A NOTE FROM THE PUBLISHER
WHY PUBLIC FINANCIAL MANAGEMENT MATTERS: PART II

The most recent issue of Governance News & Notes (September 2008) introduced the topic of public financial management (PFM) and discussed a number of problems with budget formulation that are common throughout the MENA region. First and foremost is the challenge of ensuring credibility and making the budget the primary tool for fiscal management. Other areas for reform include expanding the scope and comprehensiveness of the budget; improving the link between recurrent and investment budgeting; trying to introduce elements of a multi-year framework and improved performance orientation; strengthening budget classification; and enhancing greater transparency and parliamentary scrutiny in budget formulation. Our September issue also featured a discussion of Lebanon’s PFM reforms, including a governance newsmaker interview with Lebanon’s recent Minister of Finance, Jihad Azour. You can access it at the following webpage: http://go.worldbank.org/UO6IVFTVB0.

In this issue, we change both sub-topics and countries while remaining focused upon the broader PFM theme. Our substantive emphasis shifts from front-end problems of budget formulation to back-end problems of budget implementation, where a number of MENA countries are pursuing a variety of important reforms. They include reducing ex-ante controls on expenditure, in which multiple clearances can often lead to unnecessary delays and dilute rather than enhance authority, while at the same time doing a better job in tracking commitments. They also include improved virement (basically, empowering line departments to shift resources between budget heads within certain specified limits); improved treasury operations and cash management; the development of computerized financial management information systems; strengthening internal audit; and improving external audit, including more independent and transparent reporting relationships. Mark Ahern, our Senior Public Sector Specialist in West Bank & Gaza, will discuss common issues and problems with regard to budget implementation in MENA.

We are fortunate to include an interview with the Palestinian Prime Minister, Salam Fayyad, in this issue as well. During his first tenure as Minister of Finance for the Palestinian Authority (PA), Salam Fayyad presided over some of the most far-reaching and successful PFM reforms in the Arab world.
Major PA reform initiatives include:

- The payment of all PA revenues into a central treasury account, which eliminated previous discretionary and non-transparent spending of these funds.

- Enhanced transparency in financial management, including the regular posting of budget data on the Ministry of Finance (MoF) website and expanding the formal budget document to include more detailed information on topics ranging from balance of payments to public service employment;

- Improved control over the civil service payroll through the MoF assuming responsibility for staff numbers from the General Personnel Council (GPC); and paying salaries of all civil servants and security personnel through personal bank accounts rather than in cash; and

- The establishment of the Palestine Investment Fund (PIF), which has brought all PA equity holdings under MoF overview and provides for a centralized and commercially based management. Fiscal transparency has also been enhanced by the publication of a valuation of all PIF investments, and by the publication of the PIF’s audited financial statements.

It is particularly noteworthy that these reforms, which the IMF once characterized as “highly significant in improving both transparency and accountability,” were implemented against the background of occupation and strong domestic resistance. In his interview with noted Palestinian journalist Rami Khouri, Dr. Fayyad provides a fascinating assessment of how these reforms were implemented in the face of stiff opposition. A companion piece by Nithya Nagarajan discusses the substance and content of these reforms in greater detail.

Finally, allow me to share a brief concluding word about the World Bank and public financial management. PFM issues remain at the core of the World Bank’s work on governance and public management throughout the MENA region. We have provided lending support for PFM reforms in Morocco, Algeria, Tunisia, Iraq and Yemen and grants to support PFM reform in the West Bank and Gaza. We are currently active in providing analytic work and technical assistance in more than ten countries in the region. This experience provides a rich comparative basis for assisting the efforts of our clients to improve the quality of public spending for development and ensure that maximum value is extracted from every pound, dinar, rial and dirham spent.

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GOVERNANCE NEWSMAKER
INTERVIEW: H.E SALAM FAYYAD
PRIME MINISTER OF PALESTINE

BY RAMI G. KHOURI

Salam Fayyad: “People do not eat or drink reform. They have to feel the benefits.”

WASHINGTON: The rapid overhaul and institutionalization of the previously free-for-all Palestinian public finance sector under Finance Minister-turned-Prime Minister Salam Fayyad is one of the more striking and well known success stories in the MENA region. Less appreciated, but important for other would-be reformers who might learn from the Palestinian experience, is the combination of political, psychological and communications tools
that Fayyad and his colleagues used to achieve their goals.

“People do not eat or drink reform,” he said in an interview with MENA GN&N during a visit to Washington in mid-October, “and especially people living in difficult political and national circumstances, as the Palestinians were in 2002. People need to quickly feel the tangible benefits of any reform process if they are to protect it.”

Reviewing the ups and downs of the 2002-2006 period, he recalled, making changes that mattered to people and seeing such reforms persist required several simultaneous dynamics at the technical and political levels.

The technical level included consolidating all public revenues into a single account with the finance ministry, drawing up a unified state budget that was presented to parliament and published on the internet, and consolidating all public commercial investments and monopolistic operations (like oil and cement imports and sales) into a state-owned holding company managed by a credible board of directors headed by the finance minister.

“The starting point was the structural need to ensure that all revenues came into a central treasury account. Corruption and other such issues would be tackled, but first of all we had to stop the leakage and make sure the system functions well,” he said.

A single directive from the finance ministry and central monetary authority did the job.

“I had a circular issued to the commercial banks asking them to transfer any and all funds that come in as revenues for the Palestinian Authority (PA) to an account that was set up with one of the banks, what we called a central treasury account.

Virtually immediately, all the money started to come in, which also immediately enhanced the standing of the ministry of finance in the system.

Everybody knew that if they wanted something they had to come to the ministry of finance -- that was really basic,” he recalled.

Parallel with this, the ministry took control of the many commercial operations that were owned by the public sector and dominated by influential individuals who profited from largely unregulated and unaudited monopolistic operations in fields such as cement, and oil.

“Two months into the task, we consolidated all of these operations by establishing a public holding company, the Palestine Investment Fund (PIF), which acts as an umbrella for all of them and is 100% owned by the Palestinian Authority.”

Finding out exactly what assets the government owned and taking control of them was a logistical
challenge that was resolved often by swooping down on a company’s office by stealth, seizing the books, and freezing all bank accounts before consolidating them all into the PIF.

The third major technical move was in the petroleum products sector, where monopolistic control by a single state importer buying from a sole Israeli supplier led to several negative trends: inflated consumer prices, a flourishing black market, and reduced state revenues due to corruption.

“Oil was an incredible opportunity for me,” Fayyad said, and he dealt with this through the price mechanism, by lowering prices, eliminating the profit margin for the state, and allowing the competitive retail market to handle distribution and retail sales. Results were stunning and speedy. Prices dropped, sales increased, the black market disappeared, and government revenues shot up.

“If you are looking at anything that comes close to a controlled experiment in a chemistry lab, there is nothing that comes closer in the field of social sciences than this. You look at the data before and after, and it is just incredible. Beginning in July of 2003, we introduced a new pricing regime. July data compared to June 2003 is an incredible thing. Sales went up by 350%. PA revenues increased enormously. And prices dropped for the consumer.”

Fayyad and his colleagues learned a critically important lesson: when reforms are felt at the household level, consumers become supportive citizens who appreciate the reforms, and protect them.

“Reform meant something concrete here,” he said, “people started to pay much less for oil. But along the way we also continued to make public statements that were relatively short and easy to understand: ‘The Authority is not in the business of making money. The Authority is not a merchant. The Authority collects taxes, period. The Authority provides services.’ I would say commerce is an honorable trade, but it’s not for the state. Therefore, we are eliminating the [oil profit] margin; henceforth, we the authority are not going to be making any money on petroleum. Retailers could.”

All the while, officials were creating a public constituency for this, “making it clear that an efficient, non-corrupt public finance system was a sign of a modern government. Things that we did along the way gave the reform program a good name and generated public support. One was to work towards goals that were pre-announced, and not to talk too much, particularly in an environment where skepticism, if not cynicism, reign supreme.”

Officials implementing the reforms were conscious of the difficult political environment and the wider nationalistic aspirations of the Palestinian people. They implemented reforms whose impact would be felt quickly – like lower oil prices and government payment of due invoices – but they also wanted the public to feel that a modern state was being built in Palestine that would serve all Palestinians.

“One of the lessons of public finance reform in the developing world is that people do not eat reform or relate to reform. They do not see benefits. So what is important is to look for ways to make people actually feel the difference. We tried to do that in part by telling people we’re working towards a system that will let you -- the stakeholder in all this -- know what is it that we are doing with your money. This was about a project for national liberation and building towards statehood, so linking what you do to that broader goal, which is something of value and importance to everyone, was always important. Now we really have a key building block of the public finance system. And this is something that looks like what good countries have. That also meant something to people. It was very important, nationally.”

A key element of the reform program in Palestine, Fayyad says, was engaging the public and making them feel that change was the right and fair thing to do.

“Our approach was to do what you can, wherever you can do it, as soon as you can do it. But, at all times have clarity as to what is important and what is not too important. It was crucial to be able to put together those key building blocks, meaning centralization. Keep people involved, talk about
goals in different fora, and interact with NGOs and academia.

“Ultimately, when it comes to money, the right and wrong of things do matter to people. But I find people listen to you more when you say 'fair-unfair'. It resonates. Who's paying taxes, who's not paying? People relate to this a lot more. Ultimately, this is about a government putting itself in a position of being better able to deliver services to people in an equitable fashion and in a predictable way. If you say that and actually begin to do it this way, that's what defines credibility.”

PUBLIC FINANCIAL MANAGEMENT REFORM IN PALESTINE

BY NITHYA NAGARAJAN

The signing of the Oslo accords represented a monumental turning point for the Palestinians and Israelis. It was to lead to the establishment of a sovereign Palestinian state and set the framework for final status agreements between the two sides. It was in this context that the Palestinian Authority (PA) was born, as a nascent government that was to evolve into a fully functioning government of the future Palestinian state. The process of state building is a complex task in any context, but there were particular features of the Palestinian situation that added to the challenges. These included limited powers of the PA in terms of control over land, resources, borders; high levels of budgetary dependence on Israel as a result of its control over Palestinian clearance revenues, as well as on the international community; internal opposition as a result of the failures of the peace process; legacy of the PLO and challenges in integrating the PLO as a revolutionary movement with the PA as a developing state; and the tensions inherent in the broader process of institution building.

The PA’s public financial system was one of the institutions that witnessed slow development in the initial years after the signing of the Oslo accords. The PFM system was characterized by fundamental weaknesses, which not only challenged the integrity of the management of public finances but also contributed to deep fiscal crisis in WBG. First, the Ministry of Finance (MoF) did not have oversight over all PA revenues, nor was there a system to consolidate its revenues. Excise taxes in sectors such as petroleum, tobacco, and alcohol were channeled to bank accounts outside the control of the MoF. The PA’s shareholdings in a number of commercial enterprises, including partial shareholdings in telecommunications, and majority or full shareholdings in cement and petroleum, were not disclosed or monitored by any public oversight body including parliament. Profits from these operations were diverted outside the government’s budget. The IMF estimates that the combined revenues – from PA commercial operations and excise revenues – diverted from the budget were estimated to be in excess of US$898 million.¹

Second, the PA had no proper systems to manage its expenditures. There were multiple spending centers and line ministries had great discretion, making expenditures well beyond their budgetary allocations. Systems for internal and external audit were very weak, which created the scope for corrupt practices. There was no systematic process to manage hiring of civil service and security sector personnel, which resulted in uncontrolled expansion of the public sector and an untenable wage bill. Security sector personnel were paid in cash instead of in bank accounts.

Third, the PA did not have an adequate budget framework or system of oversight to manage public finances. For several years immediately after Oslo, the PA was reluctant to publish or formalize a budget, delayed in submitting the budget, and failed to report on execution of previous year budget to the parliament. In addition the budget development had major technical weaknesses, including the fact that it was not linked to a macroeconomic framework.

These weaknesses in the PFM system were well known for a number of years, but it was only in 2002 following intense internal and international pressure and an untenable fiscal situation that President Yasser Arafat sanctioned reforms. As part of the PA’s “100 Day Plan,” public financial reform was to

¹ International Monetary Fund, West Bank and Gaza : Economic Performance in Conflict Situation, 2003
go forward under the leadership of a newly appointed Minister of Finance, Dr. Salam Fayyad.

Dr. Fayyad aimed to undertake a comprehensive reform of the Palestinian public financial system. In the area of revenue management, he undertook three major reforms. First, he consolidated all PA revenues into a single treasury account controlled by the MoF. In so doing, he centralized management of finances and expenditures, as well as issuance of Treasury checks, under the MoF. Second, all commercial operations of the PA were brought under the umbrella of one organization, the Palestinian Investment Fund (PIF). A board of directors which included the Minister of Finance was put in place to oversee the assets, which were subject to regular audit and disclosed in annual reports. Profits were directed to the Treasury. Third, he brought the Petroleum Commission under the oversight of the MoF, and undertook pricing reforms, so as to eliminate smuggling in the sector and increase PA’s revenues.

In the area of expenditure management, Dr. Fayyad also led a number of major reforms. He tightened the institutional process by which Treasury checks were issued in the MoF. In so doing, he dramatically reduced the scope for any corrupt practices and improved the credibility of the MoF vis-à-vis commercial banks and suppliers. He established controls over expenditure by creating a separate Department of Financial Control in 2004 and out-posting MoF financial controllers to spending ministries. A number of departments were created inside the MoF, including one for internal audit and an independent procurement division. Fourth, he attempted to get some control over public sector hiring and the wage bill by bringing in payroll division under the control of MoF, enforcing strict hiring controls especially in the civil service, and eliminating cash based payments to security sector personnel.

The third major area of reform related to the budget process. The 2003 annual budget represented the first serious attempt to account for all revenues and set meaningful limits on expenditure. Steps were taken towards integrating the public investment budget. In the 2004 budget, the previous large discretionary transfer directed to the President's Office was nearly eliminated. Transparency improved significantly in so far as budget speeches and budget data were posted on the MoF’s external website.

These reforms were considered to be successful, especially in the areas of revenue consolidation and management. Nevertheless, some outstanding challenges remained. First, no effective, independent External Audit institution was in place to maintain oversight of PA public finances. The existing audit institution lacked independence, capacity, and was unresponsive to the PLC. A new national audit bureau was established, but it faced severe capacity and resource limitations. Second, the budget process continued to have weaknesses in terms of budget construction, timely submission of the budget to the cabinet, and parliamentary and civil society engagement in budget development and oversight over execution. External factors are very important in contributing to ongoing problems in this area, namely the volatility the economy is subject to as a result of the conflict and political circumstances.

Third, reformers were not able to bring the wage bill under control. In particular, the run-up to the 2006 elections brought forth increases in public sector salaries as well as hiring of security sector personnel.

Dr. Fayyad resigned as Finance Minister at the end of 2005. Since reentering the PA in June 2007, he has focused on strengthening the integrity of the PFM system. Following the election of Hamas in 2006, the international community imposed a boycott
on the PA. Financial support from many donors was channeled through the President’s Office through the “Temporary International Mechanism” (TIM) instead of the MoF. This created parallel financing mechanisms and undermined some past reform efforts. Since becoming PM and FM in the Emergency Government formed in June 2007, Dr. Fayyad has focused on reversing these developments. He has re-established the central treasury account, and ensured that all finances are channeled to this account. He has also re-established monthly reporting and monitoring on PA revenues and expenditures, and recreated financial statements for 2006. Monitoring of financial accounts became very difficult in 2006 because payments were made through multiple channels, and there was no comprehensive information available at the time on payments made and arrears that were accruing.

A second major task for Dr. Fayyad since taking office in 2007 has been to address the operational challenges resulting from the Gaza-West Bank split. Gaza is controlled by a Hamas government, while the West Bank by an Emergency Government formed by Presidential decree. In terms of PFM systems, several major issues had to be dealt with, including re-establishing the Budget department in the West Bank as well as an accounting system. These were previously managed from Gaza. In addition, new banking arrangements were developed so that payments to Gaza are now mainly managed through West Bank banks instead of those in Gaza.

A third major task of the new government has been to develop the Palestinian Reform and Development Plan (PRDP). The PRDP lays out a fiscal framework and serves as a development plan by outlining the priorities for sectoral reform. The plan was finalized in 2008, and efforts are underway to try to develop a budget for 2009 guided by the PRDP framework.

BY MARK AHERN

Budget execution is more technical and less political than budget preparation, and this should make reform less contentious and easier to manage. There are also many opportunities to make “quick wins” with budget execution reform. Although these factors make budget execution reform an attractive option, progress in the region has been slow and more should be done. I will focus on three important areas of reform.

Making expenditure controls effective

If the quantity of “checking” that takes place during the payment process is a guide, then expenditure control is a strong point for many countries in the region. However, it is the timing and quality of checks that determine whether the controls are effective.

For governments with irregular cash inflows (such as Palestine, Lebanon or Sudan) it is important to be able to control expenditures in the event of a revenue shortage. Unfortunately the controls are usually only applied once the good or service has been received or delivered. At that point the government has an obligation to the supplier and a shortage of revenues results in payment arrears. For expenditure controls to be effective control needs to be applied before the commitment is entered. Establishing robust
“commitment controls” is a priority for many of the countries in the region.

The quality of expenditure controls is compromised when too many layers of checking are introduced. The role of each individual “checker” is not clear, and it is not apparent who to hold accountable in the event of an irregularity. This is particularly the case when internal audit departments (or even external audit in Lebanon) become part of the payment process. It is preferable to apply a smaller number of checks – but to ensure that all those checking have specific roles so that it is clear what control they are exercising, and who is accountable if a problem is subsequently discovered. Unfortunately the culture of “checking” appears to be deeply ingrained in the region, and even when computer automation allows smarter controls to operate, there has been a reluctance to remove existing layers of signatures.

**Improving cash management**

Many countries in the region face higher than necessary financing costs because they are not actively managing their cash balances. Government cash sits “idle” in bank accounts at the central bank or commercial banks, when at the same time the Ministry of Finance is borrowing to finance the budget.

A number of countries have taken steps to consolidate government cash balances into “treasury single accounts” (TSA), but more can be done. For example, Jordan consolidates cash at the central bank, but is only now moving to consolidate cash in commercial bank accounts; while Lebanon excludes some government cash balances in the central bank from the TSA. When a TSA is established it is critical that good accounting systems are developed to monitor movements and balances. While Egypt was active in moving significant government cash balances to the central bank from commercial bank accounts, this measure has in part been unwound, following complaints about the quality of banking services provided by the central bank.

**Making automating of budget execution a success**

Because budget execution is a more routine operation than budget preparation it lends itself to automation. The gains from automating well are immense with fewer errors and reduced effort. But as importantly, automation opens opportunities to devolve greater responsibility for budget management to those closer to the action (therefore further from the Ministry of Finance), while ensuring that necessary controls are maintained.

Within the region many countries have embarked on automation projects with mixed success. For example, Yemen and Jordan are introducing sophisticated integrated systems purchased from large international suppliers, while Lebanon and Palestine have focused on simpler systems developed by local suppliers. Although a few good individuals have achieved excellent progress in Palestine in a very short period, this is the exception. In general projects succeed because they have followed good project management practices. The Yemen project lost a number of years because insufficient effort was put into developing an understanding of the system at the start. By way of contrast the effort put into the initial design of the system in Jordan appears to be paying dividends.
UPCOMING EVENTS AND ACTIVITIES

- **October 30-November 2, 2008**: 13th International Anti-Corruption Conference: Athens, Greece. iacc@transparency.org and www.transparency.org

- **November 6, 2008**: UAE Nationals' Corporate Ethics Building Conference. Dubai, UAE. The "UAE Nationals' Corporate Ethics Conference" will cover all facets of ethics and compliance management in major UAE public and private sector organizations. It will examine UAE Nationals' corporate ethics management practices and their relationship to organizational success. info@datamatixgroup.com and www.datamatixgroup.com

- **November 9-10, 2008**: Hawkamah Annual Regional Conference. Doha, Qatar. info@hawkamah.org and www.hawkamah.org

- **November 10-13, 2008**: Corporate Ethics & FCPA Compliance. Hyatt Regency, Dubai, UAE. Implementing Robust Anti-Bribery Policies to Ensure Compliance with the Foreign Corrupt Practices Act (FCPA) and Regional Laws. Corporate Ethics and FCPA Compliance will tackle similar issues of the Anti-Corruption Asia Summit, for the burgeoning Gulf region, but will focus more on how to build a culture of Ethics and devolve this through the organization, with special attention being paid to anti-corruption compliance. www.gulfethics.com


- **November 24-25, 2008**: OECD-MENA Senior Budget Officials Meeting. Cairo, Egypt. helene.leconte-lucas@oecd.org and www.oecd.org

NOTEWORTHY LINKS

World Bank MENA Governance Website: http://www.worldbank.org/ MENA-governance

World Bank General Governance Website: http://www.worldbank.org/governance

Transparency Palestine: www.aman-palestine.org

Ministry of Finance: Palestine http://www.mof.gov.ps/

Public Expenditure and Financial Accountability Network: www.pefa.org

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FOR FURTHER READING


West Bank and Gaza Country Financial Accountability Assessment (CFAA), World Bank Report No. 28990-GZ

West Bank and Gaza Public Expenditure Review: From Crisis to Greater Fiscal Independence, Volumes 1 and 2, World Bank Report No. 38207-WBG


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