from the ministries of Education, Planning, and Finance and the WB agreed that the process of developing and refining the education strategy needs to continue for a longer time and the process should involve a wide range of stakeholders to ensure as wide as possible acceptance of the strategy. It was also agreed that the national education strategy needed to: (i) include the country's education vision, the ministry's mission, clear priority areas, strategies and targets, (ii) be based on the government's overall development plan (the National Development Strategy), (iii) set clear targets for each timeframe that can be monitored and evaluated, and (iv) be a living document that will be updated and adapted as conditions change.

CHAPTER 8: TOWARDS A PFM REFORM STRATEGY

Summary

515. **This chapter reviews the context for PFM reform before describing the building blocks of a modernization program employing the “platform approach” to PFM reform.** This proposes an initial platform that would focus on:

- Improving budget realism and sustainability;
- Facilitating budget execution;
- Improving reporting;
- Strengthening oversight; and
- Developing PFM capacity.

Later stages of reform might proceed to better accountability (including greater focus on what public spending actually achieves); improving the linkages between policies and budgeting; and, finally, integrating accountability with performance review.

Recent and On-going Reforms and Institutional Factors Supporting Reform

516. **The strategic context for a PFM reform process has been set by the International Compact for Iraq (ICI).** This provides a firm foundation for a Government-led reform process that can be supported in a sustained and integrated manner by Iraq’s international development partners. As a basis for monitoring progress, detailed actions are set out in the Joint Monitoring Matrix (JMM) that supports the ICI. One major component of the JMM concerns the effective management of public resources in the interests of the people of Iraq.

517. **Within this component, the GoI commits itself to the objective of aligning Iraqi PFM and procurement system with sound international practice.** In order to establish the analytical framework within which PFM reform can take place, the GoI has been working as a priority action with the World Bank to complete this PEIA and evaluate the performance of the national PFM system as a basis for prioritization of PFM reform programming.

518. **In the JMM, the GoI undertakes to achieve an integrated and comprehensive budget and increase its strategic content.** In support of this objective, agreed priority actions included the following:

- By end 2008, assign primary responsibility for all aspects of budget management to the MoF and clarify the role of other agencies
- By end 2008, capture in the budget all significant revenues and expenditures, including all subsidies and donor flows

- By end 2009, integrate the recurrent and investment budgets and establish a Treasury Single Account (TSA)

519. **Several donors have been providing support to PFM reform and capacity development over the last three or four years.** These include the International Financial Institutions, the United Nations, the United States, the United Kingdom and the European Commission. Much of the multilateral aid has been channeled through the International Reconstruction Fund Facility for Iraq (IRFFI). The US Government has worked on a range of PFM issues through the US Treasury, US Agency for International Development (USAID), State Department and Department of Defense, while the UK Government through its Department for International Development (DFID) has been actively involved in economic management. The UNDP has managed a program of support to the Board of Supreme Audit as well as providing support to anti-corruption initiatives. The World Bank has provided a number of workshops on specific aspects of PFM. The IMF has been providing technical assistance in support of its Stand By Facility. The need now is to co-ordinate these initiatives under a coherent program of support to a GoI led PFM reform strategy and action plan.

520. **In designing such a program, careful recognition is required of the unusually difficult circumstances that face a fragile state like Iraq, which has been so severely affected by conflict since 2003.** Many crucially important public institutions have been devastated by the destructive effects of war and insurgency on their capacity. Large numbers of key staff have been lost to the Iraqi public service. A sustained effort over the medium term backed by Iraq's international development partners will be necessary to rebuild the capacity required for a well performing PFM system. This will require appropriate incentives to help create an enabling environment for PFM modernization.

521. **The area of public financial management (PFM) requires significant reform.** The Government of Iraq's (GoI) budget lacks realism and credibility as spending on current expenditures is rising rapidly while capital budget implementation remains slow. The quality of expenditure reporting is uncertain and independent audits are not yet available.

Key development issues

522. **Weak governance, including poor PFM, continues to weaken the ability of the state to deliver the public goods necessary to support human development.** Since 2003 Iraq has made limited progress in reforming public expenditure policy and management, yet in order to implement an improved development agenda, Iraq will have to make much more progress on a number for key fiscal and institutional challenges. Weaknesses in the PFM system not only have high costs in terms of allocative and operational efficiency but also create unacceptably high levels of fiduciary risk to public funds. The cash-based payments system has emerged as a major constraint. Increasingly, budget execution has suffered from delays and an unpredictable release of funds, undermining operational planning and resulting in a likely build-up of arrears. The system is plagued by deficient accounting and reporting systems, leading to a weak control environment. The GoI will need to focus on improving budget execution, cash

management, and the control environment, as well as strengthening tax and oil revenue administration.

523. The GoI has demonstrated its commitment to improving public sector governance by putting PFM issues at the heart of the socio-economic pillar of the International Compact for Iraq. Moreover, the GoI identified the World Bank's Public Expenditure and Institutional Assessment (PEIA) as a priority action under the Compact's Joint Monitoring Matrix (JMM) and has completed the workshops in line with the JMM benchmarks. The PEIA is intended to establish the foundation for the formation of a well structured Government-led medium-term PFM reform program.

524. A sector-wide approach (SWAp) in PFM is being established in 2008 through the ICI and the PEIA. Development partners (DPs)—AusAID, Canada, DFID, the EC, IMF, Italy, JBIC, Poland, USAID, UNDP, and the WB—have indicated a willingness to work more closely with the Ministry of Finance and Ministry of Planning and Development Cooperation to support the development of a Public Financial Management Reform Program (PFMRP), which will serve as the common reform program endorsed and supported by all partners in PFM. Moreover, the desire to work jointly in a SWAp—via a Partnership Principle Agreement is being explored—to coordinate support in order to minimize transaction costs, improve the overall quality of TA provision, and to “speak with one voice.” It is envisaged that through a PFM development partners working group, joint monitoring of progress against an agreed PFM performance management framework is achievable. Through IRFFI, the Bank could supervise a special Multi-Partner PFM Trust Fund Project as a partnership initiative with interested donors.

Development objectives

525. The strategic level objective of a GOI-owned medium-term PFM reform program would be to install much higher standards of management, accountability, efficiency, and effectiveness in the mobilization and utilization of all government financial resources. The reform program would aim to accomplish this objective by:

- making the budget credible as a management instrument;
- improving financial control and internal accountability; and
- making the budget a reliable instrument of pro-poor policy implementation.
- improving public and parliamentary scrutiny of public financial management

526. It is suggested that the primary objective of the first phase (or “platform”) of the proposed Public Financial Management Reform Program should be to establish a more credible budget. In establishing credibility, measures would be introduced that are designed to:

- Improve Budget Preparation;
- Improve Realism and Sustainability of the Budget;
- Facilitate Budget Execution;
- Improve Reporting;
- Strengthen Oversight;
- Develop PFM Capacity; and

- Improve Coordination, Monitoring and Evaluation.

Preliminary Program Description

527. **The program will build on the PEIA work**, which is intended to establish the foundation for the formation of a well-structured Government-led medium-term PFM reform program. International experience emphasizes the importance of a properly sequenced and prioritized reform program. Promising results are emerging in some countries from the application of what has become known as the “Platform Approach” to be followed PFM reform programming. Applying this approach in Iraq would support the GoI in establishing a long-term vision for Iraq’s PFM system and would aim to implement a package of measures or activities designed to achieve increasing levels (‘platforms’) of PFM competence over a manageable timeframe. Effectively, this is a “building blocks” approach under which each platform is intended to provide a clear basis for launching to the next, based on the premise that a certain level of PFM competence is required to enable further progress to take place. The outcome would be a GoI-owned PFM reform program that presents a detailed, prioritized, and sequenced action plan to remedy the problems afflicting the PFM system by strengthening accountability and improving transparency, within the context of a medium-to-long term timeframe.

528. **Based on the analysis of the PEIA an initial PFM Reform Program (PFMRP) of reform has been drafted** following the “platform approach”. The high-level objective of the first platform is to achieve a more credible and realistic budget. This platform might comprise the following seven key development objectives and supporting measures.

- Improving Budget Preparation – this would include improving budget comprehensiveness and integration, and enhancing budget guidance and compliance
- Improving Realism and Sustainability of the Budget – this would cover improving resource mobilization, cash and debt management, re-designing the budget cycle and associated institutional arrangements, piloting program-based budgeting and Medium Term Expenditure Frameworks, and increasing the transparency of inter-governmental fiscal relations
- Facilitating Budget Execution – this would include improving the ability of ministry staff to understand and implement their budgets, taking steps to avoid the accumulation of payment arrears, improving the process for approving supplementary budget credits and improving the regulatory and institutional framework for public procurement,
- Improving Reporting – improving classification systems, reinvigorating the IFMIS implementation strategy, enhancing systems for recording donor aid flows, improving in-year financial reporting, piloting expenditure tracking, reviewing the reporting requirements of public corporations and improving the transparency of non-tax revenue

- Strengthening Oversight –improving the effectiveness of internal and external audit, improving legislative scrutiny and strengthening the regulatory and institutional framework for anti-corruption
- Developing PFM Capacity – introducing motivational measures within central and line ministries, initiating integration measures between the MoF and MoP and establishing global partnership arrangements for key Iraqi public organizations
- Improving Co-ordination, Monitoring and Evaluation

529. **Subsequent platforms might have the following high level objectives:**

- Better Accountability – greater focus on what is done with public money
- Improved Linkages of Policy to Budget Planning
- Integration of Accountability and Review

530. **Further consultations with GoI departments and the Government’s development partners will be needed to finalize the program.** It is envisaged that a combination of bilateral and multilateral support would provide the required assistance to the GoI to progress the PFMRP. Multilateral assistance would include an initial grant from the European Commission of around \$20 million to finance key development measures not currently being supported. A World Bank project financed by the grant would be developed once the GoI has finalized its PFMRP. The project and funds would be managed by the MoF and MoP, MoF and the BSA with Bank supervision.

Implementation Arrangements

531. **Bilateral support for the PFMRP will involve existing implementation arrangements utilized** by development partners. Key implementation arrangements that are expected to be utilized are the Provincial Reconstruction Team and Local Governance Support mechanisms.

532. **While the security situation in Baghdad has improved significantly over recent months, it remains critical that creative project implementation arrangements be established for the World Bank supervised project, for sustained success.** It is expected that implementation arrangements will involve a combination of on-site and off-site activities. As far as possible, capacity development workshops will take place at the Adnan Palace in the “Amber Zone” of Baghdad, as per the PEIA workshops conducted between July and November 2007. This will be supplemented by extensive use of video-conferencing facilities enabling additional input from key international consultants unwilling to work for the GoI in Baghdad. It is expected that the GoI will choose to use a greater number of local experts or members of the diaspora who have strong links within Baghdad. Overseas study tours to provide exposure to modern international practice will also be considered as appropriate.