



REBUILDING FINANCIAL MANAGEMENT IN THE PALESTINIAN AUTHORITY, 2007–2012

Tristan Dreisbach and staff drafted this case study based on multiple conversations with Salam Fayyad in Princeton, New Jersey, during 2019, as well as other interviews conducted in Ramallah, Nablus, Jericho, and Washington, D.C. the same year. The case is part of a series on state building in Palestine in 2002–05 and 2007–11. Case published June 2022.

SYNOPSIS

In 2007, Salam Fayyad accepted the dual post of finance minister and prime minister in the Palestinian Authority (PA). The financial management practices he implemented during his first period as finance minister, from 2002 to 2004, had deteriorated. During the preceding two years, from November 2005 to March 2007, the government had resumed dealing largely in cash, had kept poor records of government financial transactions, and had added more employees to an already bloated public payroll. To reinstitute good practices and implement new reforms, Fayyad and his finance ministry colleagues also had to overcome challenges related to the division of the Palestinian territories into two separate areas governed by competing political parties. Fayyad relied heavily on a small group of trusted staff, delegated important responsibilities so he could also take on the demanding job of prime minister, and set clear guidelines to maximize the long-term benefits from any external technical assistance the ministry hired. Under his guidance, the ministry rehabilitated financial records and quickly created a new financial information system by adapting existing, locally built software; reformed the way the PA used commercial bank accounts to conduct its financial transactions; and filled gaps in capacity.

INTRODUCTION

“All the world stopped helping this government,” said Yousef al-Zamer, who was general director of the treasury at the Palestinian Authority’s (PA’s) finance ministry at the time of the January 2006 legislative elections in the strife-torn occupied territories. After its win at the ballot box, Hamas—considered a terrorist organization by the United States, the European Union (EU), and Israel—formed a new PA government but refused to commit to nonviolence and recognize Israel. As a result, much of the international community withdrew aid from the PA and invoked policies that all but ended the PA’s access to the international banking system. At the same time, Israel stopped transferring customs revenue it had been collecting on the authority’s behalf, thereby cutting off much of the PA’s income. The two occupied territories—the West Bank and the Gaza Strip—plunged into a fiscal and economic crisis.

“The government was highly constrained in its ability to deal with banks, so it started dealing in cash,” said Salam Fayyad, who returned to the PA as finance minister in March 2007, in a unity government under a Hamas prime minister.

The reforms that the finance ministry had implemented when Fayyad had served as minister, from 2002 to 2005, had started to unravel during the two years after he left the post. Fayyad had created a central treasury account to unify revenues, improved the budget process and expenditure controls, built capacity, and strengthened transparency. Without access to modern financial systems, however, the Hamas-led government reverted to cash transactions; the central treasury account fell out of use; and central control over spending became impossible. Ministries reopened separate bank accounts to handle their own individual revenues. And donors devised stopgap mechanisms so they could fund essential services and some government employee salaries, on a short-term basis. The survival of the PA, an interim government set up in 1994 as a step toward a permanent agreement between Israel and the Palestinians, was increasingly in doubt.¹

As conditions worsened, Fatah party leader President Mahmoud Abbas and Prime Minister Ismail Haniyeh, of Hamas, formed a power-sharing government in March 2007. One of the few things on which they agreed was that Fayyad, who had won a seat on the legislative council in the same election that brought Hamas to power, should return to the finance ministry. Fayyad’s earlier success in that role and his independent political affiliation made him an appealing choice.²

Fayyad accepted and drew on his good relations with governments in the European Union and the United States to create a workaround that enabled some donor money to again flow into the PA. In June 2007, however, the power-sharing arrangement collapsed and Hamas asserted control over the Gaza Strip. The two territories now were split politically as well as geographically, and restoration of effective systems in the finance ministry grew even more difficult.

Abbas quickly moved to create an emergency cabinet in the West Bank and asked Fayyad to serve in a dual role—as prime minister as well as finance

minister; Haniyeh maintained a competing cabinet in Gaza. Within days of Fayyad's appointment, Israel, the United States, and EU countries removed restrictions on working with the PA.

Alongside a new set of difficult duties as prime minister, Fayyad had to repair the systems he had earlier worked so hard to put in place at the finance ministry—and he had to navigate new challenges, including the reconstitution of financial information systems now split by a territorial and political divide.

THE CHALLENGE

When Fayyad left his post as minister in late 2005 to run for a seat on the legislative council, the Palestinian economy was beginning to recover from the effects of the second intifada (2000-2005), an uprising by Palestinians against the Israeli occupation. (The first intifada was a grassroots uprising that began in 1987 and continued off and on until late 1993.) The election results dealt a deadly blow to those tentative improvements, however.

Israel and aid donors began to withhold money, to weaken Hamas. The PA's revenues dropped by more than half, to US\$782 million in 2006 from US\$2.1 billion a year earlier. By March 2007, an estimated 165,000 PA workers had not received their full salaries in the year since Hamas had taken power. These shortfalls devastated more than 1 million people directly dependent on those wages. The government also was unable to make social-assistance transfer payments to 47,000 Palestinian families classified as hardship cases. Hospitals and public health centers ran out of essential medical supplies. Beginning in early September 2006, teachers protesting the PA's failure to pay them went on strike for two months, leaving tens of thousands of students without classroom education.³ GDP per capita fell to its lowest point since 1997, as measured in constant US dollars.⁴

Fayyad's first challenge was the most urgent: restore control over the PA's finances. Prior to 2007, the PA's ministries had maintained a careful territorial balance between the West Bank and the Gaza Strip. The finance ministry had been headquartered in Gaza, but in effect the government divided its resources and operations between the two areas. As violence escalated between Hamas and Fatah, killing more than 100 people in June 2007,⁵ the Gaza Strip became off-limits to Fayyad and his colleagues working in the West Bank government. Many essential resources such as servers, files, offices, and the staffs of entire units were suddenly unavailable. The finance ministry's electronic accounting system, which Fayyad had helped implement in 2003, was located in Gaza. "We were afraid that at any time, Hamas could cut the connection to the server," al-Zamer said.

The split between the West Bank and Gaza in mid-June caused almost all access to cease, said Muna Masri, the ministry's general director of internal control. "We completely lost control over operations."

A second, related, challenge was a sudden reduction in human resources capacity. Many finance ministry employees and other civil servants remained in

Gaza, where they continued working for a short time until Fayyad directed them to stay home if they felt they would jeopardize their safety by reporting to his government. As a result—and also due to the restricted opportunities for Gaza residents to relocate to the West Bank—the ministry lost some of its most experienced employees, including people with specialized skills who had important responsibilities. Notably, many were in the budget office, which had been based entirely in Gaza, and the expertise and capabilities needed to quickly restore proper financial management and strengthen controls and transparency going forward were in short supply.

Third, the territorial breakup meant that Fayyad lacked records on the PA's finances from March 2006 to mid-2007, the period that the Hamas government was in power, and he did not have a clear picture of the PA's overall financial standing. "There was no central treasury account, no record keeping—only disparate pieces of information," said Oussama Kanaan, who from 2007 to 2012 was International Monetary Fund (IMF) mission chief in the West Bank and Gaza. "We could not make sense of the accounts. Donor money bypassed the Hamas budget through many different channels. It was a chaotic situation." The monthly financial reporting that Fayyad had initiated in 2002 stopped when the Hamas government took power in March 2006 and ministries began running their own accounts and dealing in cash. Fayyad had to restart that process and find missing information in order to put together a proper budget that would be in line with international standards.

A fourth challenge was the absence of effective legislative oversight. From 2002 to 2005, Fayyad had worked closely with the legislative council, negotiating on annual budgets and answering members' questions about government finances. PA legislation required that the council receive and approve the government's budget every year. The legislature played an essential role in financial management, but the split in government meant it could no longer convene a quorum to conduct its business. The lack of a functioning council meant there would be less debate over important policies and less constructive input for the budget. It would also be more difficult for the finance ministry to communicate with political parties and with the public through hearings and speeches. Fayyad would need to resume practices he used even when the legislature was in session, namely to increase his public appearances and his interaction with civil society organization and unions in order to boost accountability.

Finally, because of his responsibilities as prime minister, Fayyad would have much less time to commit to the finance ministry than was the case during his first stint in government. Much of his time and energy had to go into managing the government—a job that required him to deal with urgent security issues, to plan for development, and to navigate the complex political dynamics of a conflict-affected occupied territory striving toward independent statehood. His cabinet comprised mainly political independents and civil society leaders, with no factional or political party representatives.

FRAMING A RESPONSE

The most-urgent priorities were to put previous financial management reforms back into effect, fill in gaps in the PA's financial records, and build an electronic accounting system to substitute for the system based in Gaza. Fayyad and his finance ministry colleagues also saw the crisis as an opportunity for new reforms. Where previous systems had failed under the Hamas government of 2006–07, the ministry could implement better systems based on lessons learned from those older projects.

Before doing anything else, Fayyad had to address the capacity and human resources gaps at the finance ministry. Although most of the ministry's Gaza staff remained where they were and could not contribute to the work of the West Bank government, Fayyad persuaded the director of the budget office, which had been based entirely in Gaza, to move to the West Bank. That step brought over vital experience and expertise that would have been difficult to replicate given the time pressure that Fayyad faced to fix the PA's financial management.

"That was important," said Mark Ahern, a public financial management adviser to the World Bank for the Middle East and North Africa who worked closely with the ministry. "[The budget director] could bring some continuity and had knowledge." Fayyad also established some new units in Ramallah to make up for the loss of similar units in Gaza—for example, a debt management office, which was important for reestablishing a debt database after the loss of records because of the Gaza–West Bank split.⁶

Fayyad also chose to lean heavily on the trusted and experienced workers he did have in the finance ministry. Thanks to the management practices he had implemented since 2002, when he arrived at the ministry for the first time, people had generally risen within the ministry's ranks based on merit rather than political considerations. The ministry had also succeeded in retaining skilled staff because there were only limited opportunities to work in the private sector, given the conditions in the Palestinian territories, and public-sector jobs were precious commodities. Almost all of Fayyad's high-ranking ministry officials were career public servants who had served in the PA since the mid- to late-1990s.⁷

To balance his work as finance minister, foreign minister, and prime minister, Fayyad chose to delegate many responsibilities and authorities. He generally spent a few hours in the morning at the finance ministry to do essential work and provide guidance before leaving to attend to his other duties for the rest of the day. He selected experienced finance ministry employees to serve on a management team that could execute plans and policies. He relied heavily on his accounting staff—most of whom had been based in Ramallah and were not affected by the split with Gaza—for their technical skills. He empowered al-Zamer by creating the position of accountant general and promoting him to the new post. The accountant general's office managed budget execution—including

payroll, cash management, bank accounts, internal controls, and reporting—and al-Zamer would be the manager overseeing much of the reform agenda.

These senior managers “carried a large amount of the load,” Ahern said. “They were committed to Salam Fayyad as an individual and driven by both that commitment and the goal of building up systems for a future state.”

The finance ministry also needed external assistance from donors to make up for capacity deficiencies, but Fayyad and al-Zamer chose to be very careful about how the ministry used such help. Fayyad worried that the one-size-fits-all solutions offered by external partners were not necessarily the best choices for the PA. He also worried that assistance that did not include a sharp focus on increasing the internal capacity of the finance ministry would lead to less-resilient reform implementation in the long run. Fayyad was determined to do as much as possible with existing finance ministry resources and carefully define the terms of engagement with external technical experts.

Negotiating these arrangements was not always easy. IMF and aid agency teams often insisted that they knew the best solutions to the PA’s problems and did not transfer skills to regular PA employees, al-Zamer said. The ministry, with few exceptions, insisted on assistance delivered instead through training programs, visits, and issue-focused technical advice, instead of through provision of personnel.⁸

Rather than follow a carefully crafted reform plan, Fayyad tried to move rapidly, seizing opportunities as they arose and responding to what seemed the most-urgent priorities. He and his management team rolled out reforms quickly across the government instead of introducing ideas on a small scale to try them out. They recognized that there could be deficiencies in performance initially but that they could fix the problems over time. Fayyad was willing to try new approaches without demanding that initial implementation be perfect.⁹

A vision of Palestinian statehood would help motivate finance ministry employees to implement reforms, Fayyad believed. He and his colleagues saw the development of good public financial management practices as representing a core element of a modern state and viewed their reform agenda as ultimately helping achieve a political solution to the lengthy Palestinian–Israeli conflict. Palestine would be more likely to achieve international recognition as an independent state if it acted as if it was already a capable state and could thus seize the moral high ground.¹⁰

GETTING DOWN TO WORK

Fayyad’s finance ministry quickly reinstated basic procedures that the 2006–07 Hamas government had disregarded, and it began working with an IMF mission to reconstitute missing financial records. The ministry also developed a new, integrated financial management information system, which would benefit many aspects of financial management and government performance.

Rebuilding financial management practices

When the June 2007 government took office, Fayyad replicated the steps he had taken as finance minister from 2002 to 2005. He initiated the preparation of a budget for the remainder of 2007 and a budget for 2008—a process mandated by law that the Hamas government had found impossible to carry out because of the sharp decline in revenues and the prevailing uncertainties. Simultaneously, he moved quickly to reestablish the central treasury account, one of the first measures he had implemented in 2002. The central treasury account had been dormant from March 2006 through June 2007 because of US restrictions on the ability of banks to deal with Hamas-led governments. He also changed the way the PA worked with banks. (Text box 1)

For the most part, the legal and procedural underpinnings were in place already. Fayyad said, “In 2002, I had to manufacture the authority to do things, but in 2007 we just acted on the basis of authority that was well-established.”

With the reactivation of the central treasury account, government agencies could no longer spend out of their own revenue; they now had to rely on money distributed by the finance ministry according to the budget and the current availability of funds in the treasury. To ensure that not a single government account was left outside the net of compliant accounts, the finance ministry opened new bank accounts for all government units and simultaneously issued a blanket order cancelling all existing accounts. In general, he said, “blanket orders based on clear boundaries and definitions are the most effective means of establishing norms.”

To address the difficult situation in Gaza, Fayyad introduced several short-term, stop-gap measures, of which three were especially notable. First, Fayyad’s government ordered the roughly 35,000 PA civil service and civil defense employees in Hamas-controlled territory to report to work. But because of the high risk of violence against public servants in the Hamas-controlled territory, the order exempted employees who feared for their safety if they complied, in which case they could choose not to report without losing their jobs, subject to subsequent review. (Text box 2)

Text Box 1. A Workaround in a Prior Crisis

The most important finance ministry achievement during the brief tenure of the national unity government, in 2007, was an arrangement that allowed some resources to flow to the PA even while US sanctions sharply curtailed access to the international banking system. In close coordination with the European Union and the United States, Fayyad opened a bank account in the name of the Palestinian Liberation Organization, an entity that was not subject to sanctions at the time. “This workaround made it possible for us to receive some funding,” Fayyad said, “and the system we put in place performed several of the functions of a central treasury account.” When he became prime minister and reactivated the central treasury account he had earlier created, Fayyad phased out this operation.

Text Box 2. Staff Safety & Staff Shortages

“As soon as the June 2007 violence subsided, we wanted civil servants and civil defense employees resident in Gaza to go back to work,” Salam Fayyad said. “But we wanted them to do so on the basis of my government’s directives, not Hamas’s.” His government was fully cognizant of the risks people faced, however, and it issued a return-to-work order that exempted security personnel from this requirement and also contained an escape clause for others who felt threatened.

Firefighters, teachers, health workers, and other government employees had to return to their jobs. But if an employee encountered violence or perceived a risk of such, that person could elect not to report and apply to remain at home without losing the job. About 8,000 civil servants took advantage of that option.

“We felt it would be reckless to expect employees to comply, if by doing so they would risk their lives,” Fayyad said. He stressed that in a crisis situation it was especially difficult to balance political objectives, management imperatives, and the need for there always to be an overall moral underpinning, when making policy choices. The directive he issued aimed to thread the needle. The process set up to screen the requests meant there was also a formal record.

Second, Fayyad’s government oversaw the creation of new banking arrangements that permitted most payments to Gaza to exclusively pass through banks located in the West Bank, so that the government would have the maximum possible oversight and control over those funds.¹¹ Most of these commercial institutions had their headquarters in Ramallah and had integrated financial systems that enabled them to exercise a high degree of control over transactions. “We had a healthy relationship with the banks,” Fayyad said. “I never pushed them to lend us more than what they were willing to offer. At the same time, they fully deferred to us on matters related to the integrity of our operations.” When they encountered pressure from Hamas, bank managers in Gaza branches were told to say they could not do anything without instructions from headquarters in Ramallah.

Third, the PA also continued to pay for delivery of some services and social assistance support in Gaza. The processing of those expenditures was difficult, however, because Israeli restrictions on financial activity in Gaza contributed to cash shortages at banks. Fayyad adhered to the principle that the government should make payments only by means of direct deposits to bank accounts, which would ensure both (1) that the finance ministry could track payments and (2) that payments went to the intended recipients.

Reconstructing financial records and creating a financial plan

Fayyad moved quickly to close the gaps in the missing and incomplete financial records from the Hamas government, whose record keeping and reporting had been nearly nonexistent. “There were receipts in cardboard boxes on the floor,” he said.

Reconstructing financial records to allow a rigorous and comprehensive assessment of the fiscal situation was an essential step toward the development of a budget and a fiscal strategy—key aspects of planning that would help the PA reengage with the donor community. To take on the task, Fayyad enlisted help from Kanaan, the IMF mission chief for the West Bank and Gaza, whom he had known since the mid-1990s. Kanaan’s focus was to help prepare a proper PA budget in line with international standards, and a key step toward that goal was the preparation of financial records.

“It was a chaotic situation from a governance viewpoint,” Kanaan recalled. Because there had been no meaningful recordkeeping, he said, “You could not make sense of the accounts.” Kanaan worked with Fayyad and finance ministry officials on two key tasks. The first was to take stock of the fiscal situation through a painstaking reconstruction of the fiscal operations that had taken place under the Hamas-led government from March 2006 until March 2007. The second focused on the development of a macroeconomic and fiscal strategy whose success depended on time-sensitive actions by the PA, Israel, and the donor community. The PA’s obligations centered on public-sector reforms and the establishment of good governance practices. Israel’s role was to relax its stringent economic and trade restrictions on the West Bank and Gaza. Donors were to provide financial assistance for the PA contingent on the PA’s undertaking key reforms as a demonstration of its capacity to govern a full-fledged state.

A major part of the project involved accounting for debts accrued through government borrowing and through nonpayment of salaries and other bills. Much of the pertinent data had to be obtained from Gaza when possible. During the short period when Gaza-based ministry employees still held their jobs after the spilt between the West Bank and Gaza, Kanaan contacted them remotely to obtain some of that information. He used donor records to help fill gaps and helped the finance ministry re-create its own accounts, said Asad Awashra, financial director at the ministry.

After several weeks, the ministry had a reasonably clear picture of the PA’s finances that it could use to engage donors in discussions about the government’s future needs. By December 2007, the PA was able to prepare a three-year development plan that was consistent with international standards and present that plan at a major donor conference.¹² Donors responded with commitments to provide support for Fayyad’s government.

Full reconstitution of the financial records took more than a year. And even after considerable time and effort had been expended on the project, the ministry still could not find certain information such as wages processed through accounts outside the finance ministry. Despite those shortcomings, the IMF agreed that the data were as complete as possible.

Going forward, Fayyad wanted to make financial data more transparent and accessible. He directed ministry employees to publish monthly financial statements on the ministry’s website. He asked staff to publish the statements by

the 10th day of every month but pushed the deadline back to the 15th after the employees responsible insisted that the early date was too ambitious, Awashra said. Fayyad emphasized that the statements constituted a top priority, and ministry employees sometimes worked on weekends and public holidays to post data on time. In the rush to prepare the statements, the ministry occasionally made errors that it later corrected, but Fayyad said he greatly valued regular and punctual reporting and accepted occasional mistakes in service of that goal.

“Publish even if it’s not perfect,” Awashra remembered being the directive. “You can correct reasonable errors later.”

Creating a new financial management information system

Another priority was the creation of a new electronic accounting system. The Ramallah-based finance ministry could not use the setup Fayyad had introduced a few years earlier, because it was based in Gaza. Fayyad and al-Zamer saw this problem as an opportunity to install a better system in the West Bank—with the full capabilities of a modern integrated financial management information system.

“I thought maybe I should take advantage of rebuilding the system to restructure work processes in a way that ensured neutrality in the management of money,” Fayyad said. He envisioned the new financial system as more than just a computer interface that helped government agencies enter data. It could define procedures essential to financial management and could change the way people did their jobs in the PA. Fayyad delegated responsibility for the initiative to al-Zamer.

“The system we had before 2007 was a very weak one,” al-Zamer said. “We needed something that covered our needs in both preparation and implementation of the budget.” Al-Zamer had started to make these changes in 2005, but his efforts had come to nothing after Hamas won the elections and the system fell into disuse. Now, al-Zamer wanted to build a system that would be better at tracking and controlling expenditures and producing financial statements. The strategy was to create a basic accounting system as soon as possible to cover the ministry’s urgent needs and eliminate the possibility that vital information could be lost. Then Fayyad’s colleagues would gradually expand these capabilities. In the meantime, the ministry had to ensure that there were hard-copy records of all transactions.

In mid-2007, Fayyad, Al-Zamer, and finance ministry colleagues consulted with software companies and learned that creating even the most basic accounting system from scratch would take about a year, which was far too long for their urgent needs. They instead had to find an existing system that they could quickly adapt to their specifications.

Aid donors had pushed for the PA to source the system from outside Palestine, said World Bank public financial management adviser Ahern, but the finance ministry team was determined to explore local solutions they could adapt to their own specifications. After evaluating several options in both government

and the private sector, the team discovered that a system in operation at the education ministry was closest to what the finance ministry needed. The finance ministry contracted with Bisan, the Palestinian information technology firm that made the system, to create a new version. The time to delivery and the cost were both minimal compared to other alternatives.

Al-Zamer then identified external assistance that could help him implement the project, choosing advisers from the UK's Department for International Development (DFID, now the Foreign, Commonwealth & Development Office) who had skills in coding and mapping such systems. Because it was important to work quickly, al-Zamer assembled a small project team of senior managers to collaborate with Bisan and DFID personnel. After about five months, the new accounting system was ready to put into operation. Its first task was to process finance ministry salary payments beginning in January 2008.

"In terms of speed and effectiveness, it was really remarkable," Ahern said. "A number of consultants came in with the expectation that a homegrown system would be no good but then decided it was actually in good shape." Still, there were shortcomings that had to be corrected. The ministry arranged for London-based professional services firm Ernst & Young to review the system and identify weaknesses—especially regarding security.

Al-Zamer and Fayyad saw the system as one step toward a more comprehensive solution. The version launched in 2008 "fulfilled just our basic needs," al-Zamer said, and neither connected to line ministries nor integrated with the ministry's budget preparation work.

In succeeding months, al-Zamer began rolling out the system across government. He chose to start with the biggest and most difficult offices because if they came on board successfully, it would be much easier to expand the system to other ministries and agencies. Al-Zamer first connected the president's office and then introduced the system in the ministries of health and education, which were responsible for much of the PA's expenditures. He continued to roll out the system to other PA ministries, agencies, and local governments, and when necessary, he said, he appealed to Fayyad, who lent his political influence to push reluctant units of government to accept a new way of handling their finances.

The system enabled government institutions to work more efficiently by empowering them to make spending decisions within limits set by the finance ministry, without having to rely on the finance ministry to execute those expenditures on their behalf. "In the past, everything had been inside the finance ministry," al-Zamer said. Having all ministries on the same system also made cooperation between various PA offices easier when it came to implementation of projects such as construction of telecommunication lines, which involved coordination between local governments, ministries, and telecommunication companies. In particular, it eased health expenditures, which could be complicated in Palestine, where patients often transferred between local health facilities and Israeli or Jordanian hospitals for care.

“In some ministries, we built financial management from zero,” Awashra said. Expanding the system was difficult when ministries had poor capacity. In such cases, al-Zamer had to send finance ministry employees to work closely with staff on implementation, including installing the system, training personnel, and integrating the system into workflows.

Some local governments resisted using the system. Al-Zamer tried to persuade them that having an electronic financial management information system was the global norm and Palestine should embrace this opportunity to keep pace with other parts of the world. He also explained that it could help them do their jobs.

Despite these initial challenges, the new system proved to be an effective tool for decentralizing powers from the central government to lower levels. For example, governors of the 16 governorates of the PA had held largely political roles with little direct decision-making power. The new financial management system required governors to be involved in disbursements of money from the central government.

“There was real work for the governor,” al-Zamer said. “Before, it was just political. The governor just made announcements. Now a governor had to work.” Decentralization through this system enabled local governments to take more responsibility for providing resources their own communities needed, such as funds for rebuilding homes damaged or destroyed by conflict.

Improving the financial management system

The finance ministry continued to develop and refine the new financial management information system over several years. Fayyad and al-Zamer identified outside advisers who could help achieve their goals for this project. These advisers “emphasized monthly reports and were trying to encourage more transparency,” Ahern said, and they contributed to building the system’s capacity to produce financial statements. The PA had no cash management department at the time and worked with a Swedish expert to develop the system’s cash management capability. External partners also helped extend the system to facilitate debt management. Using such assistance, the ministry launched a second version of the system in 2009.

In 2010, the ministry added a module to help prepare the PA’s annual budget. Al-Zamer’s team integrated the system with the budget and connected it with the payroll system so that no payment could occur without an appropriation. That same year, the government started using the system to make cash payments and established commitment controls at spending units.

In the last stage of the system’s development, a DFID adviser helped move the system from cash accounting to accrual accounting, which records revenues and expenses when they are incurred regardless of when cash gets exchanged. Al-Zamer’s team incorporated that change into the third version of the system, launched in 2010.

“At the end of 2010, we finished everything related to the budget—from preparation to implementation or execution,” al-Zamer said. Fayyad commended the result: “It has all the fundamental work processes that are necessary to execute and control expenditures.”

Rolling back payroll expansion

A more politically difficult task was reducing the government payroll, which had grown rapidly under the Fatah-led government prior to the 2006 legislative elections and which continued to grow under the Hamas-led government after the vote. Much of the hiring was politically motivated because both governments had tried to cultivate support by doling out jobs. In 2005, the PA had almost 150,000 employees—including both civil servants and security workers. By 2007, that number had reached 189,000, by some estimates, despite hiring freezes the PA had committed to prior to the elections but disregarded.¹³ In general, the newly hired employees did not perform essential positions in government. For example, there were Jerusalem affairs units and women’s affairs units within each ministry, despite the fact that there were whole ministries devoted to each of these domains, and in the security services there were many workers who collected salaries but did not show up to their jobs.

The PA could not afford to pay the full salaries of everyone on the payroll, so Fayyad had to eliminate jobs. His biggest worry was that he would appear partisan in the manner he chose to make the cuts: If he simply fired everyone Hamas had hired, it would likely inflame tensions in Palestine’s already volatile political atmosphere. “It would appear as though we were doing this on political grounds,” he said. “Excluding people because of their political identity. No, that’s not the way we were going to do it.”

To make the decision more politically acceptable, Fayyad chose to remove PA employees added shortly before the 2006 elections. That decision ultimately meant he would cut more people hired under the previous Fatah government than under the Hamas government, thereby reducing the credibility of any claim that he was acting out of malice toward Hamas. Cabinet members found the decisions wrenching, but were comforted by the fact that political affiliation was not a factor in decisions about whom to remove from the payroll. After hard deliberation, Fayyad’s government announced a decision to remove thousands of civilian employees and security workers, subject to review of the legality of their appointments.¹⁴ Cutting payroll was difficult, “but it was the right thing to do,” Fayyad said.

To lessen the blow, the PA provided social assistance payments for those who lost their jobs, recognizing that they were not at fault for the government’s hiring decisions. Fayyad succeeded in reducing the number to 143,000 by 2008, partly through cuts and partly through normal attrition or early retirement programs.¹⁵

Later, Fayyad was able to identify and remove ghost workers in Gaza by securing a court order that allowed the Palestinian Monetary Authority to

identify people on the government payroll who consistently withdrew money from their bank accounts at automated teller machines (ATMs) located in foreign countries. If an individual protested that he or she was abroad for medical treatment, the salary was restored. Fayyad said the overwhelming majority of those flagged were people who had moved abroad and were not reporting for government duties.

Managing the budget process

Fayyad reinitiated the process of preparing a formal annual budget for the PA, but the lack of a functioning legislative council complicated the task. For a variety of political reasons the council could not muster a quorum.

The organic budget law, which the PA had adopted in 1998, set out a clear process: Every May, the finance ministry had to submit a report to the cabinet on economic and fiscal developments and propose fiscal measures. In July, the ministry had to issue a budget circular clarifying the main fiscal policies and budget preparation instructions for the ministries. In October, the finance minister submitted a draft budget law to the cabinet. After approval, the budget went on to the legislative council, which then discussed the budget and voted to approve it by the end of the calendar year.

Fayyad had to create a new process. The budget office at finance instructed other ministries to nominate budget teams and gave each team log-in credentials for the financial management system's budget preparation module. Ministries identified priorities, strategies, and programs and entered the details into the system. The finance ministry then issued instructions for preparation of a detailed annual budget, which the budget office discussed with individual ministries before issuing expenditure ceilings for the coming year.¹⁶ The process was not perfect, but it provided for a degree of negotiation and planning that had been lacking under the Hamas government. Approval of the budget was wholly the decision of the president in the absence of a functioning legislature.

With no council involvement in the budget process and therefore no public hearings on the budget, Fayyad set a priority on communicating procedures and decisions to the public. He decided to invite local civil society organizations, unions, and the media to public meetings at which he answered questions about the PA's finances. He also attended annual budget discussions organized by Aman, the local affiliate of Transparency International. A few members of the legislative council participated in these discussions, and, Fayyad also met from time to time with the legislature's budget and finance committee, which had no legal standing, but which could provide important feedback.

Reforming banking operations

Beginning in 2007, as Fayyad and al-Zamer moved to rebuild the ministry's operations, they saw an opportunity to correct a related, systemic challenge. All government revenues went to the finance ministry's central account, with the ministry transferring funds to units of government depending on budget

allocations and the amount of cash available. But there were problems with the way the government used that system.

Unlike most governments, the PA did not have a central bank and therefore had to use commercial bank accounts for transactions. (A branch of the Arab Bank, for example, hosted the central treasury account.) That arrangement increased costs. Ministries relied on PA accounts in commercial banks to fund their expenditures, but the PA's erratic cash flow meant that even if the budget authorized an expenditure, there was sometimes insufficient money in an account to cover the transaction, which caused ministries to incur overdraft fees—a burdensome expense for the cash-strapped government. “The interest rate [on overdrafts] was 5 to 8%,” al-Zamer said. “When we calculated how much we lost as a result of these bank accounts, it was a huge amount of money.”

Fayyad first considered the creation of something equivalent to a central bank for the PA, but al-Zamer objected on the grounds that such an initiative required money and resources the PA did not have. “If you go to the government [central] bank model, you need a system, you need employees, you need a building,” al-Zamer said. “It will cost you a lot of money.” Instead, to eliminate the overdraft problem, Al-Zamer wanted to reform the way the PA used commercial banks.

Al-Zamer worked with representatives of Bisan, the Palestinian information technology company that helped build the financial management information system, and officials of the Bank of Palestine, a commercial bank, to find a solution. The three adapted the financial management information system so it would communicate to the Bank of Palestine a daily expenditure limit for all government spending units, each of which had a special expenditure account at the bank. The bank then applied the day's limit to each account, setting a hard cap on the amount available for withdrawal, and thereby forcing units to set priorities.¹⁷ The ministry called the system a “zero-balance account.” It reflected international best practice.

“When a ministry makes a withdrawal, we calculate it at the end of the day, and it is reflected automatically in the [central treasury] account,” al-Zamer said. “In the morning and at the end of the day, it's zero. There is no problem at all with mismanagement of bank accounts. This is how we solved it.”

Until 2009, the system required that the finance ministry communicate with the bank every day to gather information on the amount withdrawn from the PA accounts. That year, a committee in the ministry oversaw the creation of a database that improved the process by automatically collecting the information. Bisan later sold that database solution to Somalia and other countries that faced challenges in using a traditional government banking model, al-Zamer said.

OVERCOMING OBSTACLES

Although the reconstitution of records and the creation of a new information system greatly improved financial management in the PA, there was

a persistent issue at the local government level that drained PA finances and contributed to the resource shortages that plagued the authority. Fayyad described these as a “culture issues” or norm coordination problems.

Municipal governments collected electricity payments from households and paid an Israeli utility company for the municipalities’ total electricity usage, but they often fell behind. Fayyad said this had not been a significant problem in the West Bank prior to the second intifada, but as that crisis strained the economy, households could not cover all of their expenditures and found they could usually get away without paying the local government for electricity. In turn, the local government did not pay the Israeli provider.

“Eventually, more and more people stopped paying,” Fayyad said. “When I became prime minister, electricity arrears amounted to about 20% of the budget, or 9% of GDP.” Israel responded by deducting late payments from the clearance revenue money it transferred to the PA each month, meaning that the PA had to foot the bill for citizens’ failures to pay for electricity.

Property tax was another area in which the PA lost revenue when citizens and local governments did not pay their bills. Municipal governments collected property taxes from their residents and transferred that revenue to the PA, which in turn would transfer about 90% of it back to the municipalities.¹⁸ The local authorities, however, were often behind in collecting property tax payments and the central government, due to liquidity problems, was often late in transferring back the local governments’ share of the property tax receipts.

The finance ministry developed a solution to both problems. The first step was to introduce incentives to encourage local governments to pay the bills they owed the electricity provider. As an inducement, the plan provided that the PA’s finance ministry would fund 20% of a municipality’s total electricity costs. But if a municipality still did not pay its full bill, the finance ministry would deduct the difference from future central government revenue transferred to that municipal government’s account. As a second, broader incentive, the plan banned municipal governments that owed money to the PA—be it for electricity costs, property taxes, or anything else—from making any financial transactions with line ministries, effectively cutting off municipal governments from resources and assistance they required.

Those measures, while important, were not nearly effective enough to make a dent in the losses sustained by the treasury due to nonpayment by customers. To change social expectations and behavior, the government needed to grab people’s attention and send a clear message that going forward, things would be different, Fayyad said. His team quickly enacted a series of bright-line rules that he knew would probably require some exceptions at a later date, but would leave no doubt about the norms leaders sought to revive.

Central to this effort was a decision to make most public services available contingent on the potential beneficiary presenting certified evidence that his or her tax obligations to the local government were fully paid or regularized. In other words, applicants for almost any public service with the exception of birth

and death registration had to demonstrate non-delinquency with respect to local taxes and utility bills. Local governments were instructed to issue such certificates only when a person owed no electricity debt or when such debts were regularized by a combination of partial payments and rescheduling.

The union of civil servants challenged the constitutionality of this measure, and a high court issued an injunction pending a full examination of the case. However, the government responded with a detailed legal brief that led to a final judgment that lifted the injunction

The combined effect of these measures was a dramatic decline in the treasury losses, from a peak of about \$450 million to \$100 million annually. The finance ministry later reduced the amount of assistance it provided for electricity payments from 20% to 5% of the total electricity bill owed to the Israeli provider. The subsidy was to cover the cost of electricity provided to citizens who were unable to pay. (Use of pre-paid meters also helped reduce the electricity deficit, and the assurance that “no one was going to be denied access to electricity because of poverty” helped ease the introduction of this new policy.)

ASSESSING RESULTS

Fayyad’s return to the finance ministry in 2007 led to significant improvements in the PA’s financial management, even though Fayyad had to juggle his finance minister duties with his broader responsibilities as prime minister. With the help of the local IMF mission, the ministry reconstituted missing financial information from previous years to the extent possible, thereby enabling the PA to create a financial framework in the form of a clear plan that donors could follow as a basis for resuming or increasing assistance to the government.

Under Fayyad’s leadership, the finance ministry created a new financial management information system to replace a system based in Gaza that the PA had used prior to the split between the West Bank and Gaza governments. That system, built by a Palestinian company, met modern data standards and promoted transparency and accountability in the PA’s financial transactions. All of the elements of a sound budget-execution system were in place by 2008, according to the Overseas Development Institute, an international-development research group based in London, but the finance ministry continued upgrading the system through 2010 to expand its capabilities.¹⁹

The financial information system had significant benefits across the PA. For instance, it facilitated transactions between different units of government, such as local governments coordinating with ministries on development projects. The Libyan government later adopted the system for its own use.

The PA earned higher grades in a number of categories in the Public Expenditure and Fiscal Accountability assessment in 2013 compared with its 2007 scores. (The assessment was produced by a multilateral program that the World Bank, the IMF, and several European donors supported.) Areas of

improvement were (1) the degree to which government expenditure matched the original approved budget; (2) public access to key fiscal information; (3) the recording and management of cash balances, debt, and guarantees; (4) the effectiveness of payroll controls; (5) the effectiveness of internal audits; (6) the timeliness and regularity of accounts reconciliation; and (7) the quality and timeliness of annual financial statements.²⁰

Fayyad used the dream of Palestinian statehood as a motivation for improving governance in the PA. Although the agreements between Israel and the Palestinians and growing Israeli settlements in the West Bank infringed on the PA's sovereignty, Fayyad hoped that building stronger government institutions would help make the case for Palestinian independence to the international community. In 2009, he launched a plan that explicitly tied together state building and statehood, setting a two-year deadline to reach a set of governance goals. And in 2011, the United Nations, the World Bank, and the IMF released reports affirming that the PA appeared ready to take on the responsibilities of full sovereignty over its territory.²¹ But the Israelis and the Palestinians could not reach an agreement on a two-state solution, leaving the PA, which had always intended itself to be a transitional government, stuck.

REFLECTIONS

When Salam Fayyad returned to the Palestinian Authority as finance minister in 2007, he insisted that the government maintain ownership over reform implementation. He was wary of external partners offering one-size-fits-all solutions that were not necessarily suited to the Palestinian context, and he wanted to ensure that government workers would benefit from the reform process in the longer term through training and capacity building.

That mind-set led Fayyad to resist some of the proposals by external partners, such as the procurement of a financial management system from an outside vendor. Ultimately, the PA added capacity by working with external specialists that Fayyad and his colleagues selected for their specific knowledge and experience. Fayyad said that that strategy had led to successful implementation. "Use your own staff," he said. "Don't use too much assistance."

While other low-income or conflict-affected governments typically focused on financial reforms they could implement with the cooperation of a small number of people in central ministries, the PA's finance ministry emphasized budget execution and extended its reform efforts across spending ministries. This approach was possible in part because the PA benefited from having a greater number of competent and well-educated civil servants throughout government than was the case in small and fragile states. Fayyad could also rely on trusted staff in the finance ministry to manage reform implementation on a broad scale, whereas many small countries lacked similar management capacity.²²

The finance ministry operated without a reform plan, and without formal project management systems, prioritizing flexibility and ability to take advantage

of opportunities, given the PA's difficult circumstances. That strategy reduced bureaucratic delays and led to speedy implementation of some of the initiatives, but it caused achievement of some goals to lag, a World Bank report in 2012 concluded.²³

The reform effort benefited from relatively stable leadership at the finance ministry for roughly five years.²⁴ Fayyad, who had first implemented reforms in the period from 2002 to 2005, assumed the post again in 2007. He left the ministry in May 2012 but returned briefly upon the resignation of his successor, Nabil Kassis, in early 2013. He resigned both roles in May 2013. Yousef al-Zamer, the accountant general, remained in the finance ministry leadership through 2013, as did Muna al-Masri, another trusted reformer whom Fayyad named deputy minister of finance. Those leaders ensured that the finance ministry continued to focus on reforms and remained committed to their implementation.

The small size of the finance ministry's decision-making team enabled rapid adaptation, but it had some downsides. For instance, the success of reforms depended on key managers who bore heavy workloads, according to the 2012 World Bank report. The involvement of a relatively small group of finance ministry employees in the reforms led some other managers and staff in the ministry to feel excluded from the process.²⁵

Leading change was far from easy. The success of any reform was never ensured in the context of an occupation. Israel could halt transfers of the PA's customs revenues to the PA's central treasury account at any time, dealing a devastating blow to the government. Citizens could grow frustrated with the halting provision of public services during these episodes. And without reconciliation among Palestinian political factions and clear steps by Israel to help realize the "two-state solution" that diplomats had earlier envisioned, this frustration could empower those whose interests did not lie with good governance. It favored patronage politics over the kind of agenda Fayyad and his colleagues sought to pursue.

Over time, these circumstances sapped al-Zamer's optimism that a better future was possible. Al-Zamer said that before 2011, he had believed that building better governance from the bottom up could lead to statehood. "After that, I didn't believe in it," he said. "I believe that [the Israelis] don't want any success for the Palestinian people. Put simply, they don't want a Palestinian state.

"It's not easy to build a state under occupation," al-Zamer said. "You will always have a problem. You will always fail. Even if you prepare another reform in the ministry of finance, in the end it will be nothing. It will always collapse. If you don't solve the political problem, everything will be rubbish."

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