Into the Breach

Salam Fayyad and Palestine

INNOVATIONS FOR SUCCESSFUL SOCIETIES

MANAGING SPENDING AT THE PALESTINIAN AUTHORITY, 2002 – 2005

Tristan Dreisbach drafted this case study based on multiple conversations with Salam Fayyad in Princeton, New Jersey, during 2019, as well as other interviews conducted in Washington, D.C., Jerusalem, and the Palestinian cities of Ramallah, Nablus, and Jericho in June and July of the same year. The case is part of a series on state building in Palestine, 2002–05 and 2007–13. Case published March 2022.

SYNOPSIS

When Salam Fayyad became finance minister of the Palestinian Authority (PA) in June 2002, the government was struggling to manage expenditures effectively and to deliver the budget to the legislative council on time. Success in addressing those problems required winning acceptance from President Yasser Arafat and other top officials for new work processes, securing other ministries' compliance with changes in operations, and instituting radical new levels of transparency. Fayyad focused on fixing the system instead of investigating past malfeasance. Under his watch, the finance ministry began engaging with the council's budget and finance committee, instituting monthly financial reporting, introducing reliable internal control and audit procedures, and adopting internationally recognized transparency measures. Those reforms enhanced the credibility of the authority's financial management internationally, restarted the flow of external aid and PA revenues withheld by Israel, and helped temporarily end a financial crisis.

INTRODUCTION

In September 2002, during a routine meeting with President Yasser Arafat in the presidential compound in Ramallah, Palestinian Authority (PA) Finance Minister Salam Fayyad found himself under siege by the Israeli military. The Israelis, whose target was Arafat, offered Fayyad and others like him who happened to be in the compound but did not work there the chance to flee. Fayyad chose to stay with the president and a small number of other PA officials, staffers, and security personnel.

Even when Arafat told him to leave, Fayyad refused. "I said, 'I'm not a guest here. I'm a member of this leadership, and I'm staying,'" he recalled later. For 11 days, he remained with the president. When Israel lifted the siege in response to pressure from the United States, Fayyad found that the Israeli military had demolished or badly damaged most of the buildings around him and crushed the cars parked outside, including the taxi that had brought him there 11 days earlier and whose driver had fled on foot.[1] Fayyad had been employed in the finance ministry for only three months, but the experience drove home what it meant to govern in a conflict zone.

Fayyad was no stranger to the situation. He had served as the International Monetary Fund's (IMF's) first resident representative in the West Bank and Gaza beginning in December 1995. In late 2001, his term in that position ended, and he left the organization rather than go back to IMF headquarters in Washington, D.C., or accept a post elsewhere. "My destiny was to be in my own country," he said. He took a job as head of Palestinian operations for the Arab Bank, the largest commercial bank in the region, and tried to maintain the bank's operations despite the Israeli military reoccupation of Palestinian cities earlier that year. He was with Arab Bank for about half a year.

In June 2002, under domestic and international pressure to implement financial reforms in the PA, Arafat offered Fayyad the position of finance minister. The president did not give him specific goals, Fayyad said, but he knew his job was to help prevent the PA's collapse by bringing its financial systems into line with global good practices and improving the effectiveness of revenue and expenditure controls.

With respect to expenditure management, there were several clear priorities. The finance ministry had no role in or even knowledge of public spending financed through bank accounts outside of its oversight. It also lacked control over the portion of the PA's outlays that were financed by fees and other revenues collected and retained by other PA ministries and agencies. Even the payments it executed itself, such as public sector wages, were not entirely under its control. Discretionary spending was the norm, with the president often issuing so-called orders to disburse, which authorized releases of funds for a wide range of purposes. Both the internal and external audit functions were also underdeveloped, and financial reporting was limited, irregular, and unreliable. Finally, accountability was poorly institutionalized, and the minister lacked control over senior ministry staff—especially those who enjoyed direct access to the president.

Those weaknesses had many consequences. Ministers and their deputies could issue checks to pay for services without finance ministry approval—and often without the funds actually being available, which resulted in an accumulation of payment arrears. The weaknesses created opportunities for financial irregularities and corruption. They hampered the finance ministry's ability to discharge its key responsibilities in the preparation, adoption, and implementation of the PA's annual budgets. And they undermined the standing and credibility of the finance ministry both domestically and internationally.

For Fayyad, taking the finance ministry job might have seemed an unenviable prospect. It meant leaving a lucrative position as a corporate executive to manage the finances of a government in crisis. But Fayyad said he "really felt the hugeness of the moment, to be part of building your own country," even though the situation "looked desperately impossible both politically and technically."

THE CHALLENGE

Fayyad knew the PA was in a difficult spot. The second intifada, an uprising against Israeli occupation, had begun in September 2000. By February 2005, more than 4,000 Palestinians and Israelis would lose their lives, with thousands more injured. At the outbreak of the violence, Israel decided to withhold the revenues it collected on the PA's behalf, plunging the PA into financial crisis. The PA's recurrent fiscal deficit grew from roughly US$6 million in 1999 to US$993 million in 2002, necessitating external general budget support—foreign aid in the form of exceptional financing. By mid 2002, the PA could not pay its employees their full salaries on time and was struggling to provide basic services such as policing, health care, and education.[2] Despite emergency financial assistance from Arab nations and the European Union (EU), the government was on the verge of fiscal collapse.[3]

Domestic and international calls for reform of the PA had reached a level that Arafat could not ignore. Both Arafat's ruling Fatah movement and the Palestinian Legislative Council, the parliament, demanded an overhaul of government operations. More than 90% of Palestinian citizens surveyed in May 2002 agreed with that view.[4] "In the way Arafat managed before, he did respond to legitimate needs for assistance, and those who got it were happy," Fayyad said. "But those who did not outnumbered, by far, those who did. There was a lot of dissatisfaction." The EU also conditioned its continued assistance on the Palestinian Authority's adoption of a variety of measures, including making significant changes to the ways the government managed its finances.[5]

Palestinian reform advocates and international donors agreed, in general terms, on the basic elements of a public financial management agenda for the PA. During his years with the IMF, Fayyad had worked with Arafat to develop a presidential decree, issued in January 2000, that ordered, among other things, unification of the PA's accounts and the transfer of the Gaza-based payroll unit from the civil service bureau to the finance ministry. Due to stiff resistance within the PA, those reforms made only limited progress before the outbreak of the second intifada sidelined the reform agenda.

Fayyad said he was aware that fixing the PA's finances would be difficult and that the task might even be impossible. Bringing order to expenditure required him to confront several major challenges. One was a management culture that privileged personal ties to the president over bureaucratic rules and resisted oversight and transparency. That culture had its roots in historical circumstance. Many top-level officials in the PA had spent years in the nationalist struggle as members of the Palestine Liberation Organization (PLO), a coalition of political groups headed by Arafat that, beginning in the mid 1970s, started to gain recognition as the sole legitimate representative of the Palestinian people. The president's personal influence and control prevailed throughout the finance ministry, disrupting normal lines of authority.

Alterations of procedures would inevitably reshape the authority of senior politicians and civil servants, in many instances reducing their de facto authority and scopes of action. Previously, Arafat could pick up his pen and order a ministry or an agency such as the Petroleum Commission to give money from its account to a company, an individual, or a municipality that had asked for assistance. "People would submit a piece of paper, get an approval [from the president], and carry it to the ministry," Fayyad said. "Then they started knocking on the minister's door. 'Where's the money, where's the money?'" Other powerful people in the West Bank and Gaza benefited from the lack of expenditure controls and lack of transparency and might resist any changes that diminished their power.

The weakness of the existing system of laws and rules also stood in the way of rapid improvement. The government had promulgated an organic budget and financial affairs law in 1998, but it had failed to issue the regulations and procedures necessary to implement the legislation, according to Muna Masri, who was serving as director of control and audit when Fayyad arrived at the finance ministry. The omission forced financial staffs within ministries and spending units to execute payments according to their best judgments about what was right instead of relying on a single clear set of rules. The 1998 law also contributed to confusion because it contained articles that conflicted with or contradicted one another—especially those related to auditing and financial controls. (Fayyad said the problem was partly due to the fact that Arabic words for *control* and *audit* are similar, and many used them interchangeably.) Legal reform was usually a slow and laborious process, but the need for improved practice was urgent.

The third impediment to reform was the high level of sensitivity surrounding one of the functions most in need of oversight and control: payroll. Government officials had used public hiring to reward political loyalty and to alleviate unemployment and poverty.[6] By 2002, wages were accounting for 70% of the authority's current expenditures. It was a "fast-growing PA in terms of civil service and security personnel," Fayyad said. "Not so much because of something that could be justified on the basis of need but as a way of dealing with a massive unemployment problem and a reflection of the prevalence of patronage." The finance minister could only either approve or veto the entire payroll each month, and in practice, he simply signed off, no matter the total amount. "There was no line-item veto the minister could exert," Fayyad said. "Either everybody gets paid, or no one gets paid." Reforming that system would require him to directly confront the PA officials who derived power from their ability to add people to the payroll.

Fayyad lacked political clout, even though there was broad support for reform and he was central to that mission. It was his first experience in government. He had not been a member of the PLO, and he did not have an extensive history of comradeship with Arafat and other leaders of the movement. He said he had built a relationship with Arafat during his time as IMF resident representative, when he had dealt directly with the president. The question was whether that rapport would suffice for the tasks that lay ahead.

FRAMING A RESPONSE

When Fayyad became finance minister, Arafat gave him no roadmap and little guidance. Indeed, Fayyad said, he worried that given his status as a political outsider, he might not be able to generate the clout needed to repair the PA's financial management system. However, he had allies in the new cabinet who could help.

In June 2002, Fayyad, other newcomers to government, and some experienced politicians created the Inter-Ministerial Reform Committee, which focused on public security, public finance, the judiciary, and the electoral system. Within 10 days of its establishment, the committee produced a 100-day agenda, which the legislative council quickly approved and which the government released as an official plan. The financial management reforms listed in the program reflected broad agreement by leaders in Palestine and international donors. The reforms included consolidation of all PA revenue and expenditure operations as well as payroll administration under the finance ministry; rationalization of budget preparation and submission of a budget to the legislative council; and reorganization of commercial and investment operations.[7]

Knowing what he had to do—at least in broad terms—Fayyad had to figure out how to do it. Timing was crucial, and he recalled not knowing how long he would be in office, so he had to move fast to fix what he could while he had the chance. The finance ministry had to continue operating while he implemented reforms, so he decided the best approach would be to take on the big problems in small slices that would minimize disruptions (text box 1).

Fayyad decided to focus on increasing transparency in budgeting and expenditures so that the legislature and the public could more easily monitor—and police—how the PA spent its money. The mere prospect of scrutiny would help curtail misuse of funds, thereby easing the difficulty of direct confrontation with special interests.

Text Box 1: Late Nights and the Route to Reform

To improve ministry processes while also getting to know people, Fayyad inaugurated late-evening meetings with midlevel and generally junior staff. At those sessions, he asked staff members to walk him through their daily routines as well as overall ministry functions. "I led a discussion at the micro level: clarifying concepts, suggesting better alternatives, and linking all of that to the ministry's overall mission," he said. "Also, we spent considerable time correcting erroneous definitions, concepts, and methodologies." The approach enabled all staff members to carry out their regular roles while gradually phasing in new procedures. "They did not have to be perfect on Day One but simply better than the day before," Fayyad noted.

Fayyad considered the workshops valuable for the troubleshooting they permitted, the training they imparted, and the rapport they helped build among those who participated. "I bet on the juniors, and I cannot tell you how thrilled I was to see them become fully and cheerfully engaged," he said. "Many made it to the rank of director general over time."

Fayyad recalled that other considerations informed his thinking about how to tackle expenditure reform. Which measures could he implement with the simple stroke of a pen and that would not require legislative approval? Which reforms had to happen first, so as to convince stakeholders that the reform effort was serious? Which reforms could be achieved as simple matters of enforcing rules and procedures already on the books but unobserved in practice? And given the volatile, fluid nature of the political situation, Fayyad recalled being on the lookout for instances in which a changed circumstance opened an opportunity for a reform.

Across all of his priorities, Fayyad knew it was wise to concentrate on technical or procedural changes that would correct specific weaknesses in expenditure management rather than take on entrenched interests in the PA or punish past behavior. This was "a conscious decision I made from Day One," he said. "I wanted to focus on fixing the system going forward." Fayyad reasoned that reform of work processes would inevitably shift power away from those among the ministry's top-tier employees who resisted reform and would therefore create opportunities for high-performing lower-tier staff to increase their influence and, eventually, their ranks.

To achieve any of his goals, Fayyad knew he needed a good relationship with Arafat, who wielded influence over the other PA leaders. He knew he had to keep the president apprised of his work, and because Arafat had formally agreed to the reform program as far back as January 2000—when he signed the decree ordering consolidation of PA accounts and other measures—Fayyad knew he could frame what he was doing as implementation of decisions the president had already made.

Fayyad also knew he could draw political strength from support he garnered from the international community. That support, however, could cause some powerful PA figures to question his allegiances. Fayyad emphasized that although he had worked with the IMF, he was a Palestinian and not a member of the international community trying to pressure Arafat to change. His choice to remain with Arafat during the September 2002 siege helped solidify his relationship with the president and demonstrate that he was a dedicated champion of the Palestinian cause. "That really brought me into the system—much to the surprise of many," Fayyad said. "That's when people started to really take note of this guy not being simply a technocrat out there working on solving a financial crisis."

GETTING DOWN TO WORK

In the early months of his time as finance minister, Fayyad's expenditure-related goals were to stop the hemorrhage of the authority's limited resources, to enable the government to channel money to priorities it had laid out in its plan and negotiated with the legislature, to build staff capacity for expenditure reporting, and to reduce opportunities for people inside and outside the ministry to manipulate work processes for their own advantage at the expense of the public good. But the first thing he sought to do was make sure the PA stopped passing bad checks.

Improving the distribution of treasury checks

Upon taking office as finance minister in June 2002, Fayyad made it a top priority to reform the process by which treasury checks were issued and distributed. Fayyad said he first became aware of a problem with the PA's checks in 1996, shortly after beginning his work with the IMF, when he heard that a check issued by the PA treasury had bounced. He was shocked but soon realized it was a common occurrence in the West Bank and Gaza. Vendors complained that they had to wait months or even years to cash checks received from the treasury.

When Fayyad assessed the bad-check situation, one question perplexed him: why were vendors and other payees willing to wait so long to be able to cash the checks the PA issued them? "Why are people doing this?" he recalled wondering. "Let's say I am an auto dealer and import cars for the PA, and the PA continues to not pay me, yet I still import cars for the PA, and I still get checks I can't cash. Why would I continue to do this?"

Fayyad started at the source by taking a close look at the process the treasury used to produce and distribute checks. When the finance ministry paid a supplier, a senior employee in the finance ministry directed a lower-level employee to cut a check. The check then went to senior ministry staff for the requisite signatures before the ministry sent it to the supplier.

When the supplier took the check to the bank, however, a banker would take the check and then often inform the supplier the check could not be cashed. With expenditures regularly outpacing revenues, the PA usually did not have sufficient funds in the bank to cover the check. But even if the PA account did have enough money in it, the bank still might not cash the PA's check. The bankers—not the finance ministry—had discretion over which checks to clear. That discretionary power created opportunities for corruption. Suppliers willing to pay bribes would get their checks cashed first; those who didn't pay might have to wait months or years to obtain payment.

These practices not only hurt certain—usually smaller—suppliers; it also raised the PA's costs. When charging the government for their goods and services, merchants factored into their prices the likely delay to receive payment and the costs of the bribes they expected to pay.

With the whole problem in view, Fayyad set out to stop the ministry from issuing checks it could not honor and to disrupt the informal arrangements that undermined the rule of law and the government's ability to do its job. As a first step, Fayyad instructed the finance ministry employees who produced treasury checks to continue following existing procedures, with one notable difference: they would produce checks as before, but they would hold them until the ministry could ensure it had the funds to cover them. Some employees feared retaliation if they did not issue checks when pressed by high-ranking PA officials, but Fayyad told them he would take the blame, instructing them to say, "On instruction of the minister, we were told to keep this check." Although Fayyad did not exercise his authority to sign individual checks, he cleared the list of all checks that sent for payment on any given day until the system became reliably functional.

Fayyad then held a meeting with senior finance ministry officials to communicate the new procedure and the expectation that the PA would never again issue a bad check. He challenged them to commit themselves personally to that goal. He remembered explaining that he was about to make a public commitment to end past practice, pointedly asking staff members: "I will make that statement, and I want to be 100% right; and I would not want to be accused even once of not telling the truth on this matter. Can I make that statement or not?" After the meeting, he held a press conference and publicly declared that from that date onward, a check from the Palestinian Authority would never bounce.

The next question was how to decide which checks the ministry would release immediately and which it would hold back temporarily. The PA did not have money to cover all the checks it produced, so Fayyad instituted a new system. Ministry staff made a list of the PA's debts and its obligations to suppliers. Then, based on the schedule of when revenue came into the ministry and on guidance from the minister's office, the staff determined which debts the PA could pay and when.

Initially, the priority was to fund checks that had already been issued and were being held by banks for lack of funds. Rather than deciding on a check-by-check basis which payments to honor, Fayyad said, he introduced an interim, rules-based mechanism that prioritized old before new and then small over large, initially setting the ceiling for checks to be cleared at US$100. The ministry prioritized checks below that ceiling by date of issue, with older checks paid first. After paying out all checks below that initial ceiling, the ministry raised the ceiling incrementally, repeating the process. And while that process played out, the ministry issued no new checks.

The solution reduced opportunities for corruption. Fayyad said that resolving the problem with treasury checks helped set the stage for subsequent financial reforms to be taken seriously. The reform also changed a work culture at the ministry and dealt a significant blow to the standing and influence of uncooperative senior finance ministry employees, who, before the change in process, had privileged certain vendors over others. Moreover, by prioritizing smaller beneficiaries, the PA spread its meager resources broadly, enabling small businesses, whose financial reserves likely could not cover long payment delays, to benefit from reform.

Reforming the budget process

Another reform Fayyad sought to implement quickly was improvement of the budget process. He enhanced communication between the finance ministry and other ministries with regard to their funding needs for the fiscal year; he provided the legislative council with detailed information on the PA's past revenues and expenditures together with projections for coming years; and he complied with deadlines stipulated in the budget law.

The authority's 1998 Organic Budget Law set out a basic budget process and timetable. The finance ministry was supposed to issue by July 15 each year a budget circular that presented a multiyear macroeconomic framework. The ministry would then project—based on that framework—the maximum resources available under existing policies and in line with expectations regarding external aid. Each line ministry and agency then had a month to submit a detailed spending proposal for the next fiscal year. The finance ministry had to review those submissions and forward an overall budget proposal to the cabinet by October 15 for discussion. The minister presented the final version, due by November 1, in a speech to a special session of the legislative council. In turn, the council had to act on the proposed budget by December 31. The council's budget and finance committee took a first look and reported its recommendations to the plenary for an open discussion, the finance minister's responses to questions, and a formal vote. The aim of the process was to promote cogent discussion of the government's spending priorities and bolster legislative oversight. There was a provision for a continuing resolution until March 31 of the budget year in the event deliberations took longer or minor delays occurred at other stages.

Before 2002, however, the government had not followed that process to the letter. The ministry had routinely submitted late budgets and provided the council with only fragmentary or vague information. When legislators had called Fayyad's predecessor to hearings, the minister was usually unable to provide accurate data or explain irregularities, one Carnegie Endowment for International Peace report said.[8]

The dysfunctional budget process meant that spending had no clear relationship to the allocations that the council had approved. Ghassan Khatib, who became labor minister at the same time Fayyad arrived at the finance ministry, recalled that the budgets the finance ministry created also bore no relationship to the PA's development plan. "The two processes were separate," he said, so the budget did not reflect priorities.

Fayyad said he knew the shortcomings of PA budgets well from his time working with the government as IMF resident representative. He said he felt that the finance ministry's budget department had the capacity to create strong budget documents and lacked only leadership and guidance. He also saw an opportunity to improve the information the ministry provided, including additional charts, tables, and other figures that would make it easier for the council to do its job and easier for Palestinians to understand what their tax payments funded (text box 2).

Fayyad's initial steps aimed to improve compliance with the rules and deadlines set out by the Organic Budget Law. For instance, the law called for the budget to go to the cabinet for discussion every October. But under Arafat there were no formal cabinet meetings—only weekly leadership meetings that focused on broader political issues and included senior leadership members who were not ministers. Fayyad implemented a workaround that, although not technically in line with the budget process as stipulated in the law, was closer to compliance with the law than had previously been the case. He had the finance ministry's budget department send a budget circular to PA ministries and agencies, collect their responses to the circular, and discuss the submissions in conversations with the finance directors of each ministry and agency. The budget department notified Fayyad of any disagreements or other complications, which Fayyad resolved by speaking directly with the relevant ministers or agency heads. The budget then went to the council, with which Fayyad worked closely to finalize the budget law.

Text Box 2: Facts Matter

Getting a grip on the Palestinian Authority's fiscal challenges required data Fayyad did not have when he first arrived at the finance ministry. During previous years, the PA had lacked a system for recording extrabudgetary expenditures, and that lack, coupled with other anomalies, rendered pre-2002 information on the PA's finances unreliable. Those data problems inevitably confused international reporting, which Fayyad said, "often suggested a degree of exactitude that simply was not there."

One of Fayyad's goals was to boost data quality so that he and his successors could manage fiscal affairs effectively. Even so, even *accurate* information could easily create false impressions unless accompanied by copious explanation. Vivid examples of the misinterpretation of accurate statements were easy to come by. For instance, press-monitoring organization Middle East Monitor at one point referenced a 2003 World Bank report that Yasser Arafat had personally controlled a budget of US$74 million since creation of the PA in 1994 and that the PA had transferred US$900 million to an "unknown party" between 1995 and 2000. Fayyad's phone immediately began ringing with calls from people wanting to know who had stolen the US$900 million. But he realized that the journalists had misconstrued the information Karim Nashashibi, his successor as IMF resident representative, had provided at a press conference on the sidelines of the 2003 annual IMF/World Bank meetings in Dubai. Nashashibi had used the term *diversion* in describing the PA revenues that did not go to the finance ministry accounts, including oil excise revenues that were held in a special Tel Aviv bank account. Nashashibi tried to clarify and to walk back his statement but was unsuccessful, and the "transfer" story became headline news.

While taking these steps, Fayyad also had to alter the culture of decision making by standing up to political pressures that threatened to disrupt the budget process. His predecessor had struggled to resist politically powerful ministers who pushed back against budgets the finance ministry proposed—for instance, demanding higher transportation budgets or money for constructing new buildings. "Before, the final decision was not up to the minister of finance," said Aziz Abu-dagga, who served as Fayyad's office director at the finance ministry. Other ministers appealed directly to the president to get the resources they wanted. "They still tried that after Salam Fayyad came in, but they found they could not get away with it," Abu-dagga added. Fayyad resisted that political pressure, choosing instead to negotiate with ministers and push back against budget items that the cash-strapped PA could not afford.

Because he took office after the fiscal year had already started, Fayyad had to improvise when he developed the 2003 budget. Nonetheless, the approach represented a major step forward for the PA. Fayyad worked closely with the ministry's budget department, asking for the inclusion of new information, and the result was more comprehensive than previous budgets. It included macroeconomic parameters, comparisons to actual performance in 2001 and 2002, a line item on profits from public enterprises, and data on employment by ministries and agencies. The 2003 budget was the first to present figures in Israeli shekels—the currency used in transactions—as well as in US dollars. The budget also set limits on expanding civil service employment.[9]

The 2003 draft budget law included, for the first time, provisions that Fayyad said he deemed helpful for safeguarding the improvements the ministry had already implemented and for providing a legal basis and explicit legislative support for the pursuit of additional reforms that already had strong political backing. Those reforms included rules that banned government borrowing from the pension fund or from the Palestine Monetary Authority, prohibited any effort to divert PA revenues away from the central treasury account, prevented the government from using cash payments in transactions, and prohibited public sector procurement without a bidding process.

Uncertainty surrounding some donor commitments delayed submission to the legislative council until December 2002, which was later than the November target included in the 100-day reform plan. Nonetheless, the budget was only the second in the PA's history to arrive at the legislature before the beginning of the fiscal year on January 1. The council approved the 2003 budget on February 1, 2003, one month behind the deadline set by the Organic Budget Law.[10]

A year later, changes to the political system enabled Fayyad to bring the budget process into better alignment with the requirements set forth in the law. A 2003 amendment to the Basic Law introduced the position of prime minister. In March 2003, the president nominated Mahmoud Abbas, a cofounder of Arafat's Fatah movement, to serve in the role, and the legislative council approved the nomination the next month. Prime Minister Abbas began presiding over formal cabinet meetings and took some initial steps toward revamping the role of the cabinet secretariat and formalizing cabinet work processes. With his tenure lasting less than four months, however, it fell to his successor, Ahmad Qurei, to bring those initiatives to fruition, which made it possible, for the first time in the PA's history, for Fayyad to submit the 2004 budget proposal for cabinet discussion and formal approval before submitting it to the legislature.

Embracing transparency

Central to Fayyad's expenditure reform agenda was the issue of transparency. Fayyad reasoned that if the PA was to prove that it was a functional government, it had to demonstrate it was accountable to the legislature and the Palestinian public.

Seeking to standardize the full disclosure of government financial data, Fayyad asked his staff to prepare, at the end of each month, a set of 12 tables that touched on every aspect of the government's finances, including a summary of expenditures, revenues, and the deficit, as well as loans the PA took out and their repayment schedules. He ordered that the ministry post the tables on its website by the 15th of the next month—a rapid turnaround. "This was an amazing revolution," said Karim Nashashibi, who succeeded Fayyad as IMF resident representative in the West Bank and Gaza in 2001. "[It was] much more transparent than Israel or any country that I know of." The data went up on schedule, although the ministry occasionally had to revise and update the information after the original publication date.

Though only about 4% of the population in the West Bank and Gaza had access to the internet at the time,[11] the ministry counted on local media picking up dissemination of the reports. The data helped Palestinians understand the state of the PA's finances—at a time when the authority was strapped for cash and at times could not pay its employees or suppliers in time or in full. The data helped people see the revenue collected and how the authority spent the money, as well as understand the reasons for late payments to employees and suppliers. (Because of persistent gaps between revenues and expenditures, arrears remained a major problem for the PA.)

The reporting also enabled donors to scrutinize the tables and ask critical questions. At the IMF resident representative's office, which provided fiscal reports for the Ad Hoc Liaison Committee, which coordinated international aid, Nashashibi hired a team to trace all of the PA's financial data and ensure it was correct. He then sent Fayyad questions and recommendations. With the finance minister's answers in hand, Nashashibi could present the office's findings to other external partners such as the World Bank and the European Commission.

Fayyad took that approach a step further by prioritizing communication and openness with civil society as well. Beginning in 2003, AMAN, a Palestinian anticorruption NGO that served as the national chapter of Transparency International, invited Fayyad to meet with civil society representatives interested in the PA's budget. Together with his deputies, Fayyad attended the event every year until he left the finance ministry in 2005. At the meetings, the finance ministry representatives presented the draft budget they had prepared for the legislative council and answered questions from civic leaders. AMAN operations director Isam Haj Hussein, who closely followed PA financial issues, said the level of transparency was a welcome improvement over the past because it helped Palestinian civil society organizations monitor the government's budget performance, as well as develop position papers and advocacy campaigns related to the PA's spending choices.

Taking control of the electronic finance system

By the end of June 2002, the Palestinian Authority was no longer issuing checks it could not honor, but the next year, Fayyad decided the finance ministry also had to take control of the electronic financial management system the PA used for processing and tracking expenditures. The PA did not own the system. Instead, it contracted with a private-company-turned-public-corporation called al-Bahar (Arabic for *The Sea*) that owned the software and managed the servers, which were located at its offices.

The al-Bahar company began as a private firm registered in the names of two people: a director general of the finance ministry's Gaza operations, who spent most of his time engaged in other work, and the director general of Arafat's presidential office. Over time, al-Bahar had taken over smaller companies and had financial interests in a wide variety of ventures such as a real estate concern, a medical center, an advertising agency, a hotel, and a horse-racing club. The PA became the registered owner in June 1997.[12]

The director general continued to lead the company and was "extremely powerful," Fayyad said. "Close to the president, close to the chief of staff of the president." The head of the company had also, unbeknownst to Fayyad, fostered goodwill among certain lower-level finance ministry employees by giving them money every month to supplement their low salaries. "It created for him a feeling of ownership and access," Fayyad said. "He could walk in at any time."

In September 2003, while Fayyad was attending the World Bank and IMF annual meetings in Dubai, his staff discovered a treasury check the finance ministry had not produced. The origin of the check was unclear, but its existence indicated that the system was deeply flawed. The incident convinced Fayyad that the ministry had to end its dependence on the al-Bahar company and create its own system.

Rather than try to track down and punish the wrongdoer, Fayyad was determined to eliminate future opportunities for such malfeasance. He had to be careful, however, because of al-Bahar's connections; if the company knew of his plans, it would likely push back. He quietly recruited a small team of information technology and accounting specialists from the finance ministry, who met at the IT director's home. There the team developed the code for its own system over the course of several months. "This was kind of equivalent in my own head to the Manhattan Project," Fayyad said.

Once they had tested their new software and were sure it was ready to install, Fayyad's team had to choose the right moment to introduce it. The team did not want to attract unnecessary attention during the transition process, which required installing new servers and interfacing with the telephone company to connect the finance ministry offices in the West Bank and Gaza. "We needed a couple of days when nobody was working," Fayyad said. "Fortunately, we had a holiday coming up." In February 2004, the team took advantage of the extended weekend around Eid al-Adha, a Muslim holiday, to disconnect the ministry from the al-Bahar system and put the new system online.

Fayyad's attention then turned to preventing the head of the al-Bahar company from retaliating against finance ministry staff. "I was thinking about how this guy was going to feel when he discovered that he had lost control," Fayyad said. He went to the president's chief of staff and asked him to call the head of al-Bahar to deter him from retribution, pledging he would back up his deputies completely.

The tactic worked. "Sure enough, this guy was fuming, but he didn't do any harm," Fayyad said. Once the system went active, the finance ministry encountered no significant retaliation, said Abu-dagga. Because the team had kept the new system under wraps until it went live, the powerful al-Bahar company had no opportunity to mount any effective opposition.

Taking over the payroll unit

One of Fayyad's jobs as finance minister was resource management, and an important dimension of that function was expenditure control. In the PA, the biggest single expense—payroll—was also one of the most politically sensitive. During the intifada years, an already difficult unemployment problem had grown worse, thereby increasing pressure on the PA to hire people.[13] By 2002, the PA was paying US$642 million in salaries annually, which accounted for about 70% of the authority's expenditures and was equivalent to more than a quarter of gross domestic product. Payroll threatened to crowd out nonwage expenditures and transfers.[14]

Fayyad wanted to bring those outlays under control. He said he also saw the potential for such reform to help end loose government hiring practices, but he lacked the formal control over payroll functions that finance ministers usually had. Administration of the Palestinian Authority's payroll, like many aspects of government, was divided between the West Bank and Gaza. In the West Bank, the finance ministry itself handled government payroll functions, whereas in Gaza, the payroll unit was an integral component of the PA's civil service bureau. Fayyad said that that organizational peculiarity made it possible for the bureau not only to play a key role in the hiring of civil servants but also to actually initiate and complete the hiring process in Gaza without even notifying the finance ministry and without any regard to the budget.

Virtually all hiring and promotion decisions that pertained to senior positions—and many that pertained to even junior ones—took the form of a letter with a handwritten instruction "to hire" or "to promote," dated and signed by the president, Fayyad said. The letters typically came from people of standing and influence in the system.

In Gaza, such a letter required action by the civil service bureau—specifically, by its head, Mohammad Abu Sharia. "That made Abu Sharia a huge center of power," Fayyad said. The finance minister's role was nominal, he added. Although only the minister himself authorized the wage bill payment, he could do so only on the basis of a bill the civil service bureau prepared for his signature. The minister essentially had to decide between paying all of the civil servants—or none. In practice, the minister signed the bill to pay all civil servants when sufficient resources were available.

The legislative council had already passed a civil service law in 1998 that granted the finance ministry control over the payroll.[15] Like many earlier reform measures, however, the government failed to implement the provision. Shortly after taking office as finance minister in June 2002, Fayyad, who was aware of the law's provisions, asked the head of the civil service bureau to sign a memorandum of understanding that acknowledged the simple fact that the finance ministry had legitimate administrative oversight over the bureau. "I thought that was a huge step forward," Fayyad said, but it was only the first move toward his real aim: to absorb payroll operations into the finance ministry.

The real challenge was to establish de facto control of a function that physically lay in a different office. "I wanted it physically moved to the ministry of finance," Fayyad said. In a country with more mature government institutions, the bureau's acknowledgment of finance ministry oversight might have been enough, he added, but in Palestine, he expected Abu Sharia to cling to his power and influence. Fayyad could not count on someone sitting in a satellite office to truly accept his authority,

Two months after securing the memorandum of understanding, Fayyad carried out the second step of his plan in a quick stroke. Without warning, he called the head of the civil service bureau. "We made space" at the finance ministry, Fayyad said he told him. "This afternoon, I'm sending some people to unplug the computers and everything else and take them to the ministry." Fayyad was not certain he had the authority to order the move, but the head of the bureau acquiesced. That afternoon, ministry staff showed up with donkey carts—a common means of transportation in Gaza—to move computers and other equipment to the finance ministry's office.

To ensure control over all PA hiring, Fayyad merged the West Bank and Gaza payroll operations, retaining the employees from both offices and appointing his trusted director of payroll in Ramallah to serve as director of the expanded office. After that step, it was impossible to hire or promote civil servants without prior finance ministry approval.

Even with those changes, keeping the wage bill under control proved difficult. In 2004, the Palestinian Authority agreed to a wage bill containment plan as a benchmark for disbursements from a World Bank fund. The PA also passed a resolution to enforce public sector retirement at age 60 and to reduce pensions for those who lacked the minimum 15 years of service. But economic pressures on the government to serve as a buffer against job losses and unemployment during the second intifada, which lasted until February 2005, remained strong.[16]

The main driver of the increase in the wage bill was gradual implementation of the 1998 civil service law, which included an upward adjustment of pay at each grade. "That came about against the backdrop of relentless pressure by and tough negotiations with the parliament and unions," Fayyad said. Although the negotiations were hard and acrimonious, he was sympathetic to union demands, he said, because the preexisting pay scale had left many civil servants, including teachers, below the poverty line.

Introducing change at the center

While all those other initiatives were in progress, Fayyad faced an additional challenge. The legislature was complaining that the budget for the president's office was too large. Its concerns were amplified internationally—cited as evidence that Arafat, not government institutions, controlled everything, Fayyad said. The budget tables showed that total outlays recorded under the office of the president amounted to about US$104 million in 2002, or 8.7% of total government expenditure.

When the finance ministry began preparing the 2003 budget, Fayyad tried to assess how the president spent the money. "When I came in, I wanted to shift the whole system from the personalist regime it was to one that would be based on rules and standards," he said. A lot of discretionary expenditure came out of the president's office. Well intentioned though that spending may have been—Fayyad recalled that Arafat often issued funds to help poor Palestinians put food on their tables, send children to school, or return from exile abroad—it was at odds with the principles of professional public financial management. "There was no transparency, and there was no verification of need. All that was required was for someone in the president's circles to petition him on behalf of an individual or a group," Fayyad said.

"When I came in, I wanted to shift the whole system from the personalist regime it was to one that would be based on rules and standards"

The examination undertaken in the last half of 2002, as part of the 2003 budget process, revealed that a substantial portion of the resources allocated to the president's office financed activities in three broad categories: social assistance, education allowances, and health-care assistance. The PA already had ministries charged with responsibility for those services. The president's office carried out duplicate functions and undermined the legislature's ability to determine how the PA's scarce resources should be spent.

"Going to the president and saying, 'Mr. President, I am here to cut your budget' was not much of a viable option," Fayyad said. So he decided not to interfere with the president's efforts to authorize assistance to individuals but instead charged the spending against the budget of the agency that was supposedly in charge of the activity that it funded. "As a first cut, in the 2003 budget cycle, we raised budget allocations for the ministry of social affairs, the ministry of education, and the ministry of health, and we correspondingly reduced the president's budget allocations," Fayyad recalled. "We did the same, with a much sharper pencil, in the 2004 budget cycle."

With respect to the bottom line, the changes were "pretty much neutral" in their consequences, Fayyad said. "But in terms of work processes and moving toward a rules-based system, the changes were highly consequential." Under the new system, when the finance ministry received a presidential directive to disburse, say, social assistance, it first sent the directive for clearance by the minister of social affairs and, likewise, the ministry of education and ministry of health.

"By early 2004, these line ministries were programming the assistance into their own existing programs, and by 2005, assistance requests started to go directly to the ministries themselves," Fayyad said. "The ministries then created their own programs to help ensure the spending was fair and transparent."

OVERCOMING OBSTACLES

Not all of Fayyad's reform priorities could be dispatched quickly. For example, even though Fayyad said establishing internal financial controls throughout the government was critical for future capacity-building efforts and for facilitating the release of PA funds withheld by Israel, doing so proved a difficult and lengthy task.

Early on, Fayyad took steps to address immediate pressures. He recruited Hilal Salah, a Palestinian expert who had worked with an international audit firm, and asked him to prepare high-quality internal audit reports and, subsequently, to train staff to carry on with that function. Although the step annoyed some senior staff, it helped Fayyad push back against Israel's insistence that, to release the Palestinian revenues it withheld, the Israeli government handle expenditures on the PA's behalf, disbursing funds based on a list provided by the authority. Fayyad called that proposal "objectionable" and "highly demeaning."

Financial controllers played a vital role in effective management, Fayyad said. By checking all expenditures, they could reject those that did not comply with budget laws and other regulations. Fayyad's goal was to embed in each major spending unit of the PA an internal controller who would approve or reject payments and report directly to the finance ministry. At the time, most ministries lacked that capacity, even though the General Control Institute, which was responsible for external auditing, had earlier advised them to establish internal audit or financial control departments.

Fayyad turned to Masri, director of control and audit at the time, to lead the reform. In the past, Masri's department, which had limited scope and resources, had mainly conducted preliminary audits. But in 2004, Masri and Fayyad decided it was important to focus the directorate on operationalizing internal financial controls and shifting audit functions to a separate directorate. Fayyad promoted Masri to become general director of internal control, tasked with carrying out preventive measures that would ensure that the PA's expenditures and revenue collection were accurate and complied with relevant laws. Later, Fayyad also named a new general director of internal audit.

Next, Fayyad assembled a committee to develop financial regulations to guide ministries and public institutions, as well as to codify the roles and responsibilities of the new financial control and internal audit directorates. Masri, who served on the committee, played a leading role, informed by her own experience and examples she drew from other countries. In 2005, Fayyad sent the committee's proposal to the cabinet, which granted its approval.

With the regulations in place, Masri had to recruit and train controllers, who would be employees of the finance ministry. Fayyad persuaded the cabinet to issue a decree ordering ministries that had already created an internal control system to transfer the staff members in those roles to Masri's office. To fill other internal controller positions—for ministries that had none—Masri poached experienced colleagues and provided extra training with the help of the European Commission.

"Coaching these staff members on how to project themselves was very important," Fayyad said. "Don't project yourself as a cop. Don't project yourself as a source of threat or intimidation to anyone." Part of the training included how to navigate the cultures of other ministries, as well as a warning to avoid aggressive behavior in order to minimize conflict.

In 2005, the finance ministry was ready to dispatch its controllers across the Palestinian Authority but Fayyad had to manage backlash from some of the other ministries. "People were really taken aback by this," he said. "Some asked, 'You mean we can't write a check for US$10 unless a guy from the ministry of finance is sitting here?'" After discussing the matter with the economy minister, whom he knew well, Fayyad decided to be patient and—in accordance with his overall strategy of avoiding direct conflict with his cabinet colleagues—not force the issue too quickly. He started sending controllers to ministries that were more accepting of the idea, using their positive experiences to persuade other ministers to follow suit. He also prioritized one-on-one conversations with ministers instead of discussing internal financial controls during full cabinet meetings.

To help build support, Fayyad emphasized that his finance ministry would adopt the same systems he asked others to accept, and he told other ministers that the internal control department would be independent from him, too. "I'm not really involved as minister of finance, so it's not like I have oversight over you," Fayyad said. He also stressed that the embedded financial controllers represented an important step toward bringing the PA in line with international standards—an argument he said helped convince other ministers.

The finance ministry embedded financial control procedures into the financial management information system his team had set up in 2003. Before any ministry could clear a payment and request that a check be cut, the finance ministry controller embedded there had to run through an automated checklist—based on financial regulations—to determine whether to approve or reject the payment. Based on that input, the system generated an approval or a rejection. People in the unit that had submitted the request for the check received a report that cited the reasons for a rejection and the relevant financial regulations.

The internal control system was fully operational by the end of 2005. But even though Masri and her colleagues had designed it to minimize friction, resistance persisted. Ministers sometimes became quite angry, Masri said. As general director of financial control, she sometimes stepped in to communicate directly with the minister if she felt it necessary. If that did not resolve the issue, she would raise it for Fayyad to resolve.

ASSESSING RESULTS

In late 2005, after Arafat's death and amid growing tension with the PA's leadership, Fayyad left the finance ministry and announced he would run in the 2006 legislative elections. During his tenure, his finance team scored several important achievements in expenditure reform.

The expenditure controls Fayyad and his team implemented from 2002 to 2005 reduced opportunities for corruption and mismanagement and contributed to the flow of funds into the Palestinian Authority. The Inter-Ministerial Reform Committee's June 2002 100-day plan had included unification of all PA expenditure operations under control of the finance ministry, unification of PA payroll administration under the finance ministry, and rationalization of budget preparation. Fayyad's finance ministry performed well in achieving those goals. The public finance reforms were generally more successful than other kinds of reform in the plan, according to a report from an international task force that worked with the committee.[17]

Reconfiguring the process for creating and distributing treasury checks disrupted a system that was vulnerable to corruption and had inflated the costs of goods and services the PA purchased. Under Fayyad, the Palestinian Authority stopped distributing checks it could not fund and eliminated a major source of unfairness. "With that went that entire corruption loop," Fayyad said. "Completely disappeared."

Formalization of the budget process helped rein in discretionary spending while ensuring that the money the legislature allocated was spent as intended. The budget tables showed a reduction in funding of the president's office—once the site of much discretionary spending—and a shift to spending through line ministries. Total outlays to the president's office amounted to about US$104 million in 2002, US$79 million in 2003, and US$38 million in 2004. As a share in total PA spending, those outlays amounted to 8.7%, 6.1%, and 2.4%, respectively. By 2005, the budget the finance ministry drafted had reduced the president's budget further: to 1.4% of total outlays.

For the first time, the finance ministry could enforce limits on the hiring of new personnel and therefore constrain a major threat to the authority's ability to buy supplies like textbooks and medicine. By January 2003, the international task force that had worked with the Inter-Ministerial Reform Committee on its 100-

day agenda declared that the PA's payroll administration was fully under the authority of the finance ministry.[18]

Though implementation took time, by 2005 the finance ministry's oversight had extended to the point that internal controllers were active in every spending unit by approving or rejecting each spending request in accordance with financial regulations based on international best practices.

Transparency improved, too, for the first time enabling the legislature, civil society, and outside observers to know how the authority spent its money. Plus, adherence to the budget process made it possible for ministers to deliberate together and for the legislative council to review and debate government priorities—an essential step toward institution building.

The expenditure controls implemented by Fayyad and his team from 2002 to 2005, together with additional reforms in security spending and revenue management (see companion cases), encouraged partners outside the Palestinian Authority to provide the government with money it desperately needed. Other countries observed more-transparent public financial management and felt they could trust the PA to handle funds responsibly. The budgeting and transparency efforts were well received by the US Congress, which was receptive to the PA's message that it could not further reform without the clearance revenues that Israel continued to withhold in response to the second intifada. President George W. Bush heralded publication of the authority's budget online.

Pressure from the United States helped push Israel to release, in early 2003, the withheld clearance revenues after they had been frozen for two years and to resume regular transfer of PA revenues. In July 2003, just over a year after Fayyad had arrived as finance minister, the United States released its first-ever direct transfer of cash to the Palestinian Authority.[19]

Reengagement with the international community had a direct impact on the authority's revenues. In 2000, total revenues had been US$940 million but sank to below US$300 million in 2002 when Israel withheld the clearance revenues. After Israel released that money, the authority's revenues climbed back to US$1.2 billion by 2005.[20]

Not all the reforms endured, however—even in the medium term. As Palestine moved closer to a January 2005 presidential election and a January 2006 legislative election, the PA began hiring new personnel, and roughly 18,000 entry-level security recruits were added to the payroll after Fayyad stepped down to run for a legislative seat. The total wage bill surpassed US$1 billion in 2005—an increase from US$870 million in 2004. The 2005 wage bill amounted to almost 23% of the West Bank and Gaza's gross domestic product, and the government spent 82% of gross government revenue on wages.[21] Both the wage bill and the ratio of wages to GDP continued to rise annually through 2006, and the size of the public service peaked at 180,000 personnel before the 2006 elections.[22]

In the 2006 elections, Fayyad won a seat on the Palestinian Legislative Council, but Hamas, a militant religious party that the United States and Israel considered a terrorist organization, gained the majority of seats and formed a government. The shift led Israel to again withhold the PA's clearance revenues and caused external financial assistance to plummet, pushing the government into another financial crisis.

REFLECTIONS

Salam Fayyad and his team at the finance ministry perceived strong public financial management as the core of a capable state. To deliver the things people expected of government, such as public safety, a government had to be able to collect revenue to pay for performing those functions and then be able to ensure that the money went where it was supposed to go. Moreover, in a democratic society, an elected legislature should have the opportunity to review proposed expenditures and hold the government to account. That vision motivated and guided the finance ministry's reforms.

In addition to the adages he articulated to colleagues—for example, "Change work processes rather than people"—Fayyad emphasized the importance of being opportunistic when operating in a crisis situation. "If you have the authority to impose reform, don't wait," he said. "Just go out and get it done. If you don't have that luxury [of formal authority], then you have to create that authority."

"Change work processes rather than people"

For a government with less-mature institutions, Fayyad endorsed the value of having a finance minister with strong credentials and an extensive background in the field. "Bringing in a lawyer to be minister of finance may work in the United States or other advanced, mature countries where they have mature institutions," he said. "But in places where you are starting things up, no, you really have to go with accountants and finance people." In a cabinet environment in which all ministers had the same rank, strong knowledge of money and finance provided the credibility and influence needed to make the case for a strong reform agenda.

It was important to have top-level leadership in the finance ministry to implement reforms. "You cannot have financial sector reform unless you have drivers for change, and that comes from the top," said Jihad al-Wazir, who served as Fayyad's deputy finance minister from 2004 to 2005. "I think the biggest issue is whether people trust the government, trust the individual who's in charge of that institution. If you are able to get that trust and belief from your own staff, then I think you can do real change."

Finally, Fayyad's professional style and personal background bolstered his credibility and smoothed the way for many of his actions. "He knew the old ways," said Yasser Abed Rabbo, former Palestine Liberation Organization secretary-general and government minister. "He understood them. He had in mind solutions, but he did not come from outside. He came saying, 'I'm one of you,' and he proved that he is one of us."

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