

Into the Breach

Salam Fayyad and Palestine



INNOVATIONS FOR
SUCCESSFUL SOCIETIES

MANAGING REVENUE AT THE PALESTINIAN AUTHORITY, 2002 – 2004

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

“Could the Palestinian Authority survive?” That was the question on many Palestinians’ minds when Salam Fayyad became finance minister in June 2002 and the cash-strapped government was struggling to pay its civil servants and suppliers. To avert a collapse, Fayyad quickly took steps to increase government revenue. He developed a system that would direct into a single, centralized treasury account all taxes, fees, and other income collected by government offices. He created a fund that consolidated the Palestinian Authority’s tangled and largely opaque commercial and investment assets and contracted with an outside firm to conduct a full audit of those holdings. He also took action to reduce smuggling and assert control over the tobacco authority and petroleum commission—two autonomous PA agencies plagued with management problems. The reforms required Fayyad to navigate political resistance and an entrenched administrative culture wary of financial transparency. Fayyad’s achievements enhanced efficiency, helped restart the flow of tax revenues withheld by Israel, and enabled the PA to attract external support and investment, quashing—at least temporarily—an existential financial crisis.

INTRODUCTION

When Salam Fayyad became finance minister of the Palestinian Authority (PA) in June 2002, he joined a government in crisis. “It was chaotic, with lots of violence, killings, and destruction everywhere,” he said. “We were trying to make ends meet, with civil servants often going unpaid or underpaid, unemployment going through the roof, and the economy tanking.”

It was the height of the second intifada, an uprising of Palestinians against Israeli occupation of the West Bank and Gaza Strip. Israel responded to the unrest by reoccupying Palestinian cities and withholding the revenues it collected on behalf of the PA, which did not control its own borders. The PA was less than a decade old, created in 1994 as the result of agreements between the government of Israel and the Palestine Liberation Organization (PLO), the organization headed by Yasser Arafat that fought against Israel. The intention was for the PA to serve as an interim government in the West Bank and Gaza until the Israelis and the Palestinians reached a final settlement on the status of Palestine. By 2002, with Israeli tanks in the streets and economic hardship increasing, it seemed that the PA had not been able to bring its citizens any closer to statehood. Humiliatingly, Israel had carried out two major assaults on the presidential compound in Ramallah—the de facto capital of the Palestinian territories—forcing Arafat, who had become the PA’s president, to live under siege for weeks at a time.

The survival of the PA was in doubt. “Around that time, some intellectuals started to call for the PA to dissolve itself,” Fayyad said. “They said it had outlived its usefulness, and maybe it should just hand over the keys.” But Fayyad was not ready to give up. He said he believed that strengthening the PA was a step toward the ultimate goal of Palestinian statehood.

The PA desperately needed money. Violence and Israeli-imposed restrictions on Palestinian economic activity had exacted devastating tolls on commerce, incomes, and, consequently, tax receipts. The loss of access to nearly two-thirds of the PA’s revenues—namely, those commonly referred to as *clearance revenues* that Israel collected on behalf of the PA under the customs union arrangement between the two sides—had already reduced tax receipts. The government’s overall revenue intake had plummeted by more than two-thirds since the onset of the second intifada: from US\$939 million in 2000 to just US\$296 million in 2002.¹ The amount was far too low to meet expenditure commitments and led to hundreds of millions of dollars in unpaid bills.² 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.³ Despite emergency monetary support from Arab nations and the European Union, the government was on the verge of collapse.

For the PA to survive, Fayyad had to fix its financial management system, and his most urgent priority was to redress the lack of control the finance ministry had over the authority’s revenues. Ministries and agencies held money in accounts in commercial banks, keeping the revenues they collected, instead of

transferring them to the central treasury. As a result, it was impossible to know exactly how much money the PA had and where that money came from—or where it was going. Officials spent the funds at their own discretion and could even exceed what the PA’s budget allocated them, thereby subverting the legislature’s authority to review and approve the government’s annual spending.⁴ In 1997, the International Monetary Fund (IMF) had estimated that about one-quarter of the PA’s public revenue went to accounts outside finance ministry control.⁵

Fayyad was a political outsider with no government experience. He knew he had to centralize the PA’s accounts and cement the finance ministry’s authority over all of the government’s holdings, but implementing such changes would not be easy. Powerful people in the West Bank and Gaza benefited from the status quo, and Fayyad worried that the endeavor might be impossible and that failure could mean the collapse of the PA.

THE CHALLENGE

Even though he had no background in politics or government service, Fayyad did know his ministry’s work well. He had served as the International Monetary Fund’s resident representative from 1995 to 2001 and had just started a post with the Jordan-based Arab Bank—the largest commercial bank in the West Bank and Gaza—when Arafat asked him to join the government.

In Fayyad’s estimation, the ministry’s most important priority was to shift into a single treasury account all of the fees, taxes, and other income the PA collected. The fact that much revenue did not flow into the treasury caused liquidity problems that required the PA to reduce its expenditures, borrow money from banks at high interest rates, and accumulate arrears to the private sector, which raised costs.⁶ Suspicion that money the PA collected went to finance extrabudgetary outlays without the finance ministry’s knowledge—and outside of legislative oversight—alarmed some Palestinians as well as donor countries, and it was one of the weaknesses that Israel had cited to justify its withholding of the PA’s clearance revenues. Even if ministries or government-owned enterprises simply retained fees to finance their own operations during periods of uncertainty, inability to track revenue could easily disguise diversion to individual pockets or to purposes the Palestinian Legislative Council had not approved. Tighter control and more transparency were essential to solve those problems.

Part of the problem was that ministries retained fees they collected for services they administered. The PA also held significant commercial assets outside the finance ministry’s control, including partnerships with private investors in various businesses, such as hotels, a casino, banks, telecommunications providers, and even a flour mill.⁷ In 2003, the IMF estimated that those holdings were worth US\$633 million. The assets and commercial operations produced roughly US\$300 million in profits from 1995 to 2000 and continued generating profits through 2002, but that money

remained in separate accounts that were associated with those businesses and were beyond the purview of the finance ministry.⁸

There were also public import monopolies—most notably on petroleum products and cement. Other monopolies and quasi-monopolies run, directly or through related parties, by Palestinian government officials, including members of the security forces or by businessmen with close ties to the PA, spanned a vast array of commercial activities and imports such as cigarettes, and building materials, according to Fayyad.

The PA used money its commercial interests collected to fund off-budget expenditures. According to Fayyad, the largest source of financing for off-budget expenditures was the petroleum commission, which Arafat would order to send money directly to designated beneficiaries, which included both individuals seeking help and PA institutions—such as universities and municipal governments—that had asked the president for financial assistance.

To address those challenges, Fayyad had to confront a deeply embedded administrative culture that rejected financial transparency. Many of the PA's top-level officials had come from the PLO, whose leaders had been in exile in Tunisia before returning to Palestine in 1994 to create a new government. In the PLO, opacity had been a virtue; it was better that Israel not know details about the organization's finances and operations. "Arafat and the other leadership came from the diaspora, with a mind-set of revolution and working in secret," said Azmi Shuaibi, an anticorruption activist who had served as a minister in the first PA cabinet from 1994 to 1996.

The aversion to sharing information about government finances was especially apparent when it came to the PA's business activities. Fayyad faced a major problem even in simply finding information about what the PA owned or invested in. During a public inquiry in 1997, the Palestinian Legislative Council had determined that the government partially or fully controlled companies that the General Audit Institution—the auditor general—did not monitor. The government budget did not include revenues from these companies, and the PA did not make the finances public—even to legislators. The legal status of these commercial holdings was unclear. There were no balance sheets or published annual reports, which meant that even though it got estimates, the finance ministry did not know for certain how much profit the PA's commercial activities generated. The public inquiry had also showed undisclosed commercial dealings in which public officials gave private-sector actors exclusive privileges and contracts.⁹

The person who knew the most about the PA's holdings was Arafat's economic adviser, Mohammed Rashid (commonly known by his nom de guerre, Khaled Salam), an Iraqi Kurd who grew close to the PLO leadership while studying in Beirut in the 1970s.¹⁰ In addition to his close relationship with Arafat, Rashid headed the Palestine Commercial Services Company (PCSC), which had monopolized the cement trade since 1995 and used the profits to invest in dozens of other ventures, including a casino and a telecommunications company.¹¹ "He [Rashid] was the only one at the time who knew what was going

on,” Fayyad said. “He was by far a lot more important than the minister of finance in the system.”

Fayyad said he wanted to end the secrecy and make sure the government, the legislative council, and the public all knew exactly what the PA owned. He added that he expected political resistance from powerful people, including Rashid and Arafat himself. The president had placed close associates in leadership positions at the petroleum commission, the tobacco authority, and other moneymaking entities. They were people who derived power (1) from allocating resources to people the president wanted to help and (2) from their ability to approach the president on behalf of other beneficiaries. The arrangement created opportunities for rent seeking—amplified by the existence of unnecessary administrative steps and bottlenecks that other Palestinians then needed extra help to navigate. The money these enterprises earned and spent flowed entirely outside the oversight of the finance ministry and the legislature, contravening democratic norms.

Jihad al-Wazir, who worked in the planning ministry in 2002 and joined Fayyad as deputy finance minister two years later, said: “Fayyad wanted to get rid of these power centers, the ones that were not playing by the rules. These guys reported directly to the president and had alliances with security services, with the president’s office, with the Fatah cadres, and with the street.”

For Fayyad, the challenge was to bring revenues under the ministry’s control while minimizing the political backlash that might jeopardize his efforts to implement reform and ensure the government’s financial solvency. It was especially important to work carefully with the president, who could obstruct anything Fayyad tried to do. Fayyad expected that the beneficiaries of the system’s dysfunction would appeal directly to the president to preserve the status quo.

The beneficiaries included not only the president’s associates but also the PA’s ministries, which had used their multiple accounts to go beyond budgetary allocations, giving them more freedom to spend money in ways they chose.¹² Ministries that collected money through various fees retained those revenues to help cover their expenses. A centralized financial management system would raise concerns about the timely flow of operating funds, given the finance ministry’s poor record on that score. Fayyad had to convince the ministries that this reform was in their interest.

FRAMING A RESPONSE

When it came to establishing a reform plan, Fayyad did not have to start from scratch. The legislature, reform-minded cabinet ministers, and aid donors were already agreed that consolidation of all PA revenues into one treasury account was a pillar of public financial management. A 1999 report by an international task force on reform in the PA had set such consolidation as a top financial governance priority.¹³ In early 2000, Arafat had even issued a reform decree—developed with help from Fayyad, who was the IMF representative at

the time—that included the creation of a central treasury account, but resistance from vested interests and the outbreak of the second intifada stalled progress.

Palestinians and external observers also had discussed consolidation of the PA’s commercial and investment activities long before Fayyad arrived in the finance ministry. As early as 1996, the PA had committed to (1) forming boards of directors for the state-owned companies that monopolized imports and (2) bringing those companies’ revenues under finance ministry control.¹⁴ Just before the start of the second intifada in 2000, the PA and the IMF had agreed to consolidate PA investments into a single holding company, but the uprising had disrupted that initiative, too.¹⁵ Though Fayyad said he would have liked to see the PA divest its commercial operations, he acknowledged that doing so in the near term would be both politically and fiscally impossible, given the PA’s dependence on revenues the businesses generated. As a first step, he sought to bring those businesses into the light. “The state should never be in the business of making money,” he said. “The state can only be in the business of collecting taxes. But I couldn’t possibly have started the journey by saying, ‘Let’s get out of business.’ First, let’s know what we have.”

That proposal became government policy shortly after Fayyad took office. In June 2002, he joined a few other cabinet members and some experienced politicians to create the Inter-Ministerial Reform Committee, and within 10 days of its establishment, the committee produced a 100-day agenda that the legislative council quickly approved and the government released as an official plan. The elements reflected broad agreement between leaders in Palestine and international donors.¹⁶ They included unification of all PA revenue operations and reorganization of commercial and investment operations, stipulating that all taxes, fees, and profits from commercial and investment activities, together with foreign aid, should be deposited into a finance ministry treasury account.¹⁷ The plan also included other public financial reforms focused on expenditure controls and budgeting. (See the ISS case study “Managing Spending in the Palestinian Authority.”)

Implementation, however, would be challenging. “There is nothing easier than forming committees, and that can buy you some time,” Fayyad said. “But what needed to be done was abundantly clear, and we did not have much time.”

Aware of the risks of raising the ire of entrenched interests within the PA, Fayyad chose to concentrate on procedural and operational changes in order to target specific weaknesses in the financial management system without provoking opposition that would derail the reform agenda. Fayyad also knew success would depend on building strong rapport with Arafat. Only with the president’s support—or at least Arafat’s acquiescence—could the ministry assert control of the PA’s finances. Fayyad began meeting with Arafat often to discuss financial management plans, so that the president was always aware of the changes before others were. He also reminded Arafat that he already had agreed to the steps under discussion as far back as January 2000, when he had signed the decree ordering consolidation of PA accounts. Fayyad recalled that “as you know” and “as we agreed” became routine phrases in these conversations.

GETTING DOWN TO WORK

Because of his deep knowledge of the PA's financial system and his belief that significant changes usually required only a few adjustments in work processes, Fayyad was able to act quickly to accomplish some of his top priorities. He planned to take other steps later, as circumstances created opportunities to act.

Setting up a central treasury account

"A well-functioning public finance system starts with ensuring that all revenues of the PA come to the Ministry of Finance, to a central treasury account," Fayyad said. He did not want such ministries as health, transportation, and justice to use the fees they collected to finance their own operations. That kind of spending circumvented the legislature's power to decide how to allocate the PA's resources and was thus inconsistent with democratic norms.

Although other ministers were aware that creation of the central treasury account was a priority laid out in the 100-day reform plan, Fayyad anticipated that ministers would raise questions about whether they would have sufficient funds to cover their own operations. He wanted to launch this vital reform as quickly as possible in order to forestall those kinds of objections.

Fayyad took the first steps toward creation of a central treasury account in June, during his first week on the job. Instead of pressing the ministries to act, he decided to work through commercial banks. The best way to succeed, in his view, was to create a system of regular weekly transfers—to the treasury—of the balances in all of the existing accounts that ministries held in banks. But Fayyad lacked the authority to mandate that step. The institution that had that power was the Palestine Monetary Authority—the central bank—which supervised the roughly one dozen banks operating in the West Bank and Gaza.

The president's understanding and support were crucial. Fayyad worried that his plan might founder if the governor of the monetary authority questioned the directive and took it to Arafat for confirmation. Because the president had to juggle the conflicting interests of disparate constituencies and pressure groups in Palestine, his responses to specific situations were often unpredictable. "Depending on Arafat's mood that day or who spoke to him last and with what kind of spin or the extent to which he understood what the issue was about," he might favor a recommendation or reject it, Fayyad said.

To obviate that problem, Fayyad moved quickly. He informed Arafat that he would begin implementing the transfers to a central treasury account and presented that step as something Arafat had already chosen to do, which was true in the sense that it was one of the measures contained in a decree Arafat had issued two years earlier. Then Fayyad faxed—from the president's office instead of from his own—the directive to the governor of the monetary authority. "If it came from the fax machine of the president, it carried with it the signal that this is really coming with presidential approval," he said. He asked an aide to the president to call the authority's governor and, after the governor

answered, took the phone to tell him he was sending him the directive and that the governor should issue it in his own name to all banks in the West Bank and Gaza. The governor complied, Fayyad said.

The directive instructed all banks in the territories under PA control to transfer to the Arab Bank treasury account on Wednesday of each week the balances they held in government accounts. Fayyad chose Wednesday because it gave him time to check that the money had come through before the weekend began on Friday. (Like many other Muslim-majority countries, Palestine observed a Friday–Saturday weekend.) At first, Fayyad settled on that weekly schedule to avoid overburdening the transferring banks, thereby minimizing their resistance to the proposed change. He said there was one influential bank he deemed capable of derailing the reform by complaining about it to the president even if all else went according to plan.

The day after the monetary authority’s governor issued the directive, Fayyad distributed a copy of the text to all of the cabinet ministers with a cover letter informing them of the new policy. He said he was careful not to present the reform as an attack on the way anyone in the PA had managed funds in the past—and he used the money collected in the central treasury account to quickly distribute operating funds to the ministries, thereby making sure that no ministry saw a reduction in funding under the new system. That step was important: Fayyad understood that the ministries might worry whether the finance ministry would follow through on releasing funds when they were needed. For example, the health ministry had used fees it collected from people accessing health services to partially fund its operations, but those fees now went into the treasury. Fayyad ensured that the health ministry continued to receive a similar amount of funding for its operations after switching to the central treasury account system.

The intent was to show that things would be *better* for cabinet ministers, not worse, under the new policy. The finance ministry was responsible for ensuring that ministers had the funds needed to run their operations. “It’s not their job to fund their operations out of the little money they collect in fees,” Fayyad said. “It’s the Ministry of Finance’s job to provide support and ensure proper budget execution, accurate and timely financial reporting, and sound audit and control operations.”

Transferring that money to the ministries bolstered acceptance of the new policy. “Azzam al-Ahmad, the public works minister, much to my delight, actually said: ‘Oh, it’s a revolution. I will tell everybody. We actually received some money from the Ministry of Finance!’ What could have been a major issue ended up being a nonevent—notwithstanding the extra effort I had to invest in ensuring the transferring banks accepted the reform. It just happened,” Fayyad said.

Without prompting significant resistance, the reform tightened the finance ministry’s grip on PA revenues. “You have established, *de facto*, the centrality of the Ministry of Finance in managing the finances of the Palestinian Authority,” Fayyad said. “It was a key first step.”

Consolidating commercial operations and investments

Consolidating the PA's commercial operations and investments under finance ministry control was a more difficult task, mainly because it required more negotiation and compromise. The key player was Arafat's economic adviser Rashid, the person who knew the most about the government's portfolio. However, many other people had vested interests in maintaining the status quo because of the revenues and jobs these activities generated.

Although Fayyad ultimately planned to press for liquidating the PA's business holdings, he initially avoided mentioning the idea for fear that proposing to sell the assets to the private sector would be a nonstarter with Arafat and Rashid, who valued the latitude for the extrabudgetary spending those interests provided. "I didn't say anything about getting out of business at the time," Fayyad said. Instead, he met with Rashid in July 2002 and proposed setting up a public endowment that would consolidate the PA's holdings under one umbrella. Importantly, the endowment would report to the president, meaning that Arafat would retain some control over the assets.¹⁸

Equally important, Fayyad offered to make Rashid interim chief executive officer of the new entity, to be called the Palestine Investment Fund (PIF)—as long as Rashid shared, with no exceptions, full information about everything the PA controlled. "Good or bad, I need to know everything," Fayyad said. Rashid accepted the terms.

In August 2002, two months after Fayyad became finance minister, Arafat issued a presidential decree creating the PIF. Modeled after sovereign wealth funds in other countries such as Kuwait and the United Arab Emirates, the fund would control the PA's investments to ensure that profits went to the government. Concurrently, Arafat signed articles of association for the fund and issued another decree that established a seven-member board of directors, with Fayyad as ex officio chair because he was the finance minister. Other directors were the minister of economy, Rashid in his capacity as CEO, and four representatives of the private sector, including Sabih al-Masri, a highly prominent Jordanian-Palestinian businessperson who was designated as vice chair. Even though Arafat appointed the initial board, the PIF's bylaws, which the board adopted at its inaugural meeting in September 2002, stipulated that subsequent boards were to be appointed by the cabinet, subject to ratification by the president. (In 2003, the PA created the position of a prime minister, and the cabinet would begin holding formal meetings.)

The PIF's bylaws established that it was illegal for the PA to conduct any commercial activity or hold commercial assets outside the PIF. The fund could put money into investments but had to transfer to the budget all profits left over after it paid dividends to shareholders.¹⁹

The fund quickly absorbed 55 of the authority's business ventures, 53 of which fell under the purview of Rashid's commercial services company, the PCSC. Other significant official commercial operations did not get consolidated at that time, including the Petroleum Commission, the al-Sakhra Foundation (a state-owned enterprise closely tied to the PA's security services), and al-Bahar

Company, which operated several enterprises such as a real estate concern, a medical center, an advertising agency, a hotel, and a horse-racing club.²⁰

Fayyad said he adopted this approach for several reasons. First, the PCSC held most of the PA's investment and commercial operations and had attracted the most attention and the most negative publicity both domestically and internationally. Second, Rashid had full control over the PCSC's holdings and could act on his commitment to disclose all information about those assets. Third, the people who headed the other firms were likely to resist the reform, and that would introduce delays or could potentially derail the effort entirely. Moreover, because the business model of al-Sakhra and al-Bahar rested on sales of goods and services to government agencies and employees, Fayyad said he thought it would be better to address their status through changes in procurement processes. Fayyad also decided to wait for a more opportune time to intervene in the Petroleum Commission.

The next step was to perform a full accounting of the PA's business holdings. Fayyad wanted a reputable third-party review both to give the finance ministry a better sense of the PA's assets and revenue streams and to improve financial transparency the way that the legislative council and international donors had long called for. The PIF's board hired US-based financial services company Standard & Poor's to compile the PA's assets and determine their fair market value. It also hired the Democracy Council, a US nongovernmental organization, to conduct a transparency assessment and provide guidance on governance issues related to the holdings.²¹

The two external organizations finished their work and produced a coauthored report in February 2003. The report stated that the Palestine Investment Fund's holdings consisted of 55 separate enterprises and entities worth US\$650 million,²² and it listed the bank accounts that Rashid's PCSC—which owned the majority of PA investments—had controlled.²³ Fayyad held a press event and emphasized that the report covered all known PA assets. “To the best of my knowledge, this is all the Palestinian Authority has,” he recalled telling the reporters gathered there. “This is an open invitation to everyone. If they know about anything that contradicts what is in this book, I would like to be the first to know.” As of 2020, there was no evidence that the PA had any assets not accounted for in the report, Fayyad said. The fund also contracted Ernst & Young to conduct regular external audits.

Money from the fund soon began flowing into the central treasury account, starting with an initial transfer of US\$16 million in April 2003 and increasing as the fund's profits grew.²⁴ In April 2005, Rashid left his position at the fund in accordance with an agreement Fayyad said they had made in July 2002. (In 2012, a court sentenced Rashid in absentia to a 15-year prison term for money laundering and embezzlement of public funds during his PA tenure, but some observers questioned the legitimacy of those charges.²⁵ Fayyad said he believed that such misappropriation of funds during Rashid's PIF tenure was unlikely because of monitoring and oversight by the PIF board of directors and the external auditor.)

Incorporating tobacco revenues into the central treasury account

The Palestine Investment Fund had incorporated the commercial and investment interests of the PA, but there were other public ventures Fayyad wanted to put under finance ministry control. One of them was the tobacco commission, an autonomous agency the PA had set up to collect taxes on locally produced cigarettes. The commission collected money from the finance ministry's sale of an excise stamp that producers of tobacco products within the Palestinian territories had to affix to each pack of cigarettes produced. The head of the commission, Ahmad Agha, had a long-running relationship with Arafat and reported directly to the president.

The revenue the tobacco commission received did not go to the treasury. Through Agha, Arafat exercised full control over the money, issuing instructions to the agency to release funds when and as he decided. Such transactions happened outside the PA's budget processes and therefore beyond scrutiny of the legislative council.

In July 2002, Fayyad met with Agha at the tobacco commission's Gaza headquarters to talk about channeling the commission's tax receipts—which then were amounting to about US\$5 million per month—to the central treasury account. Fayyad said he was surprised that Agha, whom he had not met before, said he had already spoken to Arafat and would cooperate fully. Agha followed through, and Fayyad recalled that—of any reforms he had pursued during his career in government service—this was the easiest reform to implement.

That step stopped the commission from executing extrabudgetary transactions on the president's behalf, but it did nothing to deal with rampant smuggling that bedeviled the tobacco trade in the West Bank and Gaza. Augmentation of law enforcement was not an option. The PA had no control over its borders, and corruption within the security services further impeded the government's capability to crack down on illicit transactions.

Fayyad considered market-based interventions as the best way to curtail smuggling. With that in mind, he set up a technical committee to develop proposals for correcting the problem. Hatem Yousef, whom Fayyad promoted in 2003 to serve as the finance ministry's director general of customs, excise, and value-added tax, led the committee. Yousef first commissioned market research that, among other things, estimated the share of cigarettes smuggled from Egypt, Jordan, and Israeli settlements to be 45% of tobacco sales in the West Bank and Gaza. The smuggled cigarettes were cheap largely because the sellers evaded tariffs and excise taxes. The market researchers estimated the PA's associated revenue loss at US\$10 million to US\$15 million a month.

Then the committee spotted a potential opportunity to turn the tide. Farmers, especially those living in Yaabad and its surroundings near the city of Jenin, had begun replacing their traditional crops with tobacco, informally selling the leaves to small operators who hand-rolled cigarettes and sold them locally at low prices. Those sales escaped the tax net too, which caused problems for the government. But the return on the farmers' investments and labor was also low, because they had no other viable outlet for their tobacco leaves, which, because

of their low quality, could not be exported or even sold in bulk locally in unprocessed form. The main Palestinian cigarette manufacturer, Jerusalem Cigarette Company Ltd., relied entirely on imports of unprocessed tobacco for its manufacturing needs. Clearly there was demand for cheaper cigarettes. Was there a way to boost the competitiveness of the farmers' leaves against those smuggled into the territory?

Yousef's committee decided to approach the company about buying a preagreed quantity of the locally produced tobacco at a preagreed price and then use it to make cigarettes that were cheap enough to compete with the smuggled cigarettes. As part of the deal, the finance ministry would lower the excise tax on the new cigarettes, which it had the power to do under an existing tax law. Considerable deliberation and negotiation went into finding an agreement acceptable to the farmers and the company. The decision on the purchase price represented the greatest challenge because it had to be just high enough to make it worthwhile for farmers but not so attractive that it would lead many farmers to switch over to tobacco from other crops.

The company, whose profit margins had suffered from the influx of smuggled products, welcomed the opportunity to expand its business. In February 2005, the new product, called Jamal (Arabic for *beauty*) went on sale, and within three months, the market share of smuggled cigarettes sold in the occupied territories dropped to 3%, and the PA's revenues from tobacco sales quadrupled.

"We stopped the smuggling of cigarettes because nobody could compete" with the cheaper products, Yousef said. The initiative was so successful that even some Israelis living in settlements in the West Bank started buying the Palestinian cigarettes, he added. In 2008, based on recommendations by another Yousef-led committee, the scheme was expanded, with some adjustments, to permit a second Palestinian cigarette manufacturer to produce a similar cheap brand.

OVERCOMING OBSTACLES

Although Fayyad made considerable progress in consolidating revenues and putting the PA's commercial interests under finance ministry control, bringing the Palestine Petroleum Commission into the new system took additional time and effort.

Fayyad said that when he joined the finance ministry in June 2002, he had to deal with several problems with the petroleum trade and with the commission, a Palestinian public agency that was the sole legally authorized buyer of petroleum products from Israel. The commission distributed those products to Palestinian retailers—typically gas stations, most of which were privately owned. (The commission held a partial ownership interest in some stations.) The commission also was the regulator and price setter for retail trade in petroleum products and was in charge of licensing retailers. It adjusted retail prices every month, setting a price ceiling for each product and grade to create a predetermined profit margin for retailers and for the commission itself.

Harbi Sarsour, the commission's first head, exercised those powers alone, Fayyad said. The commission owned and operated a storage facility on the Gaza side of the border with Israel. The facility received petroleum products that were pumped from Israeli storage and loading tanks. The commission had a second installation in the West Bank village of Niilin in the Ramallah area, where products from Israel were unloaded directly into storage facilities.

The commission retained the profits it made from official sales and fees and kept them away from finance ministry control, Fayyad said. Arafat issued direct instructions to Sarsour to use those profits to finance extrabudgetary operations. The commission thus had an incentive to maximize profits by keeping prices high. "Its power was derived from its ability to spend, which in turn was dependent on how much money it made as profit," Fayyad said. The arrangement created a classic rent-seeking problem that worked to the advantage of Israeli businesspeople and a few people in the PA.

The excise portion of the tax on oil products the commission purchased, which had amounted to a monthly average of US\$7 million before the second intifada, went to an account with an Israeli bank, which Rashid, who was also the head of the PCSC, controlled. On Arafat's instructions, Fayyad said, Rashid released money from the account to help establish some of the PA's commercial operations—at least in the authority's early years—as well as to cover the same kinds of extrabudgetary outlays the profits helped pay for.

After Arafat's January 2000 reform decree, some of the funds from that account went to the treasury, but those transfers soon ceased with eruption of the second intifada, and the account remained in place. When Israel lifted the hold on the PA's clearance revenues in early 2003, oil excise revenues started to flow directly and regularly to the central treasury account. That was an important step toward reform but did not solve the problems with the petroleum commission itself.

In a situation akin to that in the tobacco sector, the high prices the commission charged created a market for cheaper, smuggled petroleum products from Israel, whose retail prices were cheaper. This illicit trade became especially widespread during the second intifada and was a problem primarily in the West Bank, which had more-porous borders with Israel than the Gaza Strip. According to the protocol on economic relations with Israel, the PA could collect tax receipts only on formal trade. Consequently, the PA's oil revenues, which were already depressed during the recession the intifada helped trigger, dropped sharply.

The Israeli government benefited from that predicament, Fayyad said. Taxes due on oil products smuggled from Israel went to Israel's treasury and were used for financing Israel's expenditures, thereby perversely making the PA a donor to Israel, with highly impoverished Palestinian taxpayers footing the bill. Fayyad repeatedly emphasized that point—especially when meeting with members of the legislative council—in order to mobilize support for reforms.

Fayyad said he believed that bringing the commission under the finance ministry's total control was the only way to fix the multitude of problems and

end corrupt practices in the oil sector. But he decided to tread carefully as he studied the situation, aware that an overly aggressive approach could lead Sarsour, the head of the commission, to appeal directly to Arafat and halt reform.

As Fayyad hammered away at the need for all PA revenues, including the commission's profits, to be transferred to the treasury, Sarsour responded by transferring roughly US\$1.2 million to the treasury in July 2002, about a month after Fayyad took office as finance minister. On its surface, Sarsour's gesture looked like a bid to cooperate. But a month later, Sarsour transferred the same amount, leading Fayyad to question whether the commission was sending its full profits to the treasury. It was nearly impossible that the profits would be identical from month to month, he reasoned. Sarsour called to inquire whether the money was received, and Fayyad confirmed it had been, but he asked why the amount was the same in two consecutive months. Sarsour promised to show him the commission's accounting records, Fayyad said, but the records never arrived. Sensing it was futile to push further at that time, Fayyad opted to wait for a more opportune moment to intervene.

In early 2003, Mahmoud Abbas became the PA's first prime minister. The long-awaited constitutional change that created the position was intended to reduce Arafat's power and introduce an institutional arrangement that would be conducive to a more structured pursuit of reform. The prime minister began holding formal cabinet meetings, restricting attendance at those meetings to members of the cabinet, and focusing the meetings on the business of government rather than on broader political issues, the latter of which had been the norm at Arafat's leadership meetings.

Fayyad, whom Abbas retained as finance minister, saw an opportunity to take concrete steps toward bringing the petroleum commission under finance ministry control. First, he submitted a motion to the cabinet to place autonomous agencies under government control, which the cabinet approved. At the next meeting, he proposed creation of an administrative link between ministries and the agencies closest to ministries' purviews, which the cabinet also approved. Fayyad then submitted a list of three agencies over which the finance ministry would have authority: the tobacco commission, a commission for promoting investment in Palestine, and the petroleum commission. He had already exerted control over the tobacco commission, and the investment commission was essentially defunct, but he said he wanted to avoid singling out the petroleum commission. "Without discussion, the cabinet approved it," Fayyad said. The motion "basically established that I had administrative purview—as minister of finance—over this entity."

Fayyad told Sarsour that the new policy would not change his business in any significant way, but he asked to visit the commission's office in Ramallah. On his arrival, he found the office nearly empty. "There was barely a bookshelf in it or a filing cabinet," Fayyad said. "That's what told me this was a shell operation." The commission appeared to do little actual work while it collected money from petroleum sales and illicit activities.

Fayyad again asked the head of the commission to send him regular updates on the commission's finances. Although most of what he received was of little value because it did not include clear data on profits, it did contain some useful information. By examining figures on imports and domestic sales of kerosene and diesel, he said, he was struck by the fact that the West Bank's share in total kerosene imports was much larger than Gaza's. And even though the West Bank was more populous than Gaza, the disparity was too large to be explained by the difference in populations. Also, per-capita income in Gaza was significantly lower than in the West Bank, and kerosene—much cheaper than diesel—was in greater demand by poor people. With kerosene and diesel being of similar chemical composition and properties, Fayyad considered the disparity as evidence that the commission was adulterating the diesel it distributed in the West Bank with the cheaper kerosene but charging full diesel price. Fayyad took the evidence to Arafat, telling the president that the petroleum commission was cheating the country. Arafat reprimanded the head of the commission but went no further.

Fayyad waited for another opportunity to acquire more control over the commission's accounts. In May 2003, such an opportunity arose when the head of the commission asked Fayyad for permission to leave the country for medical treatment. Fayyad approved the request because with the head of the commission out of the country, he could visit the commission's Gaza office and obtain the account information he needed to assert control over the commission's finances. Fayyad, his office manager, and the head of the finance ministry's accounting department arrived, without notice, at the commission's office and found the person in charge of the commission's finances. Fayyad obtained the information on the commission's bank accounts, instructed the banks to freeze those five accounts, and then backed up the directives with formal letters, which his finance ministry colleagues finalized there and then. "The accounts were frozen, and the petroleum commission was totally paralyzed," Fayyad said. "It was essentially out of business."

Although he was successful in his surprise visit to the petroleum commission's office, Fayyad said, he had not cleared the maneuver in advance with Arafat and merely assumed Arafat would quickly learn about it. He went to see Arafat at his office immediately afterward, and though he stayed there until late evening, Fayyad said, much to his surprise Arafat did not bring up the matter. He returned the next day, and Arafat still made no mention of the petroleum commission. "The sole objective of that visit was for me to be seen there in order to give people the impression that he had authorized me to do it," Fayyad said. "That served a very important purpose." On the third day, Fayyad formalized the incorporation of the commission into the Ministry of Finance.

In June 2003, the finance ministry formally brought the commission under full control, followed by a change in the management and governance structure and a full audit. Fayyad appointed one of the ministry's senior employees to replace Sarsour, who moved temporarily to an advisory post at the finance ministry.

Under the new regime, the commission stopped the practice of raising prices for the sake of profit. As a first step, Fayyad eliminated the commission's profit margin. Petroleum product prices dropped, and within three months, legal sales of those products tripled, indicating a sharp decline in smuggling. Beginning in the second month after the takeover, the commission adopted an even more aggressive pricing policy that set the price of diesel at up to 15% below cost, with the incurred loss more than offset by the revenue gain associated with the increase in formal sales. Fayyad said that Israeli officials complained about the new pricing policy, stating that it led to petroleum products' being smuggled back into Israel from the Palestinian territories. The IMF and the World Bank also offered what Fayyad called "friendly criticism" of what they deemed a "diesel subsidy."

"Whatever you wish to call it," Fayyad said, "only such a potent market-based intervention was capable—particularly under the then prevailing conditions of virtually nonexistent enforcement capabilities—of putting an end to smuggling." The increase in legal sales caused the PA's average monthly revenues from petroleum taxes to reach US\$11.7 million in 2004—more than twice the monthly average of US\$4.43 million earned in 2002.²⁶

Fayyad said he also met with an Israeli minister of state for financial affairs to make the case for having the Israeli government equalize the taxes on diesel and kerosene, with the aim of eliminating the price disparity between the two and thereby removing the incentive for product adulteration. That recommendation was adopted shortly thereafter, he said.

ASSESSING RESULTS

By August 2002, just two months after his appointment as finance minister, Fayyad had accomplished two of the financial management priorities that reformers inside Palestine and donor countries had long sought to achieve. The government's revenues now flowed into a central treasury account, and the consolidation of all PA investments and commercial operations under the Palestine Investment Fund was getting under way. (Fayyad released a report on the full consolidation in February 2003.)

The reforms encouraged partners outside the Palestinian Authority to provide the government with money it desperately needed. With public financial management more transparent, other countries had greater trust that the PA could handle funds responsibly. The US government, for instance, encouraged Israel to release the PA revenues it had withheld. Israel did so in early 2003, which enabled PA revenues to more than double to US\$763 million that year from US\$296 million in 2002. In July 2003, the US government transferred funds directly to the PA for the first time. In 2005, revenues reached US\$1.2 billion—higher than at any time in the PA's history. The improvement was not solely the result of an increase in clearance revenues released by Israel; domestic revenues more than doubled from 2002 to 2005.²⁷

The central treasury account eliminated discretionary off-budget spending. The consolidation of revenues in one place also facilitated Fayyad's subsequent

implementation of expenditure controls because it was easier to make decisions about spending when the finance ministry had complete information about what money was available. The reform also enhanced the PA's budgeting process because the annual budgets for 2003 and later years included detailed accounts of past revenue performance and expected future revenues.

Establishment of the Palestine Investment Fund brought greater transparency to the PA's finances. The fund reduced the power of those who ran the PA's commercial and investment operations because they could no longer raise money and spend it off budget. Fayyad had intended to privatize these holdings and remove the government from the business of making money, but the fund continued to make investments intended to create profits for the PA. The fund's annual statements listed its net equity as US\$713 million at the end of 2003, as US\$956 million at the end of 2004, and as more than US\$1 billion in 2005. From 2003 to 2005, the fund paid a total of more than US\$225 million of profits into the central treasury account (US\$31 million in 2003, US\$74.5 million in 2004, and about US\$120 million in 2005).²⁸

In late 2005, a year after the death of Yasser Arafat and amid growing tension with the new PA leadership, Fayyad left the finance ministry and announced he would run as part of an electoral slate of independents in the 2006 legislative elections. He won a seat on the Palestinian Legislative Council. 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 to the Palestinian Authority again being cut off from its clearance revenues, and external financial assistance declined precipitously, pushing the government into another financial crisis.

REFLECTIONS

The success of the revenue management reforms Salam Fayyad introduced as finance minister of the Palestinian Authority offered possible lessons for other leaders in similar circumstances.

Moving successfully from a personalized and patronage-based system to transparent and rule-governed institutions sometimes entailed gradual, nuanced steps to avoid boxing people into a corner. In a politically difficult environment, it was sometimes more advantageous to keep the powerful on board for a time instead of trying to immediately push them out. For example, Fayyad chose Mohammed Rashid, who was close to the president, to serve as head of the Palestine Investment Fund for a transitional period rather than risking a strong political backlash by separating him from all of the PA's business interests. Fayyad also softened the blow of removing the head of the petroleum commission by installing him as an adviser in the finance ministry, thereby allowing him to save face. That tactic enabled Fayyad to gain access to information and manage political resistance to his reform agenda.

Fayyad also prioritized changes in work processes over confrontations with people about wrongs or errors they had committed in the past. He was not interested in punishing anyone in the PA for the way they had handled off-

budget funds but, rather, looked for ways to bring those resources into the finance ministry and prevent future opportunities for extrabudgetary spending. Focusing on both the future and the power of process proved helpful in winning acceptance of change and in preempting resistance.

Fayyad emphasized the importance of being opportunistic when operating in a crisis. “If you have the authority to impose reform, don’t wait,” he advised. “Just go out and get it done. If you don’t have that luxury [of formal authority], then you have to create that authority.” For instance, when creating the central treasury account and the Palestine Investment Fund, he used the prevailing internal and external support for his reform agenda to act quickly.

To take on more-complicated reforms such as takeover and revamping of the petroleum commission, Fayyad applied patience. He waited until conditions enabled him to take action, and he avoided issuing instructions and directives prematurely.

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