

World Bank Iraq Trust Fund

Update to IRFFI Donor Committee

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Public Expenditure and Institutional Assessment Key Issues in Public Financial Management

The Bank submitted its Public Expenditure and Institutional Assessment (PEIA) to the Government of Iraq (GOI) in June 2008. The document comprises two volumes. The first contains a detailed analysis of the main issues in public financial management (PFM) at the national level and the second takes the form of a Public Expenditure and Institutional Accountability (PEIA) assessment of the performance of the PFM system. This document sets out some of the main findings of the PEIA, which, together with a similar Bank analysis of PFM at the sub-national level, have been used by the GOI to produce a PFM reform strategy and action plan.

1. One of the most important reasons that the World Bank undertook the PEIA was to establish a baseline against which progress in PFM over time can be measured. For this reason, a major part of the exercise comprised an assessment of the performance of the PFM system using the internationally-accepted Public Expenditure and Financial Accountability (PEFA) framework and methodology. Unsurprisingly, given the fact that Iraq's PFM institutions have been severely depleted as a result of the post-2003 conflict, the PEFA assessment found many weaknesses in the PFM system.
2. The PEFA assessment was produced in an extremely participative way, 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, notably four workshops in Amman, Jordan. Two of these 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.
3. Using the standard four-point rating scale, the PEFA assessment produced the following results for the 31 performance indicators (28 system and 3 donor-related indicators).

PEFA Score	Number of Indicators
A	1
B	1
C	7
D	22 (note 1)
Total	31 (note 2)

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

4. 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:

¹ It should, however, 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.

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

5. 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% over spent 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 have conspired to make execution of the capital investment budget highly problematic).

6. 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.

7. 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 in terms of the delivery of essential public services, this area of PFM must be a priority for reform.

8. 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 Cooperation (MOPDC). In Iraq, these difficulties are enhanced by large parts of the investment budget being financed and executed outside the budget by donors.

9. 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.

10. 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

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

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.

11. 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. Work is now well under way in terms of documenting the accounting framework and bringing it 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, an area where there have been many problems in implementing a major US-funded project.

12. 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. 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.

13. 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 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.

14. 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 has 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.

15. The PEIA report concludes with a series of recommendations across several dimensions of PFM; these cover budget preparation, budget implementation, financial reporting and accounting and auditing and control. The specific issue-based recommendations culminate in an overall emphasis on the importance of the development by the GOI of a PFM reform strategy and action plan. Since the PEIA report was completed, the GOI has made considerable progress producing a PFM action plan which is now forming the basis for a US\$20 million World Bank Iraq Trust Fund financed PFM Reform project.

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