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# Governance Strengthening Project (GSP/Taqadum)

Decentralization in Iraq:  
Recommendations on the Transfer of  
Fiscal Authority

# **Governance Strengthening Project (Taqadum)**

## **Decentralization in Iraq: Recommendations on the Transfer of Fiscal Authority**

**SUBMITTED BY CHEMONICS INTERNATIONAL**

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## ACRONYMS

ARDP	Accelerated Reconstruction and Development Program
GO	Governor's Office
GSP/Taqadum	Governance Strengthening Project/Taqadum
PC	Provincial Council
PPDC	Provincial Planning and Development Council
USAID	United States Agency for International Development

## INTRODUCTION

As the USAID Governance Strengthening Project/Taqadum (GSP/Taqadum) continues to assist with administratively decentralizing service delivery provided by the ministries of Health, Education and Municipalities and Public Works, it seeks to provide advice and recommendations on the transfer of fiscal authority from the central government level to the provincial level. To this end, the recommendations contained in this report are pursuant to Law 21, as amended, and specifically Articles 44 and 45.

The report recommends:

- A model for local revenue generation, collection, and management;
- An approach for the Ministry of Municipalities and Public Works to recover service costs;
- A new role as well as a functional and relations matrix among provincial treasury directorates, governor organizations, and targeted provincial directorates; and
- Procedures for financial control and audit.

### Acknowledgements

This report represents the collaborative efforts and participation of the financial team and consultants of GSP/Taqadum. All contributed significantly at the highest levels of professionalism and perspective. Thanks to the GSP/Taqadum financial team and its leader Najed Hamoodi, Sr. Budget Specialist, there is now practical opportunity to begin an effective implementation effort for devolution of fiscal responsibility. These outstanding professional women and men are representative as well of the capacity of the many in the ministries and the provinces who would be key to success in the transfer of fiscal authority.

### Critical Assumptions

Throughout, the report is anchored in several critical assumptions, which together form the basis of any consideration of change in any organization:

- *Incrementalism.* The change process towards acceptance and implementation of any recommendation will take time and should be taken in small steps to both reduce resistance and increase learning efficiency. But it must be pursued with vigor and a relentless focus on proper and strong financial and control systems, even if there are weaknesses in those systems;
- *Continuous Improvement.* Organization order elements of stability, continuity, coherence and consistency in systems and structures are necessary conditions to improvement, especially in the highly complex and difficult change environment of decentralization and fiscal devolution.
- *Fiduciary Responsibility.* To combat corruption and ensure impact, any fiscal devolution effort must have at its core the elements of as sound and effective fiscal management system as possible;

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- *Strong Systems.* By consolidating and strengthening budget, financial, and management control systems, Iraq can institutionalize the below recommendations, a key step toward continuous improvement.
- *Compliance.* Any fiscal decentralization effort must comply with the law, in this case Iraq's Law 21 on decentralization, which calls on provincial government to "issue local laws, instructions, bylaws, and regulations to organize [its] administrative and financial affairs so that it can conduct its affairs based upon the principle of administrative decentralization in a manner that does not contradict the provisions of the Constitution and federal laws."
- *Human Resources.* Provincial governments must ensure a highly competent and disciplined workforce to manage the systems, structures, and processes of a decentralized fiscal management system.

### Constraints

This is a document designed to address the devolution or transfer of fiscal authority commensurate with operational decentralization. Therefore, both structure and process in the recommendations of this report will apply fundamentally to any ministry in its effort towards a decentralization of operations.

However, there is a serious note of caution in both the application of principles and functions outlined in this report to decentralization of services to the provinces. In the transfer of fiscal authority at least, it will be important to design and operate the highest uncompromising standard of systems, structures and processes possible given a potential organizational, political and administrative environment of inequality, corruption, and weak managerial capacity.

The transfer of fiscal authority commensurate with operational and political decentralization works best in an environment where there are strong traditions of democracy, accountability and professionalism in subnational governments. Importantly, it does not provide a shortcut to governmental capacity or stability in situations where these preconditions are absent. And there is one important downside that should be noted. Operational decentralization and fiscal authority transfer may enhance production efficiency but may tend to undermine allocation efficiency by making redistribution more difficult, especially in sub-national areas with regional economic inequality such as in Iraq. Therefore, for Iraq and its consideration of transfer of fiscal authority, there must be a balance sufficient to ensure a reasonable control on national economic stability.

From the research and analysis associated with this document, two decisions will represent "first steps" in enabling fair and equitable access to basic services.

*First, improve upon then enforce equitably what is already "on the books."* There exists permissive legislation to enable units of government to issue permits and licenses, and collect fees to ensure a sense of fairness as it relates to beneficiaries of service and those who impose a burden on infrastructure. From street cuts for cable to sidewalk encroachments for

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restaurants, from unenforced connections into water or storm water systems to building approval processes that are not uniformly regulated, there is ample opportunity to begin the process of introducing an environment of order, fairness and equity.

*Second, begin the process of elected official accountability where it really belongs and that is with the citizens.*

A powerful way to do this is through the articulation of true cost of services and the beginning of a diversification of near total dependency on a single source of revenue, oil, which has contributed to such a disconnect between services received and their attendant costs.

While difficult at best, with an incremental approach towards the implementation of these two decisions accompanied by systems, organizations and activities that incorporate principles of honesty, transparency and responsiveness, Iraq can begin to see a movement towards quality of life improvements.

### Precedent

Importantly, such progress is already part of Iraq's recent history. One example of this is Law 130. Relatively unknown (although referenced as recently as 2008 in a USAID annotated publication on Law 21) or at best obscure and obviously not administered in the present fiscal landscape, Law 130 has been on the books since 1963. Known as the *Law of Municipalities Revenues*, it is legislation directed to the former Ministry of Municipalities for the purpose of identifying, collecting and enforcing a variety of revenues in the provinces to financially support a service delivery base in the provinces.

Law 130 includes an extensive listing of revenues for collection in the provinces, including fees, charges and fines. The list and schedule were comprehensive as to who might be subject to the law, such as: new construction, slaughter houses, advertising, businesses and professional services, factories, amusement parks, hotels and night clubs, auction houses—even tobacco, alcohol and soft drinks. There was as well a mechanism for resolving delinquencies and debt collection complete with interest penalties and provisions for appeals and adjudications through a Municipalities Court System. There were even exclusions listed such as religious and charitable NGOs where there were reciprocal considerations with other countries.

The law also linked these revenues to other central government activities. For example, in order for a property owner to register real estate, he had to furnish a certificate from the Municipalities that there were no unmet obligations such as business license fees, pavement fees, etc. Further, the Real Estate Tax Department would provide municipalities with lists of annual estimated property values since business license fees were collected based on calculations of property value.

Under Law 130, revenues that were collected in the province remained in the province with a few exceptions: tobacco, matches, alcohol, soft drinks and auctions. These collections were submitted to the Ministry, which in turn reallocated the amount for redistribution back to the

provincial municipalities departments based on a population formula, following a principle of equity in allocation.

Activities and functions of the Municipalities unit for which revenues were collected went to traditional municipal services such as: garbage collection; parks and gardens; street, sidewalk and other right-of-way maintenance and beautification; street lighting; and public markets.

Law 130 could be enforced without amendment for a lengthy period of time largely because of stability of governmental structures, exchange rates, and an economy that reaped the benefits of increases in pricing and quantity of oil production. Economic sanctions of the 1990's predictably and severely disrupted all of those stability factors, including taking its toll on the law through a gradual degradation of administration, collection and adjudication. Final and virtual abandonment of the law coincided with the 2003 invasion and subsequent vacuum created with the loss of governance. With virtually all institutional knowledge lost and no attempt to re-capture any vestiges of the law since, there is now a new generation with a completely different set of expectations associated with service delivery, none attributable to the pay-for-service principles of the past that were incorporated in the principles associated with Law 130.

Why is Law 130 germane or relevant to this report? With a couple of serious modifications, the comprehensive nature of the law with its extensive administrative components can offer an excellent beginning framework for a model revenue collection structure in the provinces. Structure with attendant functions such as legislative authority and legal fundamentals, billing and collection activities, cash and financial management, regulation and enforcement, and adjudication or dispute resolution mechanisms are already identified.

To update or overhaul the law, at least two significant areas would need to be addressed and re-written. First, fees within the fee structures will have to be adjusted at least because of currency value changes. Through 1989, the currency exchange rate was generally in excess of \$3 to 1 IQD; by 1995, it had fallen to \$1 to 3,000 IQD; and today it is roughly \$1 to 1,200 IQD. Second, there will need to be a re-evaluation of the definition and types of profession, businesses and organizations. Some are surely obsolete and should be deleted, such as Weed Carpet Weaving, while others that did not exist in the 1960s should be added, such as Internet Cafes.

## DEFINITIONS

Despite Iraq's prior experiences with fiscal management—and revenue generation in particular—many of the government officials and employees now charged with spearheading the country's decentralization efforts are a generation removed from the fiscal order of a functioning government. That they “cut their teeth” professionally in an era of sanctions, war, and widespread corruption, however, does not detract from their potential for developing the capacity to implement sound fiscal management systems.

Without presuming too much, the below list of definitions is intended to aggregate the most relevant concepts at the disposal of Iraq's new generation of leaders. Although some of the definitions, such as encumbrance accounting, extend beyond those applicable to this report, they are included with an eye to the future development of Iraq's systems. At the same time, although all definitions are based on principles of finance and accounting with uniform application to any organization worldwide, some categories of terms have been reduced in depth or breadth of definition, or even eliminated altogether, such as some types of audits.

### Fiscal Policy and Fiscal Management

Fiscal Policy is the sum of decisions made by a central government relating to taxation and government spending, with goals of full employment, price stability, and economic growth. Fiscal Management is closely linked to fiscal policy, which is how the government stabilizes the economy through its collection of taxes and spending.

### Financial Management System

A financial management system incorporates the elements and methodologies that an organization uses to oversee and control for income, expense, and assets. An effective financial management system improves performance by streamlining invoicing and collection; minimizing accounting errors and record-keeping redundancy; ensuring compliance with tax and accounting regulations; quantifying budget planning; and offering flexibility and expandability to accommodate change and growth.

Some standards of an effective financial management system include: ensuring payments and receivables are transparent; keeping track of liabilities; coordinating income statements, expense statements, and balance sheets; balancing multiple bank accounts; ensuring data integrity and security; keeping all records up to date; and maintaining a complete and accurate audit trail.

### Budgeting: Operational, Capital, and Cash Flow

Budgeting helps to aid in the planning and delivery of actual activities, functions, services, and operations by compelling the organization to consider its policies and priorities, the costs of

services and associated revenues. Other essentials of budgeting include: accountability, performance management, and transparency. There are three types of governmental budgets, all legislatively enacted: the operational or current budget, the capital or investment budget, and the cash or cash flow budget:

- Operational Budgeting is the quantitative expression of a plan for a defined period of time. The budget of a governmental agency is a summary or plan of the intended revenues and expenditures of that government. The budget should express the government's strategic plans of all business units, organizations, activities or events in measurable terms.

The annual operating budget is for a specified fiscal period, generally twelve months. Budget amounts are, at best, estimates and lapse at year-end. Annual operating budgets can be amended during the year, and amendments take legislative action.

- Capital Budgeting includes both a current budget as well as a multiple-year budget. Capital budgets are forecasted capital asset costs and last from the start of a project until the asset is put into service. Capital budgets can be amended which require legislative action.
- Cash Flow budgeting is applicable to both operating and capital budgets. Cash flow budgets forecast the actual receipt of and disbursement of cash.

### Fund Accounting

Fund accounting is used to account for a specific set of services, activities, or functions of a governmental organization, segregating both revenues and expenditures of that organization. The fund is self-balancing and is restricted for specific purposes in accordance with laws, regulations, restrictions, etc.

### Encumbrance Accounting

Simply stated, encumbrance accounting is a method to record a "pre-expense" to prevent overspending a budget. An encumbrance (purchase order) properly executed is a legal document and hence constitutes a pre-expense. As such, it is a promise to incur an anticipated cost. An encumbrance will lapse at year-end like the budget; however, properly executed encumbrances must be re-instated the next year and included in the new current budget.

### Appropriation

An appropriation is the actual setting aside of the monies needed to satisfy an encumbrance and settle an expense. There are annual appropriations as well as multi-year appropriations. Appropriations are generally legislatively enacted.

## Revenue Certification

Before an agency can enact a budget, a third-party—one not associated with the development, execution, or operational expenditure of a budget—will certify that revenue/monies anticipated by the agency during the period covered by the budget will in fact materialize. This certification process is an independent forecast to ensure the accuracy and reasonableness of the organization's forecasting policies and methods.

## Trial Balance

The trial balance is the report that aggregates all debit [liability] and credit [asset] balances at the end of an accounting period. This report is usually generated monthly to ensure that total debits equal total credits in the general ledger. As such, it serves as a worksheet for making closing entries and provides inputs for financial statements, which are essential for reporting purposes. A trial balance generally does not include any type of performance reviews and may or may not include prior period balances with current operational transactions. Neither will it provide a comparison to budgeted data.

## Standard Chart of Accounts

A standard set of accounts to be used across or between like organizations for comparability and accountability. Simply, all departments of an agency should use the same type of accounts to record their financial transactions so that the data is comparable and useful for reporting and planning purposes.

## Bases of Accounting

- *Cash Basis of Accounting.* Accounting records are wholly based on cash in hand; in other words, revenue and expense are recognized only when cash is actually received and actually spent (Cash Exchange).
- *Accrual Basis of Accounting.* Revenue and expense are recognized in the period when the economic event occurred—at the point when the income was earned or the expense incurred—regardless of when cash is exchanged. As an example of revenue recognition, a company may realize sales revenue in the period it delivers the product/service though it may not receive the cash from the customer for the service/product for months. Hence, the term “Accounts Receivable”. Likewise, the customer may recognize the expense incurred at the moment it receives the product/service and assumes the legal liability to pay, even though a payment may not be made for that product/service for months. Hence the term “Accounts Payable”. There are other elements to accrual accounting like Inventory, prepaid expenses, accrued liabilities, etc.

- *Modified Basis of Accounting.* Modified is much like Accrual but has Cash Basis mixed in. For example, under modified, revenue is recognized in the period earned when it is BOTH available and measurable. Simply put, the actual cash must be available to the organization and measurable. Collection of the cash is received generally within 60 days of the period earned. Conversely, expenses are reported in accordance with the accrual method when the liability is incurred.

### Management Control System

Every organization is a system composed of diverse parts or elements that are so interrelated and integrated, together they serve a common plan or purpose. An effective management control system will contain seven essential elements. Each must articulate with and complement the other in order for the system or organization to accomplish its objective of promoting improved efficiency and effectiveness in operations. These critical and necessary elements are: Stated goals and objectives; Assigned responsibilities and segregation of authority; Performance indicators and standards; Operating rules and procedures; Information flow and feedback; Independent review, evaluation and verification; and corrective mechanisms

Relative to audit specifically, the following two elements deserve particular attention:

1. *Information flow* applicable to decisions, analyses and feedback disclosing results of information. Information should be collected and reported on the basis of assigned responsibility, consistent with operating rules and policies, and relevant to decisions and evaluations based on performance standards and program objectives established in the planning process. Accounting and reporting systems comprise a necessary part of this element.
2. *Independent review* and evaluation of operating efficiencies and program effectiveness and an independent verification of the reliability of information contained in formal reports. Independence requires that someone other than the person responsible for the activity or serving under his direction perform an examination and evaluation of available evidence and render a judgment on the matters to be evaluated. Such a review not only should provide an independent appraisal of affairs but also permits verification of reported data thus adding to the degree of confidence managers can place on it. This is the audit or compliance function relative to operational reporting.

### Auditing

A comprehensive definition of auditing is an examination of records or other search for evidence, conducted by an independent authority, for the purpose of supporting a professional evaluation, recommendation, or opinion concerning the following: Adequacy and reliability of information and control systems; Efficiency and effectiveness of programs and operations;

Faithfulness of administrative adherence to prescribed rules and policies; Fairness of financial statements and performance reports that purport to disclose the present condition and the result of past operations of an organization or program

*The Financial Audit.* Cornerstone to control and audit the financial audit is defined as an examination restricted essentially to financial records and controls, for the purpose of determining that funds are legally and honestly spent, that receipts are properly recorded and controlled, and that financial reports and statements are complete and reliable.

*The Performance Audit.* is additive to the financial audit and includes an examination of records and other evidence to support an appraisal and evaluation of the efficiency and effectiveness of governmental operations, and the faithfulness of responsible administrators to adhere to legislative requirements and administrative policies pertaining to their programs and organizations.

*Compliance audits* are elements of financial audits and performance audits when that portion of the audit pertains to the faithfulness of administrative adherence to legislative requirements and administrative policies.

*Audit Independence:* a critical assumption and principle to the audit function [Attributable to R.K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing, 1961]

- **Programming Independence:** Freedom from control or undue influence in the selection of audit techniques and procedures and in the extent of their application. This requires that the auditor have freedom to develop his own program, both as to the steps to be included and the amount of work to be performed, within the overall bounds of the engagement.
- **Investigative Independence:** Freedom from control or undue influence in the selection of areas, activities, personal relationships, and managerial policies to be examined. This requires that no legitimate source of information be closed to the auditor
- **Reporting Independence:** Freedom from control or undue influence in the statement of facts revealed by the examination or in the expression of recommendations or opinions as a result of the examination.

## Taxes

Taxes are generally the largest revenue source of a government and are often used to regulate an activity. Taxes are not required to have a measurable benefit commensurate to the amount paid by the taxpayer. Therefore, the relationship of the amount of a tax to governmental cost is more important than measuring benefit and frequently plays a role in distinguishing fees from taxes. If the fee has no relationship to governmental cost, that fact tends to indicate it is not a

fee but rather a tax. And if the taxpayer need not benefit, the levy is not a fee. This rule does not work in reverse, however: if a tax happens to have both a benefit to a taxpayer and reflect some cost to the government, it is nevertheless likely to be treated as a tax and is often referred to as an excise tax.

### User Fees

A fee charged for the use of a product or service. Unlike a tax, which is imposed upon the general population, a user fee is charged to an individual only when that individual uses the product, service or commodity. Generally user fees do not regulate an activity as their primary purpose.

It is a charge to individuals where there is more of a direct benefit to the individual and the individual has a say in whether or not they receive the service or product. As an example, a user fee may be established and charged to persons utilizing a building or room for a meeting. The fee amount should be relative to a reasonable approximation of the cost of that action to the government. Such fees may vary with usage of the provided benefit "fair share"; however, a flat fee is permissible.

Because the incurrance of a fee is usually voluntary in whole or part, if the payer chooses to incur it, presumably the payer thinks the benefit is worth the fee.

### Fines

This revenue source, in addition to criminal violations, would also charge fees for regulatory purposes, acting as a penalty for a violation of recorded legal rules and regulations.

### Charge for Services

A type of fee charged to cover services related to the primary product or service being purchased. For example, a municipality may charge for providing its constituents water and sanitary sewer services. Such a charge is based on consumption and the municipality's costs of providing such a service. Typical costs include recovery of infrastructure costs, personnel costs to operate the facilities, costs of treating and conveying the water, debt service costs, and administrative costs such as insurance, indirect overhead, postage, technology, and so on.

## LOCAL REVENUE GENERATION, COLLECTION, AND MANAGEMENT

With the context of this report and key definitions clear, this section will recommend steps to develop a relevant and practical model for local revenue generation, collection and management

### Context

*Single Source Revenue Dependency.* Under increased pressures and expressed frustrations at poor or even non-existent delivery of many provincially delivered services, officials charged with such service delivery are facing a challenge of extraordinary proportions. An obvious challenge for Iraq, its economy and its attendant fiscal situation is that of single-source oil revenue dependency with in excess of 90% of all governmental services paid for from that one source. Yet, with skyrocketing public expenditure requirements, large public payroll, food and energy subsidies, a need to rebuild armed forces and fight a war at the same time (including the burgeoning needs of a significant displaced population), the worst possible scenario for such dependency has happened: a nearly 50% drop in the price of oil as of the submission of this report. Ironically, December 2014 exports were far and away the highest of 2014, eclipsing the previous best month ever by more than 11 million barrels, according to ministry figures.

While most would agree that there will be upward pressure globally on oil prices, the obvious near-term fiscal and monetary crisis for Iraq is real. There can be little expectation that the return to historical economic growth driven by oil production will happen any time soon. And, even if that growth were to return, the country is inexorably deep in a capital infrastructure deterioration mode, the result of more than 30 years of neglect and mismanagement. With revenue base assumptions for delivery of governmental services at all levels down by nearly 50% for the next fiscal year, Iraq faces a reality check. Hopefully, its leaders will encourage as well as explore a diversification of its revenue base to drive service delivery both towards balancing the present and to strengthening its future in terms of greater stability, efficiency and equilibrium in its macro-economic system.

*Cost of Service Dilemma.* There is a prevailing perception and accompanying resistance to consideration of beginning to pay for something that has been based on a “something for nothing” expectation. Indeed, the real challenge is to convince an unwilling (and, in some instances, unable) public to pay for something that is justifiably perceived to be either ineffective in quality or the result of waste and mismanagement. Ironically and sadly, this circumstance was thrust onto Iraq relatively recently, first through the war with Iran, then followed by severe and catastrophic economic sanctions. That is why, despite Iraq’s deteriorating systems, it still shows traces of quality infrastructure and systems.

Restoring this quality has become one of the key rallying points behind the decentralization of governmental services, as described in Law 21 (“The Law of Governorates Not Incorporated Into a Region”), passed in 2008 and amended in 2013. Article 45 of that law identifies functions of government currently being administered out of Baghdad to be “devolved” to the respective

provinces for administration. The clear intent, though not well stated, behind Article 44, the second key amendment (and the one that contains the potential for diversifying revenues to support services), assumes that local revenue generation authority will also be devolved to the provinces—hence the term as presented in the introduction of this report: transfer of fiscal authority (both legislatively and administratively).

With this context in mind, the following recommendations deal with the mechanics or structure of moving forward with a revenue diversification strategy.

### Recommendations

Article 44 is ambiguous at best, and therefore subject to much in the way of interpretation and application. Notwithstanding its ambiguities, there are three broad sections in Article 44 that deal with authority or allocation of revenues: Federal budget allocations, generation of revenues in the provinces, and authority of local decision-makers to allocate funding within the provinces. This section will only address the first two, as the third “authority” is outside the scope of this report.

*Federal Budget Allocations: Continue the current flow of funds from the central government to the provinces.*

This is critical when considering that nearly 90% of revenues flow from the central government to support both operational and capital budget needs. For the near term and until there can be a transition, it is recommended that all operational and capital requirements be paid for out of the current flow of funds under the present concept of general revenue sharing based on provinces’ population size.

Once the operations and maintenance budget has been funded, amounts for capital budget purposes should be set aside for allocation to the provinces on two principle bases: 1) priority of capital projects based on need and 2) commitment of a provincial revenue match similar to the concept of a block grant for funding. This concept will be illustrated regarding specific services in the Ministry of Municipalities and Public Works.

*Generation of Revenues in the Provinces.*

Notwithstanding ambiguities and definitional challenges, the intent behind this particular element of Article 44 deserves special attention. It is in this element that real transfer of fiscal authority in an environment of decentralization of operations can occur. This transfer should not include any devolution of oil revenues from the federal level. In the generation of local revenues, however, with necessary structure and control, it is entirely possible to see both more autonomy and accountability in decision-making and an increase in fundamental service delivery, particularly and especially in addressing capital budget needs.

All revenues must be based on comprehensive legislative authority that would, in addition to setting fees and charges, determine equity and fairness, collection authority, and administration and penalties for delinquencies, including provisions for dispute resolution and adjudication.

To envision such a possible reality, Iraq needs a description and definition of types of potential revenues, but to collect and manage these revenues responsibly, it also needs a viable management system for doing so. Such a system is both multi-disciplined and multi-faceted. Although the recommendations below begin to outline the prerequisites to such a system, it is outside the scope of this assignment to be any more detailed on the multiple elements of a viable revenue generation and management capacity. Nevertheless, such legislation as Law 130 might offer a beginning framework for such an effort and may point a way forward on key elements such as legislative authority and legal fundamentals, billing and collection activities, cash and financial management, regulation and enforcement, and adjudication or dispute resolution.

### Recommendation 1

Revenue collection is an integral component in any kind of transfer of fiscal authority. Challenging, however, is the ongoing need for both establishing and monitoring efficiency in the collection of revenues. As with all other aspects of fiscal responsibility, revenue collection should comply with best practices of equity, ability to pay, economic efficiency, convenience and certainty.

An effective revenue collection operation is identified in the following section of this report, vested structurally in the proposed Directorate of Financial Affairs. Both its structure and functionality are scalable. It will be supported by an accounting and information system that includes the ability to recognize revenue when it is earned; account for the receipt of revenue; have a dimension of adequate internal controls on management of cash in the revenue process; ability to identify and assess interest on delinquencies; provide the mechanisms for daily cash deposits and weekly reconciliation of revenues; ensure that all cash received is accompanied by auditable receipts.

### Recommendation 2

The proposed directorate, as it oversees collections, provisions and communications, should also monitor for fraud, corruption or wrongdoing leading to losses or inability to reconcile. There should be a provision in every legislatively authorized revenue category to enable referral of such losses to the appropriate investigatory body without threat or sanction.

### Recommendation 3

No revenue should be treated outside the scope of budgetary authorization or appropriation. Therefore, since the budget constitutes legislation of the Provincial Council based on submission from the Governor, who is charged with both formulation and execution of the provincial budget, it is inappropriate and should be unethical—if not unlawful—for the Provincial Council or its members to identify or collect revenues. Such an attempt is clearly outside the

scope of the Council's duties. The Governor should not be personally collecting revenues. Again, all revenue collection, transaction and enforcement should be a part of the Revenue Section of the Directorate of Financial Affairs as defined and summarized in the following section of this report.

### Types of Revenues

The following critical assumptions are offered as a key basis for the setting of revenues: No revenue setting legislation should be considered without a defined and stated purpose for imposing the revenue; the enforcement of revenues must meet legal and fairness standards; and the collection of revenue must include enforceability and uniformity.

*Taxes.* Outside of those countries that are dependent on a single revenue source, taxes are generally the largest revenue source of a government and are often used to regulate an activity.

Of particular note, taxes are not required to have a measurable benefit commensurate to the amount paid by the taxpayer. Therefore, the relationship of the amount of a tax to governmental cost is more important than measuring benefit. There are two approaches to the design of any tax: *ad valorem*, meaning a certain percentage charge; or fixed, meaning a specific amount charged to the product. (See Definitions above.)

With such dependency on oil as a single revenue source, the Government of Iraq has minimized taxation as a means of revenue diversification. Whether from legislative decisions or collection inefficiencies, it would appear there are really only two major tax items identified and collected—personal and corporate income tax, and social security tax. There are others (e.g. real estate transactions, imports and vehicle sales), but they are relatively insignificant in the overall budget picture.

Caution must precede the introduction of new taxes or even the enforcement of existing but not enforced ones. There are no recommendations in this report regarding new tax-sourced revenues. Potential locally-based tax decisions should be deferred until systems for the purposes of assessment, collection and distribution can be developed. It is highly recommended that an inventory of tax-based revenues be examined from the items already identified in Law 130.

*User Fees.* Unlike a tax that is imposed upon the general population, a user fee is charged to an individual only when that individual uses a product, service or commodity. Because the incurrance of a fee is usually voluntary in whole or part, if the payer chooses to incur it, presumably the payer thinks the benefit is worth the fee. The fee amount should be relative to a reasonable approximation of the cost of that action to the government. Such fees may vary with usage of the government-provided benefit (that is, the "fair share" aspect of the definition); however, a flat fee is permissible, and generally recommended. (See Definitions section, including general illustrations of fees.)

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It is possible to identify and collect literally hundreds of user fees. As with taxes, there are no recommendations regarding user fee-based revenues. However, there is a robust and comprehensive listing of fees incorporated in Law 130, 1963. Meanwhile, the following section offers one model for recovering the cost of municipalities and public works services.

## A SERVICE COST RECOVERY MODEL FOR MUNICIPALITIES AND PUBLIC WORKS

Local infrastructure has suffered the effects of long-delayed and deferred maintenance and improvement. From the war with Iran, stories include the removal of stainless steel linings in water storage reservoirs seriously crippling a sophisticated system's ability to manage pressure and flow of treated water to customers. From the disastrous consequences of sanctions imposed during the 1990s, we hear of wastewater treatment plants forced to by-pass any treatment because of lack of access to upgrades or maintenance, and dump raw sewerage into rivers and streams. Post 2003, we hear of illegal taps into systems, unpermitted or enforced street cuts and development without real oversight or regulation.

Of particular note is the continued deterioration of water, wastewater and storm water mitigation systems. Combined with significant areas of population density that have developed in the past couple of decades, there is a dire and pressing need for improvements and expansion to these critical infrastructure systems.

As with just about any other expenditure category in Iraq, there is no apparent relationship to service received from these critically important activities and the costs to provide and deliver those services. Indeed, while fees for water have been adjusted and updated based on monetary fluctuations in exchange rates, there is no relationship to those rates and cost of service. Further, collection efforts on fees in place are poor at best.

Furthermore, given the priorities for revenue allocation from oil, these systems will likely not be upgraded any time soon. While Law 130 offers a template for municipal services, such as solid waste collection and disposal and streets and rights of ways, there is an inadequate framework for dealing with the complexities of a cost-for-service system when it comes to water, wastewater and storm water mitigation.

Notwithstanding these limitations and challenges, of all services delivered through the current functions of the Ministry in the province, water, wastewater and storm water activities stand the best chance in the near term of being set apart for a cost-of-service initiative than just about any other service delivery activity.

In anticipation of recommendations relative to fiscal authority transfer for these activities, a type of revenue known as a charge for service, which is based on consumption, will constitute the primary locally-based revenue. (See "Charge for Service" in the Definitions section.)

### An Iraqi Enterprise Fund for Municipalities and Public Works

Commensurate with a decentralization of operations for water, wastewater and storm water functions and the transfer of fiscal authority, it is recommended that there be created a special utility or **enterprise fund** to begin to calculate and capture all costs and revenues associated with

the operation and maintenance and capital improvement needs of these three functions or departments in the province. It is critically important that this fund be autonomous and separate from all other general government functions.

### Recommendation 1

To effectuate the creation of this enterprise fund (with appropriate accompanying amendments to applicable laws and regulations), the following process is recommended:

- First, a continuation of near-term support from the Government of Iraq to fund costs associated with operations and maintenance of the respective systems;
- Second, the establishment of a government-administered fund and funding mechanism—or “block grant”—for the purpose of assisting in funding capital improvements based on a prioritization of need (not population) and a requirement for some minimum level of funding from the enterprise as a “match”; and
- Third, the establishment of a true cost of service enterprise with a revenue component defined as a charge for service. As previously stated and elaborate on in the Definitions section of this report, charge for services relates to the primary product or service being purchased. It is based on consumption and is directly related to total costs of the organization providing such a service.

### Recommendation 2

Assuming central government legal authorization is in place, the Provincial Council should enact legislation based on recommendations of the governor setting forth the establishment of the enterprise fund and establishing charges for services performed. In addition to conformance with law, it would be highly recommended that such charges be developed and heard in as broad a public forum as possible, including media-covered public hearings.

It is expected that there will be several charge categories and levels, from connection fees to monthly charges. A typical consumption base would have a minimum charge, then additional charges based on consumption. Water consumption is the only measurable product in the enterprise and as such should be metered according to both flow and pressure demands of the customer. Since wastewater and storm water are services too costly to meter, a charge will be set based on a formula driven by the consumption of water, typically as a percentage of minimum usage charges. Additionally, impact fees from new developments should be identified as part of the charge structure. It is likely, if done correctly, to see virtually hundreds of charge elements go into a fee structure. Preliminarily, it is recommended that the structure be as simple as possible and, importantly, not attempt to capture all costs of service immediately through these revenues.

### Recommendation 3

*A meter management unit* should be established in the enterprise for the purpose of identifying customers and measuring consumption. Its activities will include approving and permitting connections based on meter size and determine legislatively approved fees associated with the connection as well as water meter installation, maintenance and replacement of obsolete or non-working meters.

### Recommendation 4

*A revenue management unit* will be created in the enterprise for the purpose of billing and collection of charges pursuant to legislation establishing said charges. The revenue management unit will account for and deposit all funds according to procedures established by the revenue section of the Directorate of Financial Affairs.

Conditional to such a unit will be the need to develop a cash management and investment policy defining at least principles of equity and fairness in a collection system and the ability to validate consumption. Further, the accounting and information system for such an effort must recognize revenue when it is earned and account for receipts of revenues. Other elements of activity will include a system of internal controls, the ability to charge interest on delinquencies and timely reconciliation of revenues.

### Next Steps

The creation of an enterprise utility represents a complex process involving several areas of professional capacity both to create, then to implement, the structure with its attendant processes. These capacities extend far beyond the traditional engineering and maintenance expertise generally found in the operational dimensions of utility services, and include legal, financial, organizational development and, above all, significant management expertise. The pursuit of such an effort would be well worth the price and the risk. In fact, it may well be the only way to move an otherwise underfunded and inadequate infrastructure system to one that can truly work and work well.

Since such an effort is obviously beyond the scope of this report, it is highly recommended that the province seek outside consulting support to assist in the implementation of such an undertaking to ensure that key principles of management, finance, accounting and budgeting are understood and embraced.

## A PROPOSED FINANCIAL MANAGEMENT ORGANIZATION FOR IRAQ'S PROVINCES

This section will:

- Propose a new role for Provincial Treasury Departments; and
- Define roles and develop procedures for financial controls

These two objectives are linked and constitute essential components of an effective financial management and management control system. (See definitions section.)

### New Department for the Management and Control of Financial Affairs

*Types of Provincial Structures Providing Fiscal Operations.* Established and defined by law, every ministerial function in Iraq performing operations in the provinces falls into one of two types of units: Centralized or Decentralized. Describing each of these units is critical before looking to a structural consolidation of finance functions:

- Centralized functions are managed by those units that report directly to individual ministries, including but not limited to the Ministries of Education, Health, Agriculture, Housing and Reconstruction, Sport and Youth. Each provincial unit receives and disburses funding from the respective central ministry, which reports said financial activities to the Ministry of Finance. Revenues stay with ministries and generally do not apply or cover the cost of service in the provinces.
- Decentralized functions are managed by those units that report directly to individual ministries on an operational level but are managed financially by the Ministry of Finance through the Provincial Treasury Department. Those units include:
  - Interior Ministry Activities (Police, Traffic, Civil Defense, Registration)
  - Ministry of Justice
  - Ministry of Work and Civil Affairs (Unemployment, Retirements, Disabilities)
  - Ministry of Planning
  - Ministry of Public Works and Municipalities
  - Endowment (i.e. Shi'a charities)

*Current Functions of the Provincial Treasury Department.* Limited in both scope and functionality, the Treasury Department is a department of the Ministry of Finance. It is primarily responsible for revenue collection, funding and accounting for only the decentralized units listed above. Budgeting, accounting, revenue management and control are inadequate when considered under a comprehensive role anticipated under operational decentralization and the two key elements of a management control system: information flow and independent review and evaluation. (See Definitions Section for a complete explanation of these principles.)

Current functions include:

- Treasury administration: Cash/Cashiering; Recording and Documentation; Warehouse/Inventory Administration; Printing and Copying; Payroll
- Accounting: Water Resources; Capital Budget Audit on Accounts; Compilation of Accounts, otherwise known as the Trial Balance
- Audit: Expenditures; Revenues

*Basis of Accounting.* Iraq uses a cash basis of accounting (see definitions section). More sophisticated reporting, such as that enabled by an accrual basis of accounting—including year-end forecasted data, performance and budgetary data—is probably not possible at this time. It is important to note as well that cash basis accounting is no predictor, nor does it include any provision for liabilities that are in the queue for payment. This explains why trial balance reporting is, in reality, the only valid reporting and control alternative and is so important in the Iraqi financial reporting system.

Other Relevant Background Issues:

- Current charts of accounts for Iraq were changed in 2007 to conform more closely with international government financial statistics.
- The Ministry of Municipalities and Public Works uses two different accounting systems: The General Government Accounting System for all services not generating revenues and The Uniform Accounting System for any service that has an element of revenue generation.
- Provincial Accelerated Reconstruction and Development Program (ARDP) budgets and each Ministry's capital budget are accounted for and administered separately.
- Each ministry has its own cash flow procedures in the provinces. Further, all revenues generated by the respective ministry stay with the ministry. They are treated as fungible and are not necessarily used to cover the cost of service.
- Signature authorities are limited to the position of Director-General in the Ministry, a position not found in the provinces except within the Directorates of Health and Education. Provincial operations and finance managers therefore have limited spending authority in the provinces.

### Recommendations

It is clear that implications associated with a transfer or decentralization of operational functions, responsibilities and authorities under Article 45 of Law 21 present a serious challenge to the responsible management of financial and budgetary systems.

These financial structures and processes must be consistent with applicable financial principles, laws and regulations. It is anticipated that through these recommendations, many of those background issues identified above will be both considered and addressed. Others may require legislative action. Almost all will require capacity-building support for implementation. With these factors in mind, this report recommends:

*Creation of a new departmental structure to be known as the Directorate of Financial Affairs.*

This Directorate will be administered under the direction of the governor. To ensure independence (see definitions section), the Directorate will be responsible to the Ministry of Finance for compliance to established control elements of the financial management system.

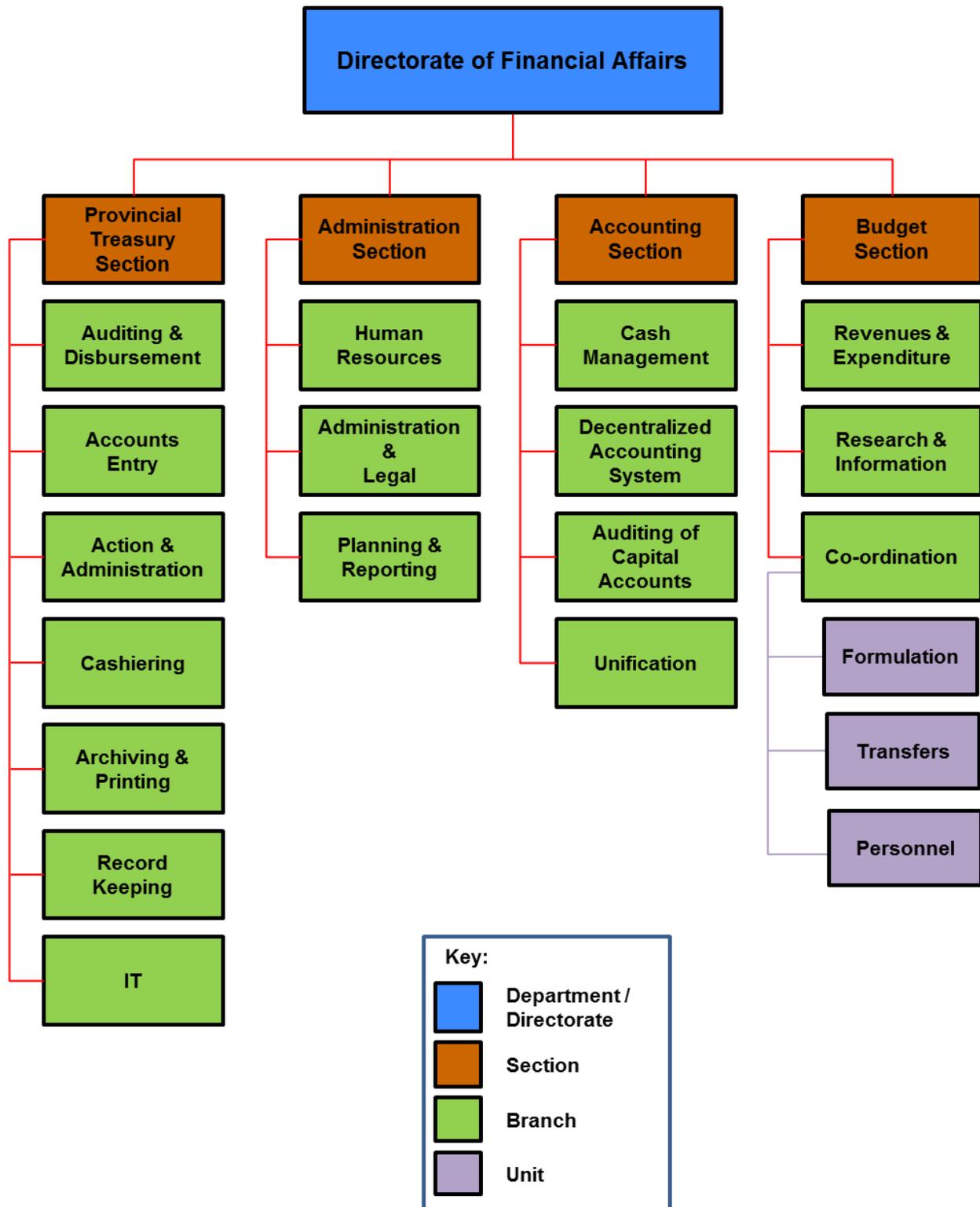
*The current Treasury Department should be downsized.*

The department, however, will continue to perform the financial functions of the Ministry of Finance as it relates to those decentralized departments listed above whose operational responsibilities will not be assigned to the province. This unit could be a section of the new Directorate of Financial Affairs.

*Concurrent with operational decentralization, there should be a consolidation of all bank accounts into two per province, one for operating and the other for capital spending.*

The new Directorate will exercise responsibility over both accounts. All subordinate spending units will be managed through the two accounts above.

The graphic on the following page presents a proposed organizational structure for the Directorate of Financial Affairs. It includes tasks of the individual departments and sections within the Directorate. Also illustrated and identified are capital budget procedures, financial management and control processes, including cash transfer procedures for districts. (Please note that the following is an interpretation of structure and terminologies from the Arabic. While there is understanding regarding functionality and activities to be performed, some meaning in the English translation will be different from the Arabic.)



## Directorate of Financial Affairs

This directorate will be structured in an organizational hierarchy by section, branch, and unit as illustrated in the chart above. Activities or functions of the Directorate are explained as follows:

### Budget Department Functions and Organization

- Complete financial planning of capital and operating components of the provincial budget
- Prepare the consolidated tables of operating and capital spending within the framework of the budget
- Lead and coordinate the authority to utilize allocations within the provincial budget in compliance with general directives issued by the Ministry of Finance (i.e. the Instructions on Procedures of Budget Implementation) and local government
- Follow up on actual financial resources that were identified in the provincial general budget
- Approve the chart of personnel of provincial directorates and secure needed funds within the budget
- Advise on financial issues that are relevant to provincial directorates
- Conduct research and analytical studies relating to the financial position of the province

The Budget Section will be chaired by a section manager with at least a university degree and relevant experience of no fewer than 10 years. The section manager will report to the Head of the Directorate.

The Budget Section consists of the following branches and units:

1. Revenues and Expenditures Branch:
  - a.** Monitors the collection of the province's revenues
  - b.** Furnishes data and information on overall and detailed collections for the preparation of the draft public budget for the province
  - c.** Processes expenditure transactions that are beyond the authority of provincial directorates according to Ministry of Finance requirements
  - d.** Provides necessary financial data for the preparation of the provincial budget
2. Research and Information Branch:
  - a.** Prepares data, statistics and studies as required for establishment and improvement of the province's financial policies and performance
  - b.** Provides the governor and provincial council with financial data and statistics that are relevant to implementation of the budget

3. Coordination Unit:

**a. Budget Formulation**

- i. Make documents and forms available that are required for preparation of investment and operating budgets centrally funded at the provincial level
- ii. Distribute instructions for budget formulation and execution between provincial directorates to ensure consistency
- iii. Review suggested draft budgets of directorates in accordance with budget formulation guidelines
- iv. Seek initial approval of the governor for directorates' appropriations recommendations
- v. Prepare the proposed budget for timely submission from the governor to the Provincial Council
- vi. Present the provincial draft budget to the Ministry of Finance so that it is included within the draft of the federal public budget
- vii. Communicate with local directorates about approved allocations for the province as set forth within the approved federal budget

**b. Budget transfers**

- i. Undertakes action to process increased or decreased adjustments to the budget
- ii. Processes suggested reallocation of funds within the budget by the directorates according to authorizations of the governor and Provincial Council
- iii. Obtains the approval of the Ministry of Finance's Budgeting Directorate to implement reallocations (outside those authorizations indicated in Item 2 above) according to the Law of Financial Management number 95 of 2004 as well as the Law of Annual Federal Budget and Instructions on Implementation
- iv. Prepares information and data on budget execution results of the prior year budget to aid in the preparation of the next year's budget

**c. Personnel**

- i. Prepares a single document listing all positions, titles, and grades within the various provincial directorates
- ii. Prepares the table of positions that is attached to the provincial budget
- iii. Ensures compliance with the approved table of positions of these directorates
- iv. Obtains the approval of the Ministry of Finance to make necessary adjustments to positions that are outside the governor's authority

## Accounting Section Functions and Organization

The Accounting Section will be chaired by a department manager with at least a university degree and relevant experience of no less than 10 years. The department manager will report to the Head of the Directorate.

The Accounting Section includes the following branches and units:

1. Cash Management:
  - a. Develops an annual expenditure plan at the provincial level according to available resources
  - b. Manages cash flow to ensure timely implementation of both investment and operational budgets
  - c. Ensures all cash is deposited daily according to applicable cash management procedures by departments
  - d. Finances the spending units of the province and provides sufficient cash to meet spending needs to sustain services according to the approved budget
2. Decentralized Accounting System Branch:
  - a. Applies the government accounting system (such as that used by the Directorates of Education, Health, etc.) to spending units of the province in terms of operational expenditures
  - b. Ensures compliance with regulatory aspects and instructions of the government accounting system
  - c. Audits monthly trial balances as submitted by spending units (for operational expenditures) to the provincial Directorate of Financial Affairs and ensures submitted trial balances are in compliance with Ministry of Finance requirements
3. Auditing of Capital accounts:
  - a. Oversees the implementation of the government accounting system in units identified by Article 45 as responsible for capital budget execution
  - b. Ensures compliance with regulatory aspects and instructions of the government accounting system
  - c. Audits monthly trial balances as submitted by spending units (for capital expenditures) to the provincial Directorate of Financial Affairs and ensures submitted trial balances are in compliance with Ministry of Finance and Ministry of Planning requirements
4. Unification:

- a. Unifies or merges the financial data for both capital and operational expenditures as reported by the spending units to the Directorate of Financial Affairs
- b. Prepares a unified provincial trial balance for the Director-General of Accounting in the Ministry of Finance, copying the Governor and Provincial Council

### Administration Section Functions and Organization

The Administration Section is internal to the directorate only, and includes the following branches.

1. Human Resources:

Manage all human resources activities of the Directorate including recruitment applications, award of bonuses, promotions, retirements, etc.

2. Administrative and Legal Services:

Responsible for administrative and legal duties as required by the Directorate to operate its activities per the applicable instructions and orders including responding to legal and administrative inquiries from all directorates about financial aspects; and provide other administrative services

3. Planning and Reporting:

Prepare programs and plans that contribute to development of activities of Directorate and follow-up of their implementation according to relevant procedures and instructions

### Provincial Treasury Section (for directorates and departments not covered by Article 45 of Law 21 as amended)

The internal structure of Section of Treasury is based on distribution of work responsibilities between sections each of which is responsible for implementation of a full stage of treasury activities as well as establishment of connection between duties of these sections in a manner that achieves better satisfaction of internal control system's requirements

Each spending unit including districts and sub districts related to the Treasury Section has a separate accounting code that is created by the Treasury Section for the purpose of financial management accuracy

The Provincial Treasury Section will be chaired by a section manager with at least a university degree and experience of no less than 10 years in financial area who will report to the head of

the Directorate. He should be a person of efficiency and integrity with no criminal conviction for financial obligations or violation of applicable laws.

The section includes the following branches

1. Auditing and Disbursement:

Within the Treasury, prior to disbursements an auditing team will be established. Duties include auditing of accounting transactions of districts and sub-districts, review of receipt and payment vouchers, reconciliation with journal entries of accounting record number 66, auditing of documents included in applications of districts and sub-districts, ensuring that receipt and payment vouchers satisfy the formal and legal conditions and auditing of cash available in the safe.

2. Accounts Entry:

This branch is responsible to enter all current financial transactions of the treasury on a daily basis into the journal. The record comprises expenses and revenues.

3. Accounting and Administration:

The responsibilities of this branch include preparation of payroll, records keeping, withholdings, distribution of salaries to employees and processing of Human Resources applications. The section also prepares disbursement vouchers of treasury section expenses. It is in charge of permanent advances, keeps their records and organizes petty cash payment vouchers

4. Cashiering:

The branch collects cash amounts that are handed to the treasury and upon receipt deposits funds into the bank. The section maintains a journal where receipt and payment of cash are recorded including amounts withdrawn from the bank to finance the treasury account.

5. Archiving and Printing

6. Records:

The branch shall keep documents and records, receive records, forms and stationary sets after they are registered [current and archived]

7. Information Technology:

The branch shall record all financial transactions, enter them into the treasury's computerized system, and match results against the manual records.

#### Financial Management Processes and Procedures for All Decentralized Operating Directorates in the Provinces

1. Spending unit submits funding request to Directorate of Financial Affairs of the province.
2. The request of funding will be accompanied by the following:
  - a. Trial balance of the previous month including tables of expenditures and revenues
  - b. Bank statement of re-current account of the spending unit as of the last five days from date of request
  - c. A reconciliation statement of re-current account shall be presented according to the format adopted in instructions of government accounting system
3. If the request is relevant to operations and maintenance spending, then it should be submitted to Decentralized Accounting System branch
4. If the request is relevant to capital spending, then it should be submitted to Auditing of Capital Accounts branch
5. The trial balance along with all attachments will be audited by the concerned branch to ensure the accuracy of financial procedures of spending unit and cash balance as stated in re-current account statement
6. The appropriate branch prepares a funding form which shall include all the needed information to complete the funding process
7. The request shall be referred to Cash Management branch to make cash transfer to spending unit requesting funding
8. Cash Management branch shall issue an order make a transfer from its bank account to spending unit's bank account

#### Cash Transfers to Districts

The Directorate of Financial Affairs will be required to open a re-current bank account for districts under the name "branch current account". Once the account is opened and given a code, the Governor's Office will fund the branch current account from its bank account according to the following steps:

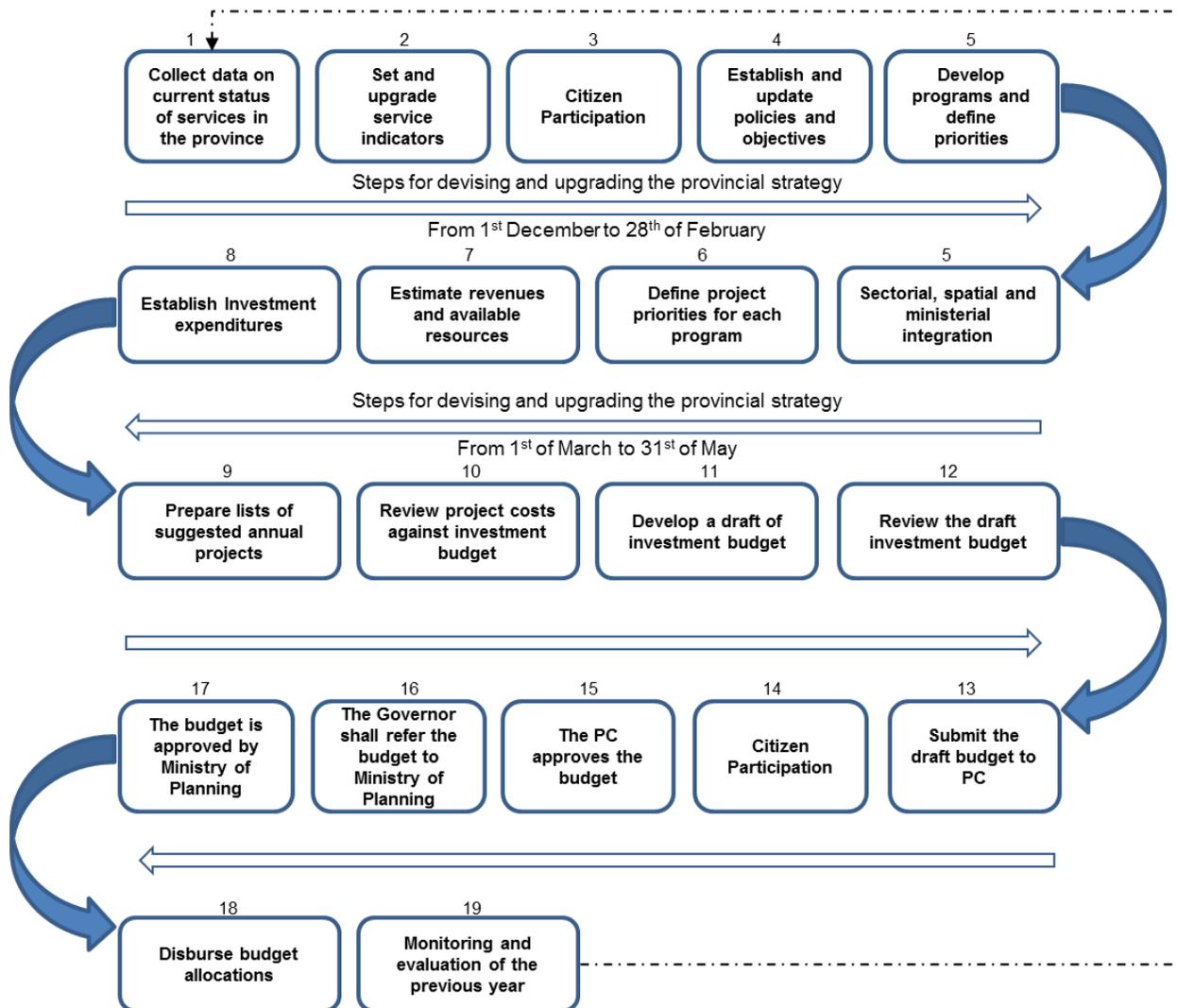
## Decentralization in Iraq: Recommendations on the Transfer of Fiscal Authority

1. The appointee in charge of district presents a request to Governor's Office in which he states the amounts of funds requested for the month
2. The request shall be accompanied by a monthly trial balance, statement of current account and statement of reconciliation
3. The Governor's Office will check the request along with attachments to ensure accuracy of procedures followed by the appointee in charge of the district
4. After review of the request is verified, the Governor's Office will issue an order to transfer the amount required from its account to the district's bank account
5. At the end of month, the district shall submit a trial balance with required documentation to the Governor's Office for consolidation into its trial balance to be submitted to Directorate of Financial Affairs

## A Recommendation for the Development of a Capital Budget Process for Submission and Approval

In 2013, GSP/Taqadum prepared a recommendation under a decentralization scenario, for a comprehensive process for the development and approval of a capital budget in the province. Although a handbook on the subject was produced, there was no implementation because circumstances at the time did not support the recommendation. While not a part of the scope of work of this project, this recommendation deserves to be incorporated into this report since it would identify both role and expectation of the staff of the Budget Section of the Directorate and provide a meaningful and comprehensive discipline in long-term planning and prioritization of projects under a decentralization of service scenario. It is largely unaltered from the earlier development.

### Provincial Capital Budgeting Process



## Preparation of Capital and Operating Budgets in the Provinces

The following offers a description of budget process steps, including implementation and attendant authorities, to budget implementation:

1. Collect information on current status of services in the province:

Available sources of information on current status of services in the province are multiple including information directly collected from service directorates, citizen satisfaction surveys, citizen complaints offices, open meetings with people and provincial directorates affiliated to Ministry of Planning. As the planning and budget preparation process is not limited to improvement of service delivery only and since it extends beyond improvement to achieve a comprehensive and sustainable growth at provincial level, then the information may be broader to include information on population, economy and environment of the province.

2. Identify and update standards and indicators:

Some services have no clear standards and indicators. These standards and indicators may be outdated or obsolete. In this case, the information collected in the first stage shall be used to lay the foundation for development of new service standards or upgrading of the existing. This step is critical for planning and assignment of allocations between various programs and projects. These standards and indicators exhibit where we are and to where we want to be. Responses to both questions shall be the basis for formulation of the province's development policy and future trends in development and improvement of services at provincial level.

3. Formulate policies and identify objectives:

The Provincial Council shall assume responsibility for formulation of policies by using all the available information, statistics, identified/upgraded service standards and indicators. Such information and indicators shall present an overview on existing gaps in level of services delivered to citizens. The formulation of policies largely relies on geographic, demographic and economic nature of the province.

The policies set by Provincial Council shall guide the developmental efforts that aim to achieve the policy objectives. Formulation of policies should be accompanied by identification of clear, realistic, measurable, achievable, sustainable and timetabled objectives for policies. Specification of clear objectives for policies shall take planning

and budget preparation in the right direction and move in directions set by the province's public policy.

4. Develop programs and define priorities:

Once policies are created and objectives are specified by the Provincial Council, the executive authority shall translate these policies into specific programs so that the objectives of these policies are achieved within the defined time table. It shall be favorable to introduce the definition of program:

- a set of projects, activities and procedures that are established to achieve specific objectives stated in policies within a defined period of time. The policy objectives may not be accomplished within a program. It may be essential to design more than a program to carry out a policy. The significant matter is that programs do not signify projects only. Programs may include a set of draft laws, instructions or administrative procedures. What combines these elements is that they are designed to accomplish the goal of provincial public policy. Since policy objectives are not achievable within the budget year, these programs often tend to take from 3 to 5 years in order to accomplish the objectives.

Such programs must have clear objectives which need to be determined according to information, standards and indicators that were collected and identified during steps 1 and 2. Information and indicators shall have an effect on identification of priorities for implementation of these programs. Since policies were determined according to information and indicators, then they shall impact on design of programs. The implementation priorities must be defined on basis of impact degree with respect to change of indicators into a better level.

The decisive factor in specification of program priorities shall be the extent to which these programs assist in reaching the wanted goal. Indeed, there are additional factors to consider in specification of priorities including cost, time, environment and availability of implementation capabilities.

5. Sectorial, spatial and ministerial integration

Once suggested programs are placed among priorities of implementation, these programs must be subject to sectorial, spatial and ministerial integration. The integration becomes important when programs are proposed. These programs should be integrated and connections have to be established between programs. For example, if a program for land reclamation was proposed, then it should not contradict with other programs including improvements to highways and it should be linked to programs of enhancement of irrigation systems or establishment of dams. At the same time, the spatial integration of these programs should be achieved, i.e. the suggested programs

have to be distributed in equal manner throughout the province so that an equivalent growth for the province is achieved. In addition, the spatial growth may become broader to include more than a province. A specific program may impact on several provinces and thus possible to co-fund these programs by the participating provinces. The ministerial integration simply means that suggested programs should not contradict with ministries' programs. For example, health programs tend to be of local and national nature. Therefore, it should be appropriate to discuss any proposed program at provincial level with officials from Ministry of Health to avoid any repetition or incompatibility.

### 6. Identify project priorities within the program

Identification of project priorities within the program depends on a set of financial, economic, environmental and social factors. Still, the decisive factor in identification of project priorities is the extent to which projects impact on achievement of desired objectives, i.e. what percentage is achieved by the project in order to accomplish the objective. As mentioned earlier, programs may include draft laws, instructions or administrative procedures. Therefore, the program objective may be achieved through enacting a law, issuing special instructions or taking specific administrative procedures. In this case, the priority of implementation shall be given to these factors.

In general, if we are to address how to identify project priorities according to its current concept, the initial feasibility studies shall be of crucial importance in determining priorities during this stage. The identification of priorities also depends on a group of available alternatives to achieve the program objective. Selection from the available alternatives shall form a standard for identification of priorities.

### 7. Identify available resources and estimate revenues

The available resources mean all the resources that are at hand at provincial level including financial, humanitarian, technical, economic and environmental resources. Identification of such resources shall be crucial during the stage of finalizing suggested programs and projects into annual plans for implementation. In other words, these programs and projects shall be included into the annual investment budget of the province.

As regards the estimation of revenues at provincial level, there are various types of financial revenues that can be generated as stated in Law 21 of 2008 as amended in addition to financial resources that are allocated to provinces from revenues of oil and gas, border crossings and entry visa fees. Generally speaking, it is possible to pre-estimate these revenues of all types using simple mathematical methods. The importance of estimation of expected revenues comes from identification of implementation priorities of projects included in the annual plan. This shall mainly

depend on size of revenues. Consequently, the distribution of revenues between various programs and projects with the aim to achieve policy and program objectives shall be conclusive factor in selection of program and project priorities for implementation within the investment budget of the province.

8. Estimate investment costs

After forming a clear picture of the available resources and expected revenues by those who establish plans and develop budgets, it shall be necessary to estimate and calculate investment costs to achieve harmony between what is at hand and what is planned for. By investment costs, we mean all the potential expenses for implementation of projects. The investment costs are usually calculated through detailed feasibility studies which state all costs related to project implementation.

The estimation of investment costs should be as accurate as possible to avoid planning for large number of projects while the financial resources are limited. Through previous experiences, some provinces formulated grand plans which exceed the expected revenues leading to a great number of unaccomplished projects and significant administrative and regulatory burdens.

9. Prepare lists of suggested annual projects

After estimating overall costs for suggested projects, a list of suggested annual projects is prepared so that these projects shall be implemented during the next financial year. This list includes projects that were placed among priorities of implementation to achieve the objectives. This list contains information on each suggested project including the estimated cost, the project's location, method of finance (ministerial or local), term of implementation and any other necessary information. The source of most of this information shall be the detailed feasibility studies attached to this list.

10. Review project costs and investment budget

At this stage, the overall costs of suggested projects and available human, administrative, technical and financial resources shall be reviewed. At this stage, the best utilization of available resources shall be reached. It may be mandatory to rearrange the project priorities in light of this review in order to arrive at the best allocation of resources between the suggested projects. Indeed, such rearrangement may be subject to other considerations. This list may be decreased to a specific number of high priority projects and other low priority projects shall be taken out of the list to strike a balance between the available resources and expected costs.

11. Develop a draft of investment budget

Once a final list of suggested projects is prepared, a draft investment budget is developed for the province. In general, the draft budget will include the following items:

- Introduction to policies adopted
- Summary of the main goal of the budget and secondary objectives that need to be achieved
- Planning considerations according to which a draft budget was prepared
- General outline for the budget
- Presentation on total expected revenues
- Presentation on total expected capital and operational spending
- Detailed tables on list of suggested projects with economic feasibility studies attached to them

#### 12. Review the draft capital budget

The governor, his deputies and advisors each of which has a respective field of specialization, shall review the draft budget to determine if it achieves the objectives set within the policies adopted by Provincial Council, the priorities and details of expected revenues and costs. They shall verify that all suggested projects meet general conditions as required by Ministry of Planning. Typically, a capital budget will extend as a plan beyond one year, most often up to five years. Once the draft budget is reviewed and approved by the governor, the draft budget is referred to Provincial Council.

#### 13. Submit the draft budget to Provincial Council

The draft budget shall be referred to Provincial Council according to an official letter to the Chairman. The chairman shall distribute the copy of draft budget between Provincial Council committees for review and consideration. Members may provide comments or suggestions concerning the draft budget. The Committees shall check the extent to which the draft budget achieves the objectives of the province's public policy, observe the geographic locations of projects and activities to include the province as a whole and review distribution of allocations between different sectors and agreement of distribution between districts and sub-districts according to population.

The Chairman shall set a date for the session where the draft is presented and discussed and opinions and remarks of different committees are provided. In case of many comments and suggestions, the chairman shall call for another meeting to host the governor who shall introduce his own opinion on stipulations of the draft budget.

#### 14. Provincial Council approves the draft budget

Upon conclusion of hearings and meetings, the draft investment budget shall be voted on for approval and acceptance by majority of members

15. Refer the budget to Ministry of Planning

**Financial Controls and Audits:**

**Recommended Roles and Responsibilities for Decentralized Service Delivery in the Provinces**

Control is an integral and necessary element of any financial management system. While all too often the term is identified in a negative sense with concepts like “domination” or characteristics of involuntary subservience, in reality, control is a positive and necessary aid to order. There are four major elements constituting a control environment: standards, a measurement system, measurement activity, and adjustment. Whenever there are established standards, the other elements must also be in place. Audits are measurement activities. They determine improvement opportunities for organizations to make adjustments to meet control standards.

Unfortunately, there are weaknesses in Iraq as relating to both control and auditing much of which is structural [current charts of accounts, and cash based accounting as examples] but some of which lie in roles and processes [such as principles of independence and out dated financial information systems]. The following are further explanations highlighting the control and audit “relevant environment”. To address these inherent weaknesses would require dramatic changes to current systems and introduce an element of nearly catastrophic change without invoking the principle of incrementalism in the change process. To recommend a process of implementation is well beyond the scope of this report but should be pursued.

*Management Control System.* There are deficiencies in virtually every one of the seven principle elements of the management control system. Of particular significance to this deliverable are weaknesses in information flow and feedback; independent review, evaluation and verification; and a corrective mechanism of accountability. (See definitions section for more detail.)

*Pre-disbursement audit function.* An essentially process-driven activity, it is performed by a unit located in each ministry. Rules and procedures are applied differently across sectors and levels.

*Internal audit function.* Internal audit functions are incomplete; a relatively new concept, most internal auditing is limited to financial auditing. There is virtually no performance or compliance based auditing. [see definitions section under auditing]

*Audit Independence.* Notwithstanding the presence of the Supreme Audit Board and the efforts of the Ministry of Finance, there are still process activities that are ill defined in terms of execution towards the principles of programming, investigative and reporting independence. [See Definitions section on audit independence]

## Recommended Roles and Responsibilities in the Control Environment

Implicit to any definition of a system, the control environment of a financial management system will include more than one organization structure. Two represent key roles and responsibilities given current capacities.

*The Provincial Directorate of Financial Affairs.* Financial control begins within the Province's Directorate of Financial Affairs as recommended. Within the systems limitations enumerated above, the Accounting Section of the Directorate will be responsible for control including pre-disbursement and disbursement audit functions. Branches in the Section will perform the following activities:

1. Unification Branch: Production of periodic financial reports; Maintenance of an adequate system of accounting records; and a comprehensive set of controls that will mitigate risk, enhance the accuracy of the province's reported financial results, and ensure that reported results comply with accepted accounting principles and reporting standards.
2. Cash Management Branch: Compliance with local rules and regulations; ensuring all invoices paid have appropriate documentation, meet legal requirements to be paid and are paid timely; ensuring employees are paid appropriately and timely; and ensuring there are or will be sufficient revenue to pay all legal liabilities timely.

While there are improvements that could be considered over time, the Directorate should endorse and require that all control units under its authority including those in the operating departments adopt and implement the publication of the Supreme Audit Board, *Guidance Manual for Ministerial Internal Auditing Units*.

*The Supreme Audit Board.* To fulfill the duties and expectations of oversight, control and compliance, The Supreme Audit Board should increase both depth and frequency in the conduct of a periodic examination and audit of records and other evidence to support the faithfulness of responsible administrators to adhere to legislative requirements and administrative policies pertaining to their programs and organizations. The following two areas should be covered in addition to the traditional financial audit activities:

1. A review and methodology that pertains to the faithfulness of administrative adherence to legislative requirements and administrative policies;
2. An assessment of operational efficiency – focusing primarily on operating policies, procedures, practices and controls – including the utilization and control of non-financial resources such as property, equipment, personnel, supplies, etc.

The Supreme Audit Board presently includes a "Findings Section" of the audit or review that identifies non-compliance related issues. The Findings Section upon transmittal to the Province

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should also require a Management Response to those issues from the Governor. Such Management Response will include steps and timelines for corrective action.

Strengthen the role of the Supreme Audit Board to consider the power to refer to criminal justice system to prosecute for violations and to the Ministry of Finance to execute controls in spending authority, such as freezing allocations.

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